# Electronics Line 3000 Announces Results of Year 2008

Petach Tikvah, Israel (March 31, 2009) – Electronics Line 3000, a global leader in electronic security with remote management solutions, achieved 6% growth in revenues over the past year, compare to 2007 and positive cash flow from operating activities . Nevertheless the company has decided to take a conservative approach due to internal and external challenges.

## General

We hereby submit the Directors' Report for the year ended December 31, 2008 (the “Reported Year”) and the respective year 2007.

## Corporate Description and Business Environment

The Company engages in the design, development, production, marketing and sale of electronic security with remote management solutions and complementary products for the mass residential and small commercial markets. These solutions can be monitored and enable remote management of the premises for security, automation, and video applications.

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS).

## General Results Review

The Company is facing internal and external challenges due to the recent developments in the global economy. These global economic developments and new challenges have affected the Company’s 2008 results; mainly the results of Q4 2008.

The Company’s US subsidiary has been undergoing a transition phase severely influencing the Company’s 2008 results as well as the US subsidiary’s cash and cash-flow situation. The Company is taking the necessary measures to address this issue and prevent further losses. . In addition the Company believes that in the midst of the global economic crises, conservatism is needed, therefore the company has decided to increase the provision for slow moving inventory by US$300,000.

The provision for bad debts was also increased by US$240,000 in order to account for potential losses due to potentially reduced customer creditability.

The Company decided to write off US$521,000 in a deferred tax asset, most of it resulting from the consolidation of that asset from the US subsidiary, taking into account the developments in global markets over the past few months. The management believes that this write off is necessary, due to the current economic situation of the US subsidiary; the Company may be able to use this deferred tax asset based on expected profit levels.

In light of the global situation, the Company has been implementing an efficiency plan from December 1st 2008, which mainly will affect 2009 results.

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The Company's revenues in the Reported Year amounted to US$ 36.4 million, compared to revenues of US$ 34.4 million for 2007. The Company's 2008 increase in revenues is mainly attributed to a 29% increase in sales from the Company's headquarters. However, revenues from the Company's U.S. subsidiary were significantly lower than in 2007.

Gross margins in the Reported Year amounted to 36% compared to gross margins of 39% in the comparable year. The reduction in the Gross margin is due to the Company's decision to increase the provision for slow moving inventory by US$300,000, the changes in the exchange rates and reclassification of freight according to international accounting policies, and the above mentioned transition of the Company's US subsidiary.

Gross margins in the Reported Year amounted to 36% compared to gross margins of 39% in the comparable year. The reduction in the gross margin is due to changes in the exchange rates and reclassification of freight according to international accounting policies, and the above mentioned transition of the Company's US subsidiary.

The gross profit in the Reported Year amounted to US$13.1 million compared to US$13.3 million for the fiscal year of 2007.

Changes in exchange rates, mainly a 13% devaluation of the US Dollar against the New Israeli Shekel (average value of 3.58 NIS per $ during the Reported Year, compared to 4.1 NIS per $ for the comparable year of 2007), resulted in an erosion and created much pressure on expenses in general and on the gross margins in particular.

Research and development costs and know-how, amounted to US$3.6 million compared to US$2.0 million for the year 2007. The increase in expenses is due to two main reasons: firstly, the strengthening of the R&D team with new, highly qualified staff, which will allow the Company to continue developing new solutions and remain at the forefront of the market, quickly reacting to emerging market demands; secondly, a new Company policy, announced during the final quarter of 2007, to no longer capitalize R&D expenses. Q1 2008 was the first quarter in which these costs were expensed directly to the R&D expenses account.

Sales and marketing expenses amounted to US$7.4 million during the Reported Year and US$8.6 million for 2007. The main reduction is driven by reclassifying of the freight according to the international accounting policies, and reduction in travel expenses. The Company continues to develop and expand its marketing and sales capabilities with a focus on targeting strategic customers.

General and administrative expenses amounted to US$3.3 million during the Reported Year and to US$2.6 million for 2007. The increase in the Reported Years mainly derives from an increase in salaries and related expenses.

The Company's operating loss amounted to US$1.2 million during the Reported Year, compared to an operating loss of US$ 6.1 million (US$48,000 excluding the US$6.1 million impairment of intangible assets) for 2007.

Financing and other expenses, net amounted to US$1.0 million during the Reported Year, compared to US$1.4 million for 2007.

Part of these costs, as well as payments in NIS to local suppliers, have been hedged against the US Dollar from the middle of the second quarter. Nevertheless the influence of the strengthening of all currencies against the US Dollar negatively influenced operating loss.

Loss before taxes on income amounted to US$ 2.2 million during the Reported Year, compared to a US$ 7.5 million loss for 2007 (US$ 1.4 million loss excluding the US$ 6.1 million expense for impairment of intangible assets).

Tax expense amounted to US$ 704,000 during the Reported Year, compared to US$ 194,000 tax benefits for 2007. As mentioned above, the Company has decided to write off US$ 521,000 of a deferred tax asset, most of it resulting from the consolidation of the US subsidiary, taking into account the developments in global markets over the past few months. The management believes that this write off is necessary due to the current economic situation of the US subsidiary. As the market situation improves, the Company may be able to use this deferred tax asset based on expected profit levels.

The Company ended the Reported Year with a net loss of US$ 2.9 million, compared to a US$ 7.3 million loss (US$1.1 million loss excluding the US$6.1 million expense for impairment of intangible assets) for 2007.

**Move from Prime Standard to General Standard**

Following the Board resolution dated February 8th 2009 to move from the Prime Standard to the General Standard, the Deutsche Boerse has announced Electronics Lines 3000's revocation from the Prime Standard on March 17th 2009.

The revocation does not affect the admission to the regulated market (General Standard). It has the objective of reducing the costs and the administration efforts associated with the listing and will take effect three months after the announcement of the revocation by the executive of the German Stock Exchange in the internet on www.deutsche-boerse.com. i.e – June 18th 2009.

On June 18th 2009, all Electronics Line 3000 shares will be traded on the General Standard for the first time.

**The Company's Financial Position**

The Company's cash and cash equivalents as of December 31, 2008 (hereinafter: "the Reported Date") were US$ 2.3 million, compared to US$ 3.1 million on December 31, 2007.

The Company's trade receivables on the Reported Date were US$ 6.6 million, compared to US$ 8.3 million on December 31, 2007.

The Company's prepaid expenses, other accounts receivables, advance payments to suppliers and income tax receivables on the Reported Date were US$ 1.4 million, compared to US$1.3 million on December 31, 2007.

The Company's inventories on the Reported Date were US$ 6.7 million compared to US$ 8.6 million on December 31, 2007.

Net investment in non-current assets, less amortization, on the Reported Date amounted to US$ 4.7 million, and a US$5.8 million investment on December 31, 2007, comprising of the following:

- Net investment in property, plant and equipment less amortization was US$ 4.4 million on the Reported Date, compared to US$ 5.0 million on December 31, 2007.
- Deferred taxes were US$ 215,000 as of the Reported Date, compared to US$ 788,000 on December 31, 2007.
- Security deposits were US$ 86,000 as of the Reported Date, compared to US$ 85,000 on December 31, 2007.

The short term credit balance from banks and others on the Reported Date amounted to US$ 8.1 million, compared to US$ 9.8 million on December 31, 2007.

The Company's trade payables as of the Reported Date were US$ 4.0 million compared to US$ 4.1 million on December 31, 2007.

Other current liabilities, accrued expenses and income tax payable were US$ 2.5 million, compared to US$ 2.8 million on December 31, 2007.

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Long term loans were US$ 77,000 on the Reported Date compared to US$ 85,000 on December 31, 2007.

## Financial Ratios

| | **December 31, 2008** | **December 31, 2007** |
|---|---|---|
| Current Ratio | 1.1 | 1.3 |
| Quick Ratio | 0.7 | 0.8 |

## Cash Flow

During the Reported Year, net cash provided by operating activities was US$ 1.8 million compared to US $974,000 used during the entire year of 2007. Most of the increase in cash provided by operating activities derives from the decrease in inventories, a decrease in current liabilities and a decrease in trade receivables.

During the Reported Year, the Company directed US$ 365,000 towards investment activities, compared to US$ 1.5 million during the entire year of 2007.

During the Reported Year, cash used in financing activities amounted to US$ 2.1 million, compared to US$ 2.7 million that were provided in financing activities during the fiscal year of 2007.

## Financing Sources

Shareholders' equity as of December 31, 2008 amounted to US$ 5.9 million, a ratio of 27 % to the total balance sheet, compared to US$ 9.7 million and 36%, respectively, as of December 31, 2007.

On December 31, 2008, short and long term credit from banks and other creditors designated for financing working capital and investments in fixed assets and rental property was US$ 14.8 million, compared to a credit balance of US$ 16.9 million on December 31, 2007.

## Statutory declaration

We assure to the best of our knowledge that the consolidated financial statements provide a presentation of the Group's financial position and results from operations that corresponds to the actual conditions, in accordance with applicable accounting standards, and that the Group management report presents the course of business including the business result and situation of the Group in a way that corresponds to the actual conditions and describes the material risks and opportunities of the Group's expected future development.

| | |
|---|---|
| __________________ | __________________ |
| Amir Hayek | Bob Marbut |
| President & CEO | Chairman of the Board |

Petach Tikva, March 31, 2009

**ELECTRONICS LINE 3000 LTD.**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2008**

**U.S. DOLLARS IN THOUSANDS**

**INDEX**



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**INDEPENDENT AUDITORS' REPORT**

**To the Shareholders of**

**ELECTRONICS LINE 3000 LTD.**

We have audited the accompanying consolidated financial statements of Electronics Line 3000 Ltd. and its subsidiaries ("the Group"), which comprise the consolidated balance sheets as of December 31, 2008 and 2007, and the consolidated statements of operations, consolidated statements of changes in equity and consolidated statements of cash flows for each of the years then ended, and a summary of significant accounting policies and other explanatory notes.

We did not audit the financial statements of certain subsidiaries, whose assets constitute approximately 30% and 36% of total consolidated assets as of December 31, 2008 and 2007, respectively, and whose revenues constitute approximately 39% and 50% of total consolidated revenues for the years then ended, respectively. The financial statements of those companies were audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to amounts included for those companies, is based on the reports of the other auditors.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

**Auditors' Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors’ judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate for the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained, together with the reports of the other auditors, are sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, based on our audit and the reports of the other auditors, the consolidated financial statements give a true and fair view of the financial position of the Group as of December 31, 2008 and 2007, and of its financial performance and its cash flows for each of the years then ended, in accordance with International Financial Reporting Standards.

| | |
|---|---|
| Tel-Aviv, Israel | KOST FORER GABBAY & KASIERER |
| March 31, 2009 | A Member of Ernst & Young Global |

## CONSOLIDATED BALANCE SHEETS

**U.S. dollars in thousands**

| | Note | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| ASSETS | | | |
| CURRENT ASSETS: | | | |
| Cash and cash equivalents | 3 | 2,297 | 3,128 |
| Trade receivables | 4 | 6,529 | 8,295 |
| Income tax receivable | | 291 | 225 |
| Prepaid expenses | | 691 | 416 |
| Advances to suppliers | | 112 | 187 |
| Other accounts receivable | 5 | 331 | 440 |
| Inventories | 6 | 6,552 | 8,611 |
| Total current assets | | 16,803 | 21,302 |
| NON CURRENT ASSETS: | | | |
| Property, plant and equipment: | 7 | | |
| Cost | | 14,664 | 14,397 |
| Less - accumulated depreciation | | 10,258 | 9,441 |
| | | 4,406 | 4,956 |
| Deferred taxes | 14d | 215 | 788 |
| Security deposits | | 86 | 85 |
| Total non current assets | | 4,707 | 5,829 |
| Total assets | | 21,510 | 27,131 |
| LIABILITIES AND EQUITY | | | |
| CURRENT LIABILITIES: | | | |
| Short-term credit from banks and others | 9 | 8,141 | 9,832 |
| Trade payables | 10 | 4,096 | 4,102 |
| Accrued expenses | | 518 | 283 |
| Income tax payable | | 98 | 201 |
| Other current liabilities | 11 | 1,888 | 2,350 |
| Total current liabilities | | 14,741 | 16,768 |
| LONG-TERM LIABILITIES: | | | |
| Bank loans | 12 | 77 | 85 |
| Accrued severance pay, net | 13 | 776 | 612 |
| Total long-term liabilities | | 853 | 697 |
| EQUITY: | 16 | | |
| Share capital | | 10,933 | 10,933 |
| Additional paid-in capital | | 6,610 | 6,535 |
| Foreign currency translation reserve | | 1,300 | 2,191 |
| Hedge reserve | | 15 | - |
| Accumulated deficit | | (12,942) | (9,993) |
| Total equity | | 5,916 | 9,666 |
| Total liabilities and equity | | 21,510 | 27,131 |

The accompanying notes are an integral part of the consolidated financial statements.

| March 31, 2009 | | | |
|---|---|---|---|
| Date of approval of the consolidated financial statements | Bob Marbut<br>Chairman of the Board of Directors | Amir Hayek<br>President and CEO | Shirly Gavriely<br>VP Finance |

## CONSOLIDATED STATEMENTS OF OPERATIONS

**U.S. dollars in thousands, except per share data**

| | Note | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|---|
| Revenues | 18 | 36,435 | 34,373 |
| Cost of revenues | 19 | 23,366 | 21,041 |
| Gross profit | | 13,069 | 13,332 |
| Operating costs and expenses: | | | |
| Research and development | 20 | 3,608 | 1,981 |
| Selling and marketing | 21 | 7,403 | 8,656 |
| General and administrative | 22 | 3,262 | 2,648 |
| Impairment of intangible assets | 8b | - | 6,130 |
| Total operating costs and expenses | | 14,273 | 19,415 |
| Operating loss | | (1,204) | (6,083) |
| Financial income | 23a | 100 | 123 |
| Financial expenses | 23b | (1,143) | (1,083) |
| Other income (expenses) | | 2 | (448) |
| Loss before taxes on income | | (2,245) | (7,491) |
| Taxes on income (tax benefit) | 14b | 704 | (194) |
| Loss | | (2,949) | (7,297) |
| Loss per share (basic and diluted) | 24 | (0.29) | (0.72) |

The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

**U.S. dollars in thousands**

| | Share capital | Additional paid-in capital | Foreign currency translation reserve | Hedge reserves | Accumulated deficit | Total equity | Total recognized income (expense) |
|---|---|---|---|---|---|---|---|
| Balance as of January 1, 2007 | 10,895 | 6,396 | 2,137 | - | (2,696) | 16,732 | |
| Exercise of options | 38 | 45 | - | - | - | 83 | |
| Cost of share-based payments | - | 94 | - | - | - | 94 | |
| Foreign currency translation differences | - | - | 54 | - | - | 54 | 54 |
| Loss | - | - | - | - | (7,297) | (7,297) | (7,297) |
| | | | | | | | (7,243) |
| Balance as of December 31, 2007 | 10,933 | 6,535 | 2,191 | - | (9,993) | 9,666 | |
| Net gain on cash flow hedges | - | - | - | 15 | - | 15 | 15 |
| Cost of share-based payments | - | 75 | - | - | - | 75 | |
| Foreign currency translation differences | - | - | (891) | - | - | (891) | (891) |
| Loss | - | - | - | - | (2,949) | (2,949) | (2,949) |
| | | | | | | | (3,825) |
| Balance as of December 31, 2008 | 10,933 | 6,610 | 1,300 | 15 | (12,942) | 5,916 | |

The accompanying notes are an integral part of the consolidated financial statements.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Cash flows from operating activities: | | |
| Loss before taxes on income | (2,245) | (7,491) |
| Adjustments for: | | |
| Depreciation and amortization | 896 | 1,343 |
| Impairment of intangible assets | - | 6,130 |
| Loss on sale of property, plant and equipment | - | 1 |
| Increase in accrued severance pay, net | 164 | 82 |
| Cost of share-based payments | 75 | 94 |
| Financial expenses, net | 1,043 | 960 |
| | (67) | 1,119 |
| Operating cash flows before working capital changes | | |
| Decrease in trade receivables | 1,039 | 1,547 |
| Increase in prepaid expenses and other accounts receivables | (77) | (221) |
| Decrease (increase) in inventories | 1,407 | (1,530) |
| Decrease (increase) in security deposits | (1) | 25 |
| Decrease in trade payables | (5) | (592) |
| Increase (decrease) in accrued expenses | 235 | (289) |
| Increase (decrease) in other current liabilities | 231 | (379) |
| | 2,829 | (1,439) |
| Cash provided by (used in) operations | 2,762 | (320) |
| Interest received | 11 | 29 |
| Interest paid | (630) | (548) |
| Income taxes received | 132 | 5 |
| Income taxes paid | (431) | (139) |
| Net cash provided by (used in) operating activities | 1,844 | (973) |
| Cash flows from investing activities: | | |
| Acquisition of intangible assets | - | (880) |
| Acquisition of property, plant and equipment | (381) | (609) |
| Proceeds from sale of equipment | 16 | 24 |
| Net cash used in investing activities | (365) | (1,465) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of options | - | 83 |
| Decrease in short-term bank credit, net | (472) | (66) |
| Repayment of loan from shareholders | - | (150) |
| Receipt of long-term loans from banks and others | - | 4,077 |
| Repayment of long-term loans from banks | (1,642) | (1,300) |
| Net cash provided by (used in) financing activities | (2,114) | 2,644 |
| Effect of exchange differences on cash and cash equivalents of foreign operation | (196) | 16 |
| Increase (decrease) in cash and cash equivalents | (831) | 222 |
| Cash and cash equivalents at beginning of year | 3,128 | 2,906 |
| Cash and cash equivalents at end of year | 2,297 | 3,128 |

The accompanying notes are an integral part of the consolidated financial statements.

## NOTE 1:- GENERAL

Electronics Line 3000 Ltd. ("the Company") was incorporated in Israel in December 2002 for the purpose of absorbing the assets and activities of Metis Capital Ltd. ("Metis") (formerly: Electronics Line (E.L.) Ltd.). The Company's shares are publicly traded on the Prime Standard, a market operated by the Frankfurt Stock Exchange.

The Company and its subsidiaries ("the Group") are engaged in the design, development, production, marketing and sale of electronic security with remote management solutions, and complementary products for the mass residential and small commercial markets. These solutions can be monitored and enable remote management of the premises for security, and automation and video application. The registered office of the Group is located at 2 Granit Street, Petach Tikva, Israel.

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

a. Basis of preparation:

The consolidated financial statements of the Company and its subsidiaries have been prepared on a historical cost basis, except where otherwise indicated, in accordance with International Financial Reporting Standards ("IFRS").

b. Accounting policies:

The accounting policies adopted are consistent with those of the previous financial year.

c. Significant accounting judgments, estimates and assumptions:

The preparation of the consolidated financial statements in accordance with IFRS requires estimates and assumptions by the Company's management. Management is not presently aware of any significant uncertainty in applying these estimates, which might result in a material change in the carrying amounts of assets and liabilities within the next financial year. Following are the most significant effects of the estimations on the amounts recognized in the financial statement:

1. Impairment of non-financial assets:

The Group assesses whether there are any indicators of impairment for all non-financial assets at each reporting date. Intangible assets are tested for impairment annually and at other times when such indicators exist. Other non-financial assets are tested for impairment when there are indicators that the carrying amounts may not be recoverable.

When value in use calculations are undertaken, management must estimate the expected future cash flows from the asset or cash-generating unit and choose a suitable discount rate in order to calculate the present value of those cash flows.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

2. Share-based payments:

   The Group measures the cost of equity-settled transactions with employees by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value requires determining the most appropriate valuation model for a grant of equity instruments, which is dependent on the terms and conditions of the grant. This also requires determining the most appropriate inputs to the valuation model including the expected life of the option, volatility and dividend yield and making assumptions about them. The assumptions and models used are disclosed in Note 16b.

3. Deferred tax assets are recognized for all unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and level of future taxable profits together with future tax planning strategies. Further details are contained in Note 14.

4. Development costs are capitalized in accordance with the accounting policy in Note 2i. Determining the amounts to be capitalized requires management to make assumptions regarding the expected future cash generation of the assets, discount rates to be applied and the expected period of benefits (see Note 8).

d. Functional and presentation currency:

The consolidated financial statements are presented in U.S. dollars, which is the Company's functional and presentation currency. Each entity in the group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency. Transactions in foreign currencies are initially recorded at the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the date of the initial transactions.

The financial statements of a subsidiary have been translated from the functional currency (GBP) to the presentation currency (U.S. dollar), in accordance with the following principles set forth in IAS 21, as follows:

The assets and liabilities are translated into U.S. dollars at the closing rate at the date of each balance sheet. Share capital, additional and paid-in capital are translated into U.S. dollars using the exchange rate at the date of the transaction. Income and expenses are translated at average monthly exchange rates for the periods presented. The exchange differences resulting from the translation are recognized as a separate component of equity ("foreign currency translation reserve"). Upon disposal of the subsidiary, the deferred cumulative amount recognized in equity is recognized in the statement of operations.

Foreign currency transactions:

Transactions in foreign currencies are translated at the exchange rates prevailing at the dates of the individual transactions. At the end of the accounting period, the unsettled balances of foreign currency receivables and liabilities are translated at the exchange rates prevailing at the period-end. Foreign exchange gains and losses resulting from the translation are included as a net amount under financial income and expenses, net.

U.S. dollars in thousands, except share and per share data

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Following are data about the representative exchange rate of the U.S. dollar in relation to the New Israeli Shekel ("NIS"), Euro and the GBP:

| As of | Exchange rate of NIS 1 | Exchange rate of € 1 | Exchange rate of £ 1 |
|---|---|---|---|
| | | $ | |
| December 31, 2008 | 0.26 | 1.39 | 1.45 |
| December 31, 2007 | 0.26 | 1.47 | 2.04 |
| **Change during the year ended** | **%** | **%** | **%** |
| December 31, 2008 | - | (5.4) | (28.9) |
| December 31, 2007 | 9.7 | 11.4 | 4.1 |

e. Consolidation of the financial statements:

The financial statements of the Company have been consolidated with those of its wholly-owned and controlled subsidiaries. Control is normally evidenced when the Company owns, either directly or indirectly, more than 50% of the voting rights of a company's share capital and is able to govern the financial and operating policies of an enterprise so as to benefit from its activities. Inter-company transactions and balances, including profits from inter-company transactions not yet realized outside the Group, have been eliminated upon consolidation.

A schedule of active investee companies has been included in the Appendix.

f. Cash and cash equivalents:

Cash includes cash on hand and cash in banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with original maturities of three months or less and that are subject to an insignificant risk of change in value.

g. Receivables:

Receivables are recognized initially at fair value and subsequently measured at amortized cost and less allowance for doubtful accounts. An allowance for doubtful debts is made when there is evidence that the Company will be unable to collect the full amount. The carrying amount of the receivable is reduced through use of an allowance account. Impaired debts are derecognised when they are assessed as uncollectible.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

h. Inventories:

Inventories are valued at the lower of cost and net realizable value.

Costs incurred in bringing each product to its present location and condition are accounted for as follows:

| | | |
|---|---|---|
| Raw materials | - | purchase cost on a first in, first out basis; |
| Finished goods and work in progress | - | cost of direct materials and labor and a proportion of manufacturing overheads based on normal operating capacity but excluding borrowing costs |

Net realisable value is the estimated selling price in the ordinary course of business, less estimated costs of completion and the estimated costs necessary to make the sale.

i. Property, plant and equipment:

Property, plant and equipment are presented at cost less accumulated depreciation. When assets are sold or retired, their cost and accumulated depreciation are eliminated from the accounts and any gain or loss resulting from their disposal is included in the statement of operations. The initial cost of property, plant and equipment comprises its purchase price, non-refundable purchase taxes, and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditures incurred after the property, plant and equipment have been put into operation, such as repairs and maintenance and overhaul costs, are normally charged to income in the period the costs are incurred. In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its originally assessed standard of performance, the expenditures are capitalized as an additional cost of property, plant and equipment. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets.

The annual depreciation rates are as follows:

| | % |
|---|---|
| Installations and leasehold improvements | Shorter of the lease term or useful life (5 - 10) |
| Machinery and equipment | 10 - 15 (primarily 10) |
| Motor vehicles | 15 |
| Office furniture and equipment | 6 - 33 |

j. Intangible assets:

Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost, less any accumulated amortization.

Intangible assets include software and production files development costs. Intangible assets are amortized using the straight-line method over their estimated useful lives (6-10 years) and assessed for impairment whenever there is an indication that the intangible assets may be impaired.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

k. Accounting for leases:

Operating lease - leases of assets under which substantially all risks and rewards of ownership are effectively retained by the lessor are classified as operating leases.

The Group as lessee - lease payments under an operating lease are recognized as an expense on a straight-line basis over the lease term.

l. Research and development costs:

Expenditures for research are recognized as an expense when incurred. Expenditures on development are charged against income in the period incurred except for product development costs, which comply with all of the following criteria:

- the product is clearly defined and costs are separately identified and measured reliably;
- the technical feasibility of the product is demonstrated;
- the product will be sold or used;
- the product will generate future economic benefits because a potential market exists for the product;
- adequate technical, financial and other resources required for completion of the product are available.

Capitalization of costs commences when the above criteria are first met. Expenditures recognized as an expense in previous accounting periods are not re-instated.

The carrying value of development costs is reviewed for impairment annually when the asset is not yet in use, and when events or changes in circumstances indicate that the carrying value may not be recoverable.

m. Revenue recognition:

Revenue is recognized upon delivery when the significant risks and rewards of ownership of the goods have passed to the buyer, it is probable that there is an inflow of future economic benefits to the Company and the amount of revenue can be measured reliably.

Interest income is recognized as the interest accrues.

n. Income taxes:

1. The Group provides for deferred income taxes using the liability method of accounting. Under the liability method, deferred taxes are recognized for temporary differences between the tax basis of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred taxes are measured based on enacted tax rates that will be in effect in the year in which the differences are expected to reverse. Deferred tax assets in respect of carryforward losses and other temporary deductible differences are recognized to the extent that it is probable that they will be utilized.

2. Taxes that would apply in the event of the distribution of earnings by investees as dividends have not been taken into account in computing deferred taxes, when the distribution of dividend does not involve an additional tax liability or when the Company is able to control the distribution of dividends that will cause additional tax liability.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

3. Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

o. Impairment of non-current assets:

All assets are reviewed for impairment at each balance sheet date. Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is recognized in profit or loss.

The recoverable amount is the higher of an asset's fair values less costs to sell and its value in use. The net selling price is the amount obtainable from the sale of an asset in an arm's length transaction less the costs of disposal while value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. Recoverable amounts are estimated for individual assets or, if this is not possible, for the cash-generating unit to which the asset belongs.

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the Group makes an estimate of recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in profit or loss unless the asset is carried at revalued amount, in which case the reversal is treated as a revaluation increase.

p. Royalty-bearing grants:

Royalty-bearing grants for funding of approved research projects are recognized at their fair value where there is a reasonable assurance that the grant will be received and all stipulated conditions will be complied with. Such grants are recorded as a liability when repayment is probable. If repayment is not probable, the grants are deducted from the related expenses.

q. Interest bearing loans and borrowings:

All loans and borrowings are initially recognized at fair value less directly attributable transaction costs.

After initial recognition, interest bearing loans and borrowings are subsequently measured at amortized cost using the effective interest method.

Gains and losses are recognized in the income statement when the liabilities are derecognized as well as through the amortization process.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

r. Derivative financial instruments and hedging:

The Group uses derivative financial instruments such as forward currency contracts and options to hedge its risks associated with interest rate and foreign currency fluctuations. Such derivative financial instruments are initially recognized at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at fair value.

Any gains or losses arising from changes in fair value on derivatives during the year that do not qualify for hedge accounting are taken directly to profit or loss.

The fair value of forward currency contracts is calculated and options by reference to current forward exchange rates for contracts with similar maturity profiles. The fair value of options is determined using an appropriate pricing model.

Cash flow hedges:

The effective portion of the gain or loss on the hedging instrument is recognized directly in equity, while any ineffective portion is recognized immediately in profit or loss.

Amounts taken to equity are transferred to profit or loss when the hedged transaction affects profit or loss.

If the hedging instrument expires or is sold, terminated or exercised without replacement or rollover, or if its designation as a hedge is revoked, amounts previously recognized in equity remain in equity until the forecast transaction or firm commitment occurs.

s. Borrowing costs:

Borrowing costs are expensed as incurred.

t. Severance pay:

The Company's obligation for severance pay for its employees in Israel is covered by regular payments to insurance companies, pension funds and severance pay funds and by the accrual on the balance sheet. The Company's liability is calculated, on the basis of the latest salary, according to law and labor agreements. Accumulated amounts with the insurance companies and pension funds are not under the control or administration of the Company, and accordingly, neither those amounts nor the corresponding liability are reflected in the consolidated financial statements.

The amounts deposited with the severance pay fund include profits accumulated to the balance sheet date and may be withdrawn only after fulfillment of the obligations under the Severance Pay Law and labor agreements.

Severance pay liability:

The Company's liability for severance pay pursuant to Israel's Severance Pay Law is based on the last monthly salary of the employee multiplied by the number of years of employment, as of the date of severance. The cost of providing severance pay is determined using an independent actuary. Actuarial gains and losses are recognized immediately in the statement of income in the period in which they occur.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Pursuant to Section 14 of the Severance Pay Law, which covers most of the Company's employees, monthly deposits with insurance companies release the Company from any future severance obligations in respect of those employees (defined contribution). Deposits under Section 14 are recorded as an expense in the Company's statement of operations.

u. Payables:

Payables are recognized initially at their fair value and subsequently measured at amortized cost.

v. Basic and diluted earnings (loss) per share:

Basic earnings (loss) per share are computed using the weighted average number of shares outstanding during the period. Diluted earnings (loss) per share are computed using the weighted average number of shares outstanding during the period plus the dilutive effect of share options outstanding during the period.

w. Contingencies:

Contingent liabilities are not recognized in the consolidated financial statements. They are disclosed unless the possibility of an outflow of resources embodying economic benefit is remote.

x. Share-based payment transactions:

Employees (including senior executives) of the Group receive remuneration in the form of share-based payment transactions, whereby employees render services as consideration for equity instruments (‘equity settled transactions').

The cost of equity-settled transactions is recognized, together with a corresponding increase in equity, over the period in which the performance and/or service conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award (‘the vesting date'). The cumulative expense recognized for equity-settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and the Group's best estimate of the number of equity instruments that will ultimately vest. The income statement charge or credit for a period represents the movement in cumulative expense recognized as at the beginning and end of that period.

No expense is recognized for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

Where the terms of an equity-settled aware are modified, the minimum expense recognized is the expense as if the terms had not been modified. An additional expense is recognized for any modification, which increases the total fair value of the share-based payment arrangement, or is otherwise beneficial to the employee, as measured at the date of modification.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Where an equity-settled award is cancelled, it is treated as if it had vested on the date of cancellation, and any expense not yet recognized for the award is recognized immediately. However, if a new award is substituted for the cancelled award, and designated as a replacement award on the date that it is granted, the cancelled and new awards are treated as if they were a modification of the original award, as described in the previous paragraph.

y. Standards issued but not yet effective:

IAS 1 (Revised), "Presentation of Financial Statements":

The revised IAS 1, "Presentation of Financial Statements", was issued in September 2007 and becomes effective for financial years beginning on or after January 1, 2009. The Standard separates owner and non-owner changes in equity. The statement of changes in equity will include only details of transactions with owners, with all non-owner changes in equity presented as a single line. In addition, the Standard introduces the statement of comprehensive income: it presents all items of income and expense recognized in profit or loss, together will all other items of recognized income and expense, either in one single statement, or in two linked statements.

The effect of the adoption of IAS 1 (Revised) will require the Company to disclose the above items in the financial statements.

IFRS 3 (Revised), "Business Combinations" and IAS 27 (Revised) Consolidated and Separate Financial Statements:

The revised standards were issued in January 2008 and become effective for financial years beginning on or after July 1, 2009. IFRS 3R introduces a number of changes in the accounting for business combinations that will impact the amount of goodwill recognized, the reported results in the period that an acquisition occurs, and future reported results. IAS 27R requires that a change in the ownership interest of a subsidiary is accounted for as an equity transaction. Therefore, such a change will have no impact on goodwill, nor will it give rise to a gain or loss.

Furthermore, the amended standard changes the accounting for losses incurred by the subsidiary as well as the loss of control of a subsidiary. The changes introduced by IFRS 3R and IAS 27R must be applied prospectively and will affect future acquisitions and transactions with minority interests.

IFRS 2 (Revised), "Share-based Payment":

The amendment to IFRS 2, "Share-based Payment", was published in January 2008 and becomes effective for financial years beginning on or after January 1, 2009. The Standard restricts the definition of "vesting condition" to a condition that includes an explicit or implicit requirement to provide services. Any other conditions are non-vesting conditions, which have to be taken into account to determine the fair value of the equity instruments granted. In the case that the award does not vest as the result of a failure to meet a non-vesting condition that is within the control of either the entity or the counterparty, this must be accounted for as a cancellation.

The Company estimates that the revised Standard will not have a material effect on its financial position and operating results.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

z. Changes in accounting policy and disclosures:

The accounting policies adopted are consistent with those of the previous financial year except as follows:

The Group has adopted the following new and amended IFRS and IFRIC interpretations as of 1 January 2008.

IFRIC 11 IFRS 2 – Group and Treasury Share Transactions
IFRIC 12 – Service Concession Arrangements
IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

The Group has also early adopted the following IFRS and IFRIC interpretations as of 1 January 2008.

IFRS 2 Share-based Payment (Revised) effective 1 January 2009
IFRS 8 Operating Segments effective 1 January 2009
IAS 23 Borrowing Costs (Revised) effective 1 January 2009
IFRIC 13 Customer Loyalty Programmes effective 1 July 2008.

Adoption of these standards and interpretations did not have any effect on the financial performance or position of the Group except for IAS 23 and IFRIC 13. They did however give rise to additional disclosures, including, in some cases, revisions to accounting policies.
The principal effects of these changes are as follows:

IFRS 2, "Share-based Payment (Revised)":

The IASB issued an amendment to IFRS 2 in January 2008 that clarifies the definition of a vesting condition and prescribes the treatment for an award that is effectively cancelled. The Group early adopted this amendment as of 1 January 2008. It did not have an impact on the financial position or performance of the Group as no events occurred that this interpretation relates to.

IFRS 8, "Operating Segments":

The IASB issued IFRS 8 in November 2006. IFRS 8 replaces IAS 14 Segment Reporting (IAS 14) upon its effective date. The Group early adopted this amendment as of 1 January 2008. The Group concluded that the operating segments determined in accordance with IFRS 8 are the same as the business segments previously identified under IAS 14. IFRS 8 disclosures are shown in Note 8, including the related revised comparative information.

Commentary:

Good Group (International) Limited has a non-complex structure of different business activities. Therefore, the operating segments determined in accordance with IFRS 8 are the same as the business segments previously identified under IAS 14. The more complex the group structure, the more likely it is that the segments identified will not be the same as those identified when applying IAS 14.

U.S. dollars in thousands, except share and per share data

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Please refer to our publication ‘IFRS 8 Operating Segments: Implementation Guidance’ for further information. The publication is available for download on www.ey.com/ifrs.

IAS 23, "Borrowing Costs (Revised)":

The IASB issued an amendment to IAS 23 in April 2007. The revised IAS 23 requires capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. The Group’s previous policy was to expense borrowing costs as they were incurred. In accordance with the transitional provisions of the amended IAS 23, the Group has adopted the standard on a prospective basis. Therefore, borrowing costs are capitalised on qualifying assets with a commencement date on or after 1 January 2008. During the 12 months to 31 December 2008, €303,000 of borrowing costs have been capitalised on long-term construction in progress.

## NOTE 3:- CASH AND CASH EQUIVALENTS

| | December 31, | |
|---|---|---|
| | **2008** | **2007** |
| U.S. dollars | 1,582 | 861 |
| Euros | 106 | 167 |
| GBP | 353 | 1,176 |
| NIS | 256 | 924 |
| | 2,297 | 3,128 |

Short-term deposits are made for varying periods of between one day and three months, depending on the immediate cash requirements of the Group, and earn interest at the respective short-term deposit rates.

## NOTE 4:- TRADE RECEIVABLES

a. Composition:

| | December 31, | |
|---|---|---|
| | **2008** | **2007** |
| Open accounts | 6,957 | 8,058 |
| Checks receivable | 163 | 625 |
| | 7,120 | 8,683 |
| Less - allowance for doubtful accounts | (591) | (388) |
| | 6,529 | 8,295 |

Trade receivables are non-interest bearing and are generally for 60-90 day terms.

U.S. dollars in thousands, except share and per share data

## NOTE 4:- TRADE RECEIVABLES (Cont.)

b. As at December 31, 2008, trade receivables with nominal value of $ 511 (2007: $ 388) were impaired and fully provided for. Movements in the allowance for doubtful accounts were as follows:

| | Individually impaired |
|---|---|
| At January 1, 2007 | 229 |
| Charge for the year | 133 |
| Exchange rate adjustments | 26 |
| At December 31, 2007 | 388 |
| Charge for the year | 241 |
| Exchange rate adjustment | (38) |
| At December 31, 2008 | 591 |

c. As at December 31, the ageing analysis of trade receivables is as follows:

| | | | Past due but not impaired | | | |
|---|---|---|---|---|---|---|
| | Total | Neither past due nor impaired | < 30 days | 30 – 60 days | 60 – 90 days | 90 day |
| 2008 | 6,529 | 3,720 | 1,361 | 567 | 602 | 279 |
| 2007 | 8,295 | 6,486 | 286 | 90 | 167 | 1,266 |

## NOTE 5:- OTHER ACCOUNTS RECEIVABLE

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Government authorities | 294 | 367 |
| Other receivables | 37 | 73 |
| | 331 | 440 |

## NOTE 6:- INVENTORIES

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Finished products | 3,366 | 4,923 |
| Work in progress | 588 | 834 |
| Raw and auxiliary materials | 2,598 | 2,854 |
| | 6,552 | 8,611 |

The amounts of write-down of inventories recognized as an expense in 2008 and 2007 are $ 521 and $ 644, respectively.

U.S. dollars in thousands, except share and per share data

## NOTE 7:- PROPERTY, PLANT AND EQUIPMENT

| | Installations and leasehold improvements | Machinery and equipment | Motor vehicles | Office furniture and equipment | Total |
|---|---|---|---|---|---|
| Cost: | | | | | |
| Balance as of January 1, 2007 | 5,881 | 4,569 | 155 | 3,228 | 13,833 |
| Acquisitions during the year | 19 | 379 | 103 | 108 | 609 |
| Disposals during the year | - | - | (50) | - | (50) |
| Currency translation differences | 1 | - | 2 | 2 | 5 |
| Balance as of December 31, 2007 | 5,901 | 4,948 | 210 | 3,338 | 14,397 |
| Acquisitions during the year | 45 | 89 | 41 | 206 | 381 |
| Disposals during the year | - | - | (67) | - | (67) |
| Currency translation differences | (9) | (5) | (10) | (23) | (47) |
| Balance as of December 31, 2008 | 5,937 | 5,032 | 174 | 3,521 | 14,664 |
| Accumulated depreciation: | | | | | |
| Balance as of January 1, 2007 | 2,218 | 3,283 | 106 | 2,782 | 8,389 |
| Provision during the year | 606 | 327 | 14 | 127 | 1,074 |
| Disposals during the year | - | - | (25) | - | (25) |
| Currency translation differences | 1 | - | 1 | 1 | 3 |
| Balance as of December 31, 2007 | 2,825 | 3,610 | 96 | 2,910 | 9,441 |
| Provision during the year | 402 | 332 | 25 | 137 | 896 |
| Disposals during the year | - | - | (51) | - | (51) |
| Currency translation differences | (9) | - | (5) | (14) | (28) |
| Balance as of December 31, 2008 | 3,218 | 3,942 | 65 | 3,033 | 10,258 |
| Depreciated cost as of December 31, 2008 | 2,719 | 1,090 | 109 | 488 | 4,406 |
| Depreciated cost as of December 31, 2007 | 3,076 | 1,338 | 114 | 428 | 4,956 |

U.S. dollars in thousands, except share and per share data

## NOTE 8:- INTANGIBLE ASSETS, NET

a. Software and production files development costs composed as follows:

| | 2008 | 2007 |
|---|---|---|
| Cost: | | |
| As of January 1 | 9,153 | 8,273 |
| Additions | - | 880 |
| As of December 31 | 9,153 | 9,153 |
| Accumulated amortization: | | |
| As of January 1 | 3,023 | 2,754 |
| Provision | - | 269 |
| Impairment (see b. below) | 6,130 | 6,130 |
| As of December 31 | 9,153 | 9,153 |
| Amortized cost as of December 31 | - | - |

b. The impairment loss in the amount of $ 6,130 represents the write-off of the carrying amount of the intangible assets. Near the end of 2007, prior to the introduction of a new product based substantially on the technology embedded in the capitalized development costs, the Company reevaluated the recoverable amount of the intangible assets. For that purpose, the Company performed an updated analysis of potential customer demand and possible changes in technology. This analysis was based on internal management evaluations and consultations with external experts. The Company concluded that due to the potential for rapid changes in technology and the consequential effect on customer demand, the Company is no longer able to make a reliable forecast as to the expected future economic benefits from these intangible assets and, therefore, these assets were written off. A reversal of impairment loss might be necessary in the future if the predictions of future revenues would become more substantial.

In 2008, based on current market conditions and the uncertainties relating to the global economic crisis, the Company concluded that all the criteria for capitalization of development costs had not been net and therefore no costs were capitalized during the year.

U.S. dollars in thousands, except share and per share data

## NOTE 9:- SHORT-TERM CREDIT FROM BANKS AND OTHERS

a. Composition:

| | Annual interest rate | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| | % *) | | |
| Overdrafts: | | | |
| NIS | | 69 | - |
| Short-term loans: | | | |
| NIS | 5.5 | 434 | 702 |
| U.S. dollars **) | 3.9 | 1,290 | 1,140 |
| | | 1,793 | 1,842 |
| Reclassified from long-term loans ***) | | 4,252 | 6,336 |
| Current maturities of long-term loans (see Note 12) | | 2,096 | 1,654 |
| | | 8,141 | 9,832 |

*) Weighted average annual interest rate as of December 31, 2008.

**) Includes shareholders' loan of $ 140 and $ 278 at December 31, 2008 and 2007, respectively. The loan does not bear interest since June 2006.

***) Breach of financial covenants - see Note 17d.

b. Liens:

The Company recorded a floating charge (a non-specific lien on all assets of the Company on which there is no previous specific lien) on the Company's assets in favor of three of the Company's banks.

## NOTE 10:- TRADE PAYABLES

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Open accounts | 3,494 | 4,048 |
| Checks payable | 602 | 54 |
| | 4,096 | 4,102 |

Trade payables are non-interest bearing and generally have terms of 60-90 days.

U.S. dollars in thousands, except share and per share data

## NOTE 11:- OTHER CURRENT LIABILITIES

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Government authorities | 99 | 144 |
| Accrued salaries and related expenses | 1,698 | 1,550 |
| Metis (see Note 15c) | - | 618 |
| Others | 92 | 38 |
| | 1,889 | 2,350 |

## NOTE 12:- BANK LOANS

a. Composition:

| | Average interest rate*) % | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| U.S. dollars | LIBOR + 1.7 | 6,339 | 7,978 |
| NIS | 6.75 | 86 | 97 |
| | | 6,425 | 8,075 |
| Less - current maturities | | 2,096 | 1,654 |
| | | 4,329 | 6,421 |
| Reclassified to current liabilities **) | | (4,252) | (6,336) |
| | | 77 | 85 |

*) As of December 31, 2007.
**) See Note 17d.

b. As described in Note 17d, the Company is not in compliance with loans covenant, and therefore, the banks can demand repayment of these loans at any time. According to their original contractual terms, the long-term loans are repayable in future years based on contractual undiscounted payments (including interest), as follows:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| First year | 2,095 | 2,168 |
| Second year | 2,096 | 2,479 |
| Third year | 1,297 | 2,339 |
| Fourth year | 933 | 1,408 |
| Fifth year | 25 | 933 |

U.S. dollars in thousands, except share and per share data

## NOTE 13:- ACCRUED SEVERANCE PAY, NET

| | December 31, | |
|---|---|---|
| | 2008 | 2007 |
| Accrued severance pay | 784 | 622 |
| Less - deposits with severance pay fund | 8 | 10 |
| | 776 | 612 |

## NOTE 14:- TAXES ON INCOME

a. Income taxes applicable in Israel:

1. Measurement of results for tax purposes under the Israeli Income Tax (Inflationary Adjustments) Law, 1985:

   Under the Income Tax (Inflationary Adjustments) Law, 1985, the Company's results for tax purposes are measured in accordance with the changes in the Israeli CPI.

   In February 2008, the "Knesset" (Israeli parliament) passed the Income Tax (Inflationary Adjustments) Law (Amendment No. 20), 2008, which limits the scope of the Income Tax (Inflationary Adjustments) Law starting 2008. Pursuant to the amended law and under the transition provisions prescribed therein, the adjustment of results for tax purposes to the changes in the Israeli Consumer Price Index ("CPI") will be discontinued starting 2008 and the results will be measured in nominal values, excluding certain adjustments for changes in the CPI carried out up to December 31, 2007. The amended law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting 2008.

2. Tax benefits under the Israeli Law for The Encouragement of Industry (Taxes), 1969:

   The Company is an "industrial company" as defined by the Israeli Law for the Encouragement of Industry (Taxes), 1969 and, as such, is entitled to certain tax benefits, primarily accelerated depreciation and the right to claim public offering expenses as a deduction for tax purposes.

3. Tax benefits under the Israeli Law for The Encouragement of Capital Investments, 1959:

   Metis was accorded the status of an Approved Enterprise under the Israeli Law for Encouragement of Capital Investments, 1959. On December 31, 2002 (see Note 1), the benefits deriving from this status were transferred to the Company. These benefits include an exemption from income taxes on income from the Approved Enterprise for a period of four years beginning with the first year in which it reports taxable income (started in 2000) and a reduced tax rate of 25% for the following three years (starting 2004).

   The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above law, regulations published thereunder, and the instruments of approval for the specific investments in "Approved Enterprise". In the event of failure to comply with these conditions, the benefits may be canceled, and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2008, management believes that the Company is meeting all of the aforementioned conditions.

U.S. dollars in thousands, except share and per share data

**NOTE 14:- TAXES ON INCOME (Cont.)**

In the event of distribution of a dividend from tax exempt income, as described above, the Company will be required to pay income tax at a rate of 15% and the dividend will be subject to 15% tax withholding. The Company's policy is to reinvest its tax-exempt earnings and not to distribute such earnings as dividends. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise".

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate.

A recent amendment to the Law, which was officially published effective as of April 1, 2005 ("The Amendment") has changed certain provisions of the Law. As a result of the Amendment, a company is no longer obligated to implement an "Approved Enterprise" status in order to receive the tax benefits previously available under the alternative benefits provisions, and therefore there is no need to apply to the Investment Center for this purpose (Approved Enterprise status remains mandatory for companies seeking grants). Rather, a company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the Amendment. A company is also granted a right to approach the Israeli Tax Authorities for a pre-ruling regarding their eligibility for benefits under the Amendment.

b. Income tax expense included in the statements of income:

| | Year ended December 31, | |
|---|---|---|
| | **2008** | **2007** |
| Current taxes | 131 | 217 |
| Deferred taxes | 573 | (424) |
| Taxes in respect of previous years | - | 13 |
| | 704 | (194) |

U.S. dollars in thousands, except share and per share data

**NOTE 14:- TAXES ON INCOME (Cont.)**

c. Tax computation:

The difference between income tax expense on profit before taxes computed at regular tax rates and income tax expense in the consolidated statement of operations is explained as follows:

| | Year ended December 31, | |
|---|---|---|
| | **2008** | **2007** |
| Loss before taxes on income | (2,276) | (7,491) |
| Tax expense (benefit) computed at statutory tax rate of 27% (2007 - 29%) | (615) | (2,172) |
| Increase (decrease) in tax due to: | | |
| Different tax rates | (76) | (48) |
| Non-deductible expenses | 57 | 90 |
| Losses and other items for which deferred taxes were not provided | 808 | 2,075 |
| Taxes in respect of previous year | - | (13) |
| Reversal of deferred tax assets | 520 | - |
| Differences in the basis of measurement (U.S.$/GBP - CPI) *) | 10 | (126) |
| | 704 | (194) |

*) The amount represents the difference resulting from the basis of measurement for income tax purposes in Israel (calculated based on the New Israeli Shekel linked to the Israeli Consumer Price Index) and the measurement currency of the Company (the U.S. dollars).

d. Deferred taxes:

Deferred tax assets are computed at an average tax rate of approximately 25% and 26% for 2008 and 2007, respectively.

The group recorded deferred tax assets, principally for tax loss carryforwards and also for other temporary differences, as of December 31, 2008 and 2007 in the amount of $ 215 and $ 788 respectively.

The deferred tax assets were recorded based on the Group's management best estimation of realization of these losses and temporary differences in the foreseeable future.

U.S. dollars in thousands, except share and per share data

## NOTE 14:- TAXES ON INCOME (Cont.)

e. Changes in deferred taxes:

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Balance at the beginning of the year | 788 | 364 |
| Change during the year | (573) | 424 |
| Balance at the end of the year | 215 | 788 |

f. Tax rates applicable to the income of the Group companies:

1. The Company:

On July 25, 2005 the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: 2005 -34%, 2006 - 31%, 2007 - 29%, 2008 - 27%,2009 - 26% and 2010 and thereafter - 25%.

2. Foreign subsidiaries:

The principal tax rates applicable to the subsidiaries whose place of incorporation is outside Israel are:

U.S. - 33%.
United Kingdom - 24% - 30%.

g. Carry forward losses for tax purposes:

The Group's carry forward losses for tax purposes as of December 31, 2008 and 2007 amount to approximately $ 11,570 and $ 7,094, respectively. With respect to tax losses carry forward of approximately $ 10,743 and $ 4,834, no deferred tax asset was recognized as of December 31, 2008 and 2007, respectively.

## NOTE 15:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalties:

1. The Company is obligated to pay royalties of 2% -3.5% of the revenues from products in the development of which the Chief Scientist participated. The royalties are limited to the amount of the grant received, linked to the U.S dollar. Total grants received as of December 31, 2008 and 2007 amounted to approximately $ 1,670 and the balance of contingent royalties amounts to approximately $ 1,238 and $ 1,239, respectively.

U.S. dollars in thousands, except share and per share data

**NOTE 15:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

2. Under the conditions of an agreement for participation by the Bi-National Fund for Research and Development (BIRD) in joint R&D programs between the Group and a U.S. company, BIRD granted grants to the Group. In consideration for this grant, BIRD is entitled to royalties of between 2.5% and 5% of the gross sales of products resulting from this research, up to the amount of the grant, linked to the U.S dollar. Thereafter, BIRD will be entitled to royalties of 2.5% of sales up to an additional amount equaling half of the grant received. On January 1, 2003, the benefits and the obligations deriving from this agreement were transferred to the Company from Metis. The grants received by the Company and the balance of contingent royalties as of December 31, 2008 and 2007 amounted to approximately $ 340.

   It was also agreed with BIRD that should one of the companies register a patent on a product developed, the Group will also pay royalties to BIRD at the rate of 1.5% of the gross sales of the product resulting from the research, for the duration of the patent.

b. Operating leases:

The Company entered into agreements with Metis to lease the plant and office building until 2021 and 2024, respectively. The Company has an option to cancel the leases in 2011 and 2014, respectively. Annual rent - U.S.$ 845. The rent is linked to the higher of the change in Israel's CPI or the exchange rate of the NIS in relation to the U.S. dollar. Certain of the leases have escalation clauses.

Total lease expenses amounted to $ 1,400 and $ 1,339 for 2008 and 2007, respectively.

The foreign subsidiaries rent their facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2010.

Future minimum lease payments in years subsequent to December 31, under non-cancelable operating lease are as follows:

| | **2008** | **2007** |
|---|---|---|
| First year | 1,453 | 1,231 |
| Second through fifth years | 3,403 | 3,327 |
| Thereafter | 50 | 598 |
| Total | 4,906 | 5,156 |

c. Metis:

On May 22, 2006, the Company signed a compromise agreement with Metis. In accordance with the agreement, the consulting agreement with Metis was concluded and it no longer has any force. As a compromise between the parties, the Company agreed to pay Metis $ 2,550 instead of the $ 3,600 that it committed to pay pursuant to the consulting agreement. The compromise settled the Company's relationship with Metis regarding the consulting agreement. The compromise also concluded the arbitration procedure between the Company and Metis.

The agreement was approved by the audit committee, the Board of Directors and the meeting of Metis' shareholders on June 29, 2006.

U.S. dollars in thousands, except share and per share data

**NOTE 15:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

As a result of the agreement, the Company recorded in 2006 a non-recurring expense in the amount of $ 900.

As of December 31, 2008, the Company paid all its liabilities regarding Metis.

**NOTE 16:- EQUITY**

a. The share capital is composed as follows:

| | December 31, 2008 | | December 31, 2007 | |
|---|---|---|---|---|
| | Authorized | Issued and outstanding | Authorized | Issued and outstanding |
| | Number of shares | | | |
| Ordinary shares of NIS 5 par value each | 50,000,000 | 10,162,848 | 50,000,000 | 10,162,848 |

The authorized share capital of the Company is NIS 250,000,000 comprised of 50,000,000 authorized Ordinary shares, par value NIS 5 each.

b. Stock Option Plan:

On June 8, 2005, the Company's Board of Directors adopted a share option plan according to which up to 290,735 options exercisable into Ordinary shares of the Company may be granted to officers, directors, employees and consultants of the Group.

On August 8, 2005, the Company's Board of Directors granted 102,500 options (including 15,000 options to the former Managing Director). The options granted expire 10 years after the date of grant and vest over a period ending in December 2008. The exercise price of the options granted is € 2.297 ($ 2.844 on date of grant). The exercise price of the options was based on the average market price of the Company's shares for a period of 30 days prior to the grant. The options were granted under section 102 of the Israeli Income Tax Ordinance.

The weighted average fair value of options granted by the Company in August 2005 is $ 2 per share, which was estimated based on the following data and assumptions:

Share price - € 2.77 (U.S.$ 3.43); exercise price - € 2.297 ($ 2.84); expected volatility - 94%; risk-free interest rate - 2%; expected dividends - 0% and expected average life of options - 2.5 years.

Compensation costs in respect of these options, in accordance with IFRS 2, "Share-Based Payment", were recorded commencing in the third quarter of 2005.

In November 2005, 22,500 options were granted to the President and CEO. The options granted expire 10 years after the date of grant and vest over a period ending in November 2009. The exercise price of the options granted is € 4.043 ($ 4.757 on date of grant).

**NOTE 16:- EQUITY (Cont.)**

The weighted average fair value of options granted by the Company in November 2005 is $ 1.74 per share. Compensation costs in respect of these options, in accordance with IFRS 2 were recorded commencing in the fourth quarter of 2005.

On May 9, 2006, the Company's Board of Directors ("BOD") resolved to accelerate the vesting of 21,875 options granted in August 2005 such that these options vest immediately.

In addition, on May 9, 2006, the BOD resolved to increase the number of shares available for option grants under the June 2005 share option plan up to 500,000 options. On that date, the BOD granted 125,183 options (including 41,561 options to the CEO) at an exercise price of € 5.19 ($ 6.59 on date of grant). The options vest over a period ending in December 2009 and expire 10 years after date of grant.

Furthermore, the BOD granted an additional 97,692 options (including 35,939 options to the CEO) at an exercise price of € 5.19 ($ 6.59 on date of grant). These options vest on December 31, 2011, unless vesting is accelerated upon achievement of targeted share market prices in the range of between € 7 and € 15.

The weighted average fair value of options granted by the Company in May 2006, in the amount of $ 3.04, was estimated by applying the Binomial Model for option pricing based on the following data and assumptions (weighted average): share price - $ 6.48; exercise price - $ 6.59; expected volatility - 58.2% (based on historical values); risk-free interest rate - 3.78% and expected dividends - 0%.

In November and December, 2006, the BOD granted 30,000 options and 20,000 options, respectively. The options were granted mainly to officers and employees, which began to work for the Company in 2007. The options vest over a period ending in January 2011 will expire 10 years after the date of grant. The exercise price of the options granted is € 5.19 **(**$ 4.2 at date of grant). The weighted average fair value of options granted by the Company in November and December 2006 are $ 1.17 and $ 1.22 per share, respectively, compensation cost in respect to these options, in accordance with IFRS 2 was recorded commencing January 2007.

On June 28, 2007, the Board of Directors granted 30,000 options. The options granted expire 10 years after the date of grant and vest over a period ending in June 2011. The exercise price of the options granted is € 5.19 ($ 6.99 on date of grant). The weighted average fair value of options is $ 1.24 per share.

Total cost of share-based payments amounted to $ 75 and $ 94 for 2008 and 2007, respectively.

U.S. dollars in thousands, except share and per share data

**NOTE 16:- EQUITY (Cont.)**

The following table illustrates the number and weighted average exercise prices (WAEP) of, and movements in, share options during the years:

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | Number | WAEP (U.S.$) | Number | WAEP (U.S.$) |
| Outstanding at beginning of year | 248,908 | 6.23 | 347,875 | 5.61 |
| Granted during the year | - | - | 30,000 | 6.99 |
| Forfeited during the year | (15,000) | 6.99 | (96,310) | 5.28 |
| Exercised during the year | - | - | (32,657) | 3.09 |
| Outstanding at end of year | 233,908 | 6.18 | 248,908 | 6.23 |
| Exercisable at end of year | 107,930 | 3.61 | 122,930 | 3.78 |

**NOTE 17:- FINANCIAL INSTRUMENTS**

The Group's principal financial instruments, other than derivatives, comprise bank loans and overdrafts and trade payables. The main purpose of these financial instruments is to raise finance for the Group's operations. The Group has various financial assets such as trade receivables and cash, which arise directly from its operations.

It is, and has been throughout 2008 and 2007, the Group's policy that no trading in derivatives shall be undertaken.

The main risks arising from the Group's financial instruments are cash flow interest rate risk, credit risk and foreign currency risk. The Board of Directors reviews and agrees on policies for managing each of these risks, which are summarized below.

a. Interest rate risk:

The Group's exposure to the risk of changes in market interest rates relates primarily to the Group's debt obligations with floating interest rates.

b. Credit risks:

Cash and cash equivalents as of December 31, 2008 are deposited with large banks in Israel. Accordingly, management does not anticipate losses arising from credit risks in respect of these assets.

There are no significant concentrations of credit risk within the Group. The Group's customers are dispersed over a number of countries, mainly developed countries. The Group customarily receives bank guarantees in respect of customers with high credit risk. In respect of certain other customers, the Group insures the receivables through foreign trade risk insurance. Management regularly monitors trade receivables and includes provisions in the consolidated financial statements, which, in its opinion, are adequate to cover doubtful accounts. In light of the above, the exposure to credit risks in connection with trade receivables is limited.

U.S. dollars in thousands, except share and per share data

**NOTE 17:- FINANCIAL INSTRUMENTS (Cont.)**

c. Foreign currency exposure:

The Group is subject to foreign exchange risk as it operates and has sales in different countries worldwide. Group management regularly monitors its foreign exchange risk and attempts to limit such risks by making adequate decisions regarding cash and credit positions.

As of December 31, 2008 and 2007, the Company's monetary liabilities in NIS exceeded monetary assets by $ 4,337 and $ 4,554, respectively.

The following table demonstrates the sensitivity to a reasonably possible change in the US dollar exchange rate in relation to the NIS, with all other variables held constant, of the Group's profit before tax (due to changes in the carrying value of monetary assets and liabilities).

| | Increase/ decrease in exchange rates | Effect on profit before tax |
|---|---|---|
| 2008 | +10% | (434) |
| | -10% | 434 |
| 2007 | +10% | (455) |
| | -10% | 455 |

As of December 31, 2008 and 2007, the Company's monetary assets in Euro exceeded monetary liabilities by $ 792 and $ 1,491 (all current), respectively.

The following table demonstrates the sensitivity to a reasonably possible change in the US dollar exchange rate in relation to the Euro, with all other variables held constant, of the Group's profit before tax (due to changes in the carrying value of monetary assets and liabilities).

| | Increase/ decrease in exchange rates | Effect on profit before tax |
|---|---|---|
| 2008 | +10% | 79 |
| | -10% | (79) |
| 2007 | +10% | 149 |
| | -10% | (149) |

U.S. dollars in thousands, except share and per share data

## NOTE 17:- FINANCIAL INSTRUMENTS (Cont.)

d. Liquidity risk:

The Group monitors its risk to a shortage of funds using a recurring liquidity planning tool. This tool considers the maturity of both its financial investments and financial assets and projected cash flows from operations.

The Group's objective is to maintain a balance between continuity of funding and flexibility through the use of bank overdrafts and bank loans.

The Company has financial covenants with its three principal banks which include certain customary financial covenants that the Company is required to fulfill, including the ratio of shareholders' equity to total assets, certain profitability level, cash balances and other balance sheet ratios. As of December 31, 2008, the Company did not meet a specific ratio and, accordingly, long-term loans in an amount of $ 4,252 were reclassified to current liabilities (see Note 9). The Company's management believes that the banks will not demand early repayment and, therefore, the Group's exposure to liquidity risk is limited.

e. Fair value of financial instruments:

The carrying amounts of cash and cash equivalents, trade receivables and other receivables, credit from banks and others, trade payables and other current liabilities approximate their fair value due to the short-term maturity of such instruments.

f. Capital management:

The primary objective of the Company's capital management is to ensure that it maintains a strong credit rating and sufficient capital, including externally imposed capital requirements (ratio of equity to total assets – see d above), in order to support its business and maximize shareholders value. The Company complies with the externally imposed capital requirements to which it is subject.

The Company manages its capital structure and makes adjustments in light of changes in economic conditions.

## NOTE 18:- REVENUES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Foreign: | | |
| Europe | 25,113 | 22,154 |
| United States | 5,581 | 7,730 |
| Other countries | 5,584 | 4,336 |
| | 36,278 | 34,220 |
| Domestic - Israel | 157 | 153 |
| | 36,435 | 34,373 |
| Includes sales to one major customer | 4,506 | 3,963 |

U.S. dollars in thousands, except share and per share data

## NOTE 19:- COST OF REVENUES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Purchases and changes in raw and auxiliary materials | 15,879 | 14,928 |
| Labor | 3,464 | 2,957 |
| Manufacturing and other expenses | 1,507 | 1,220 |
| Depreciation and amortization (including write-down of inventories) | 713 | 979 |
| | 21,563 | 20,084 |
| Changes in finished products and work-in-progress inventories | 1,803 | 957 |
| | 23,366 | 21,041 |

## NOTE 20:- RESEARCH AND DEVELOPMENT EXPENSES

| | | |
|---|---|---|
| Salaries and related expenses | 1,959 | 1,358 |
| Other | 1,649 | 623 |
| | 3,608 | 1,981 |

## NOTE 21:- SELLING AND MARKETING EXPENSES

| | | |
|---|---|---|
| Salaries and related expenses | 4,583 | 4,613 |
| Commissions | 92 | 236 |
| Advertising | 344 | 483 |
| Foreign travel and transportation | 860 | 1,093 |
| Rent | 553 | 663 |
| Other | 971 | 1,568 |
| | 7,403 | 8,656 |

## NOTE 22:- GENERAL AND ADMINISTRATIVE EXPENSES

| | | |
|---|---|---|
| Salaries and related expenses | 1,378 | 1,046 |
| Management and consulting fees | 206 | 217 |
| Provision for doubtful accounts and bad debts | 241 | 133 |
| Depreciation | 182 | 194 |
| Other | 1,255 | 1,058 |
| | 3,262 | 2,648 |

U.S. dollars in thousands, except share and per share data

## NOTE 23:- FINANCIAL INCOME AND EXPENSES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| a. Financial income: | | |
| Short-term deposits | - | 29 |
| Foreign exchange differences | 34 | 94 |
| Other | 66 | - |
| | 100 | 123 |
| b. Financial expenses: | | |
| Bank borrowings, net | (655) | (627) |
| Foreign exchange differences | (323) | (430) |
| Other | (165) | (26) |
| | (1,143) | (1,083) |

## NOTE 24:- LOSS PER SHARE

The following reflects the income and share data used in the basic and diluted net earnings (loss) per share computations:

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Loss attributable to Ordinary shares for basic and diluted earnings per share | (2,950) | (7,297) |
| Weighted average number of Ordinary shares for basic earnings per share | 10,162,031 | 10,162,031 |
| Effect of dilution: | | |
| Share options | - | - |
| Adjusted weighted average number of Ordinary shares for diluted earnings per share | 10,162,031 | 10,162,031 |

In the calculation of the diluted earnings per share for the year ended December 31, 2008, all share options were not taken into account because of the anti-dilutive effect.

U.S. dollars in thousands, except share and per share data

## NOTE 25:- BALANCES AND TRANSACTIONS WITH RELATED PARTIES

a. Balances with related parties:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Short-term credit (Note 9a) | 140 | 140 |

b. Transactions with related parties:

Since March 1, 2003, Mr. Bob Marbut, who is the Chairman of the Board of Directors and an indirect controlling shareholder of the Company, has been acting as CEO and president of a subsidiary in the United States ("STG"). The employment contract was for a period of one year, but is automatically renewable for additional one year periods, unless one of the parties makes prior notice of cancellation. In consideration for his services, Mr. Marbut is entitled to an annual salary of $ 350.

On May 14, 2007, the Company's shareholders approved Mr. Marbut's decision to waive $ 150 of his agreed salary in favor of Mr. Ron Chaimovsky, a director of the Company. On May 15, 2007, the Company signed an agreement with Mr. Chaimovsky. According to the agreement, Mr. Chaimovsky will provide management and consultation services to the Company. In consideration for his services, Mr. Chaimovsky is entitled to an annual salary of $ 150.

c. Compensation of key management personnel of the Group:

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Short-term employee benefits | 2,193 | 2,065 |
| Share-based payments | 36 | 77 |
| Severance pay | 34 | 89 |
| | 2,263 | 2,231 |

## NOTE 26:- GEOGRAPHIC SEGMENTS

a. General:

The Group operates in one business segment of electronic security with remote management solutions and complementary products.

The Group operates in two principal geographic segments according to IAS 14: the United States and Europe.

U.S. dollars in thousands, except share and per share data

**NOTE 26:- GEOGRAPHIC SEGMENTS (Cont.)**

b. The following data are presented in accordance with IAS 14:

1. Revenues:

| | Year ended December 31, | |
|---|---|---|
| | **2008** | **2007** |
| Sales to external customers: | | |
| Europe | 25,087 | 22,154 |
| United States | 5,581 | 7,730 |
| Other countries | 5,741 | 4,489 |
| | 36,409 | 34,373 |
| Intersegment sales: | | |
| Europe | 2,061 | 2,219 |
| United States | 318 | 424 |
| | 2,379 | 2,643 |
| Total revenues | 38,788 | 37,016 |
| Adjustments | (2,353) | (2,643) |
| Total revenues in financial statements | 36,435 | 34,373 |

2. Segments results:

| | 2008 | 2007 |
|---|---|---|
| Sales less directly attributable and allocable expenses: | | |
| Europe | 4,630 | 3,569 |
| United States | (891) | (30) |
| Other countries | 734 | 187 |
| | 4,473 | 3,726 |
| Adjustments | 201 | 950 |
| | 4,674 | 4,676 |
| Unallocated expenses | (5,878) | (10,759) |
| Operating loss | (1,204) | (6,083) |
| Financial income | (1,143) | (1,083) |
| Financial expenses | 100 | 123 |
| Other income (expenses), net | 2 | (448) |
| Taxes on income (tax benefit) | 704 | (194) |
| Loss | (2,949) | (7,297) |

U.S. dollars in thousands, except share and per share data

**NOTE 26:- GEOGRAPHIC SEGMENTS (Cont.)**

3. Segment assets:

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Europe | 6,301 | 9,419 |
| United States | 2,443 | 3,849 |
| Other countries | 1,818 | 1,728 |
| | 10,562 | 14,996 |
| Adjustments | (34) | (181) |
| Unallocated assets | 10,982 | 12,316 |
| Total assets | 21,510 | 27,131 |

4. Segment liabilities:

| | 2008 | 2007 |
|---|---|---|
| Europe | 1,240 | 3,171 |
| United States | 6,881 | 6,642 |
| | 8,121 | 9,813 |
| Adjustments | (6,656) | (7,670) |
| Unallocated liabilities | 14,129 | 15,322 |
| Total liabilities | 15,594 | 17,465 |

5. Tangible fixed assets:

a) Capital expenditure:

| | 2008 | 2007 |
|---|---|---|
| Europe | 50 | 8 |
| United States | 7 | 16 |
| | 57 | 24 |

b) Depreciation:

| | 2008 | 2007 |
|---|---|---|
| Europe | 23 | 21 |
| United States | 17 | 18 |
| | 40 | 39 |

**SCHEDULE OF ACTIVE INVESTEE COMPANIES**

| Entity | Place of incorporation |
| --- | --- |
| Electronics Line (UK) Ltd. | United Kingdom |
| Electronics Line USA Inc. | United States |
| Sectec Global Inc. | United States |

All of the investees are wholly-owned subsidiaries held directly by the Company for all reported periods.

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# The Annual Report's Management Discussion And Analysis (the "Report")



## Market Overview and Operational Activities

BUSINESS OVERVIEW AND IMPORTANT TRENDS IN THE INDUSTRY

**Overview**

The Company engages in the design, development, production, marketing and sale of security with remote management solutions as well as complementary products for the mass residential and small commercial markets. The Company's solutions include both wireless and wired security platforms including intrusion prevention, hazard detection including fire and water leaks, medical monitoring, home automation, video event capture and remote video look-in. These solutions can be monitored by a third party or by the end user and enable remote management via WAP and Web user interfaces to interactively manage the premises for security and automation, video and other applications. All these are provided using multiple communications protocols including PSTN, GSM, TCP/IP and GPRS.

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The Company was incorporated as a private company limited by shares on December 19, 2002 with the Israeli Registrar of Companies in accordance with the laws of the State of Israel and started its activities on January 1, 2003.

Although in its current corporate form, the Company has existed for almost six years, Metis Capital Ltd. ("hereinafter "Metis") previously Electronics line (E.L.) Ltd, which transferred the business to the Company has existed in one form or another for over 20 years. Thus the Company has much more experience and familiarity with the security market, the technologies serving this market, its customers and competitors than would be apparent based on the period of its corporate existence.

The Company has a strong technological foundation and believes it is one of the leading companies in the field of integration of advanced communication methodologies with security systems for residential and small commercial users. While the majority of security system manufacturers focus primarily on PSTN and GSM (public switched telephony network, which is a telephone system based upon copper wires that carry analogue voice signals) narrow band telephone communication, the Company has also developed a platform that is compatible with GPRS cellular communications and high speed broadband Ethernet communications, in addition to traditional PSTN and GSM communications.

The Company's customers include leading security monitoring companies, service providers and distributors throughout the world. The Company supports its global customer base from its headquarters in Israel and three of its subsidiaries: two in the United States and one in the U.K. The Company further enhances its presence by using a network of distributors in various countries. The Company sells through both traditional security channels – monitoring companies and distributors – and non-traditional channels – including utility companies, cable companies, and non-security distributors.

The Company has a presence, and believes it is well positioned in important markets around the world, in particular Northern and Western Europe and consistently strengthens its position in additional regions in Latin America, APAC and more. The Company's brand is associated with high quality products and solutions.

The Company is a customer-centric organization and continuously endeavors to work with its customers to understand the market needs and to introduce new solutions to the market. The Company provides its customers with features for maximum convenience – including wireless detectors, wireless communicators, advanced management tools such as remote programming software and remote firmware updates. For the end user, the Company provides solutions that are designed to be easy to use and attractive and also have enhanced functionality, including a 45kg pet-immune motion detector, remote connectivity capabilities and home automation applications.

The Company has its own manufacturing facility and employs a multi-skilled R&D team that performs engineering, development and quality assurance testing. The Company believes this combination provides it with the flexibility and capabilities that are important in a market driven company to respond to customer demands.

**<u>Products and Product Families</u>**

The Company's most innovative and stylish solution is the *iConnect* product line which offers residential security, safety, connectivity and control with interactive remote management applications. These enable users to control and be connected to their homes, anywhere, anytime. Sophisticated remote management capabilities are attained using advanced communications based on PSTN, GSM, Ethernet, and a newly implemented GPRS platform. During 2008, the Company added a WAP user interface for system management, in addition to the Web user interface.

Additional prominent product families are the *infinite* and the *infinite Prime* product lines, which enable using phone line, cellular and internet for communication between the premises, monitoring station and end-user. The *infinite Prime* product line includes a couple of options for the international market including a hybrid solution, and an Ethernet communications solution. *infinite* Prime was introduced to the market in August 2005, and includes an updated version of the *infinite* product with advanced end user and service provider features to enable voice communication, enhanced two-way connectivity and remote management, as well as a design that simplifies installation.

The Company's wireless family of products includes equipment located at the premises (such as a home or small business) – a control panel and peripherals such as motion detectors, door/window magnets, glass break detectors, water leak detectors and smoke and fire detectors. In addition, the Company sells equipment that is centrally located - such as a monitoring station – and this includes a receiver and other software used to monitoring signals from the home and to connect into the premises remotely.

The Company also sells fully wired security solutions – the Summit and Penta control panels and wired detectors as the secondary product family. These are used for similar solutions as the wireless product lines, but they are wired and target more traditional security customers.

## Industry Information

*Market Size*

The global residential security market is estimated to be U.S.$6.6 Billion in 2008, with an annual growth of 6% through 2008. Currently, the penetration of monitored residential burglar alarm systems is approximately 20% in the U.S. and 5% across Europe, and even lower in Asia. The U.S. market alone installs more than one million new residential systems per year.

*Market Structure*

The main players in the security market are: (1) the manufacturers of systems, (2) integrators, service providers, distributors and installers of systems who are responsible for reselling and/or installing the systems at end-user sites, and (3) alarm monitoring service companies that are responsible for monitoring the protected areas through monitoring centers and informing the local police or private security companies or other authorities of activations received by the systems.

*Market Trends*

The growth in the residential market is attributable to several factors: (1) the expected general growth in crime, (2) increase in the standard of living, and (3) a reduction in prices of security solutions. These factors all contribute to a growth in demand for security with remote management solutions.

In addition, the increasing availability of broadband and GPRS, encourage growth in the residential market. The trend appears to be that more and more end-users will be looking to be connected with their home or office. As part of this trend, end-users will be looking to obtain information valuable to them, such as if a child has arrived home from school, to look in on the nanny, remotely manage appliances, check the status of an alarm system or oversee operations within a store.

The Company is leveraging the opportunity to develop the channels seeking for security with remote management solutions. As a direct result of new technology which is digital/IP-based, the Company is able to integrate its technology and bundle the security with remote management solutions with service providers' other offerings (security providers, as well as cable companies, utility companies and telecommunication companies). This increases the number of distribution channels and provides the Company with a larger target market. The Company endeavors to work with service providers with established reputations and large customer bases, which enables the Company to benefit from their reputations. The Company offers multiple business models to service providers in order to maximize the Company's revenues from these customers.

The Company believes that both the service providers and the end users benefit from the Company's relationships with service providers. The service providers are able to increase their revenue base by offering the Company's solutions, and the end users are able to receive more value for the existing broadband or other platforms in their home or office.

*Trend from Wired to Wireless Solutions*

The Company focuses its marketing and sales efforts on its product family of wireless products and solutions. In the past, security systems were standard wired systems – these took days to install and lots of drilling and resultant damage in the homes and commercial installation sites. In addition, these systems were difficult for an end user to use and provided only the basic functionality of monitoring of intruders. Today, wireless solutions can be installed in less than two hours, with minimal drilling in the walls. The detectors may use encrypted RF (radio frequency) to communicate back to the control panel thus eliminating the need to run wires throughout the home. In addition, these solutions have easy-to-use interfaces including one button arming and disarming. This decrease in installation time reduces the overall cost of a system. As a result of this increase in functionality and the decrease in costs, the Company believes that there is and will continue to be a greater demand for wireless solutions in the foreseeable future. None the less the Company also offers a wide range of wired products, while the *infinite Prime* and iCOnnect also support existing wired installations.

*Increased Functionality of Wireless Security Solutions*

Today's security solutions integrate new technologies. They offer advanced functionality, including home automation – the ability to manage lights and appliances from the control panel, two-way connectivity and interactive medical monitoring and fire detection. A user can receive notifications from the system through a website, via email or an SMS message from a cell phone or other personal data accessories (PDA's). For example, a customer may send a web commad or SMS to turn on the lights in a home, arm the security system, operate electrical appliances (air conditioning or hot water boiler) or receive an email about an emergency in the home.

*Insurance Cost Savings*

In some jurisdictions, a form of security system is mandatory in order to obtain property insurance. In addition, if a property owner has a professionally installed monitored solution, the property owner may be eligible for an insurance premium reduction. As a result, payments of the monthly service fees are often offset, in whole or in part, by the reduction in insurance premiums and do not constitute a new or significant financial burden on the customer.

*Demand to Always be Connected to the Home or Office*

The Company believes users have an increasing desire to be connected to their homes and offices, wherever they are. With cell phones and broadband access becoming ever more popular and available, people are more aware of the benefits of always being connected to their homes or offices. New security with remote management solutions integrates innovative communications such as GSM/GPRS (cell phone) and Ethernet (internet). These types of communications enable an end user to proactively receive information about the status of the home (e.g., if a child arrived home from school or if an elderly parent got out of bed in the morning).

*New Companies Distributing Security with Remote Management Solutions*

Professional security systems have principally been sold through traditional security monitoring and distribution companies. Today, many new players, such as value added resellers, in addition to service providers, are looking for additional solutions to add to their product portfolio in order to increase their revenue per customer; therefore, the availability of the solutions to the end customers is expanding.

*Market Structure*

The main players in the security with remote management market are: (1) the manufacturers of systems, (2) integrators, service providers, distributors and installers of systems who are responsible for reselling and/or installing the systems at end-user sites, and (3) alarm monitoring service companies that are responsible for monitoring the protected areas through monitoring centers and informing the local police or private security companies or other authorities of activations received by the systems

*Industry Standards*

Industry standards create a barrier to entry into the industry and into specific countries, as they are costly and time consuming to obtain. As in other industries, alarm manufacturers are expected to conform to ISO 9001:2000 quality standards.

The Company received confirmation from the Israeli Institute of Standards that the Company's production facilities in Israel comply with the requirements of the Israeli and International Standard ISO 9001:2000. This approval is valid through September 30, 2009.

Certain of the Company's products have received international standards approvals, including:

| **Standard** | **Country** | **Nature of Products** |
|---|---|---|
| VDS | Germany | Security and Functionality |
| CE | European Union | Communication – RTTE Directive |
| EN50131 | European standard for Alarm system | Functionality |
| F&P | Denmark | Security and Functionality |
| UL | USA | Security and Functionality |
| FCC | USA | Communication Interruptions |
| ACTA | USA | Telephony |
| CCC | China | Security and Functionality |
| NCP | Holland | Security and Functionality |
| ANPI | Belgium | Security and Functionality |
| F&G | Norway | Security and Functionality |
| AUSTEL | Australia | EMC & Communication |

**Business Strategy**

The Company engages in the design, development, production, marketing and sale of security with remote management solutions as well as complementary products for the mass residential and small commercial markets. These solutions can be monitored and enable remote management of the premises for security, automation and video applications.

The Company's vision is to be a leading global provider of wireless security with remote management solutions for the mass residential and small commercial markets.

Key elements of the Company's growth strategy include:

- Focusing on non-traditional marketing and distribution channels, such as value added resellers, utility companies, cable companies and others to develop new markets for security with remote management solutions.

- Continuing to position the Company's wireless products as an innovative quality solution that reduces operating expenses for the service provider and increases functionality and control for the end user.
- Develop new and strengthen existing relationships with key target customers in order to sell to their customers the wireless security with remote management solutions.
- Providing a full range of market solutions – from standard, low cost solutions to high end, advanced solutions
- Increasing services which are available as part of the Company's platform for remote management solutions, including advanced video capabilities, remote management applications and more.
- Leveraging wireless technology and various platforms to develop new solutions.
- Invest in both short-term and long-term R&D in order to improve product design and lower production costs.
- Continuously evaluate the Company's organizational structure and make changes as needed to maximize efficiency, sales and profitability.

## Trends and Developments

The following are several characteristics, trends and developments, which are currently affecting or are likely to affect the operations of the Company in the future:

Developments in Markets or Changes in Customer Needs

As technologies converge, end user demands for solutions may evolve and new companies may enter the market to provide competitive or complementary solutions to the Company's offerings. The Company intends to continue to focus on developing new solutions to meet the customers' needs. In addition, the Company intends to develop new channels to reach end users in both the residential and commercial markets, with a particular focus on markets where it has been successful in the past.

## Customers

*General*

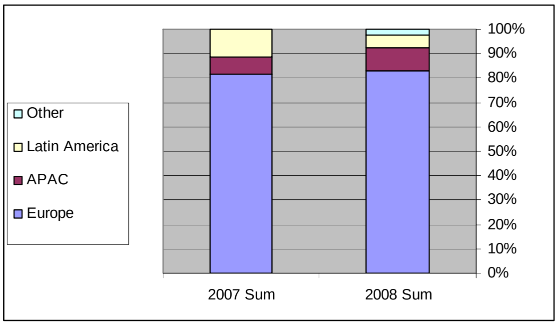
The Company's current customers include monitoring companies, distributors, value added resellers, security providers and service providers in Europe, Latin America, APAC and other parts of the world. Approximately 99% of the products that are produced by the Company are exported from Israel, where they are manufactured.

Key Customers of the Company include the following:

- Three major security service providers.
- Four non-traditional distributors working through alternative channels,
- One European non security service provider.

The Company's only field of activity is the design, development, production, marketing and sale of security with remote management solutions as well as complementary products for the mass residential and commercial markets.

The following is the distribution of the revenues of the Company according to geographical regions. The figures include sale's distribution from the Company's headquarters:




*Service Providers*

The Company sells its products to large service providers, such as monitoring, utility or cable companies, with strong marketing organizations that have a large customer base. These service providers, in turn, sell and install the Company's solutions at the end user's location. In addition, these service providers take responsibility for technical support and maintenance of the solutions.

*Monitoring Companies*

The Company sells its products to large national and international security monitoring companies. These monitoring companies buy the equipment from the Company and in turn, sell and install the Company's solutions at the end user's location. These service providers take responsibility for the monitoring of emergency events, and the technical support and maintenance of the systems.

*Distributors and Value added resellers*

The Company also sells to local distributors who buy the product from the Company and re-sell the products to installers who take responsibility for the sales, installation and maintenance of the Company's solutions. The Company focuses only value-added resellers that can also be responsible for marketing and advertising activities, as well as approaching service providers.

## Marketing and Sales

The Company sells its products and solutions directly through its own sales force and the sale forces of its subsidiaries, as well as indirectly through local distributors. The Company has an established customer base with which it works either on an order-by-order basis or via yearly forecasts with regular purchase orders.

The Company's sales and marketing headquarters are located in Israel. In addition, the Company has local and regional direct sales offices through its subsidiaries in the UK and USA.

The Company has indirect sales channels through local distributors. The Company engages only with selected distributors chosen for their proven ability to act as effective marketers in their territories. The Company's strategy is to use indirect sales mainly in territories considered less strategic for the marketing of the Company's products. The Company works on both exclusive and non-exclusive bases with its local distributors. In exclusive relationships, the Company typically imposes minimum annual purchase requirements on the distributors. Should a distributor fail to meet these annual minimum purchase requirements, the Company may choose to terminate the distributor's exclusivity or distribution agreement.
In several countries, there is more than one distributor, and different distributors may sell different models of the Company's products. Such distributors purchase the products from the Company and re-sell them to end users.

The Company utilizes a variety of marketing programs to support its sales efforts and to promote its products and systems including seminars, print advertising, trade shows, speaking engagements, public relations activities, web site advertising and more. The sales and marketing department also performs product demonstrations and prepares product literature, including product presentation materials, brochures, data sheets and materials that are relevant to the area of interest of a specific customer.

The Company markets products under its own brand names and also under private labels for selected large customers.

From its office in Israel and through its subsidiaries, the Company provides global customer support. The customer care team consists of trained professionals who use advanced computer and communications systems to respond to the technical needs of the Company's customers. The Company provides customer support to its customers, but not to the end users of the systems. To minimize overall service calls and increase customer satisfaction, the Company's products and services are specifically designed with remote diagnostic and management tools that enable the customer to troubleshoot and maintain the system. In addition, this capability enables the Company to provide customers with real-time support if they are experiencing trouble while at an end user's premises.

**Competition**

The market for security with remote management solutions is an established yet growing industry. The market is global in nature, yet it has national customizations. The players in the security with remote management market include manufacturers of systems, service providers, distributors, installers and the monitoring stations. The main manufacturers of systems include large global entities such as Tyco, a worldwide leader in fire protection and electronic security; General Electric, a global conglomerate with a security group providing wired and wireless intrusion products and fire protection components; Honeywell, a global conglomerate; and Bosch, a global conglomerate with a security division focused on large scale electronic security systems. Smaller players include Visonic, Rokonet and Crow – small Israeli companies selling intrusion product.

**Manufacturing Capability**

The Company manufactures its own products from its facility in Petach Tikva, Israel. The Company maintains two independent robotic production lines with a combined capacity of 15 million components per month when operated with three shifts. The Company also has additional machines for sub-assembly. As of the date of this Report, the Company, on average, utilizes approximately 70% of its manufacturing capability. The Company, to the extent necessary, also transfers a part of the production to sub-contractors.

**Raw Materials and Suppliers**

The Company's raw materials are mainly electronic, metal and plastic components, such as microchips, control panel covers and motion detector covers. Most of the raw materials have several alternative vendors, thus minimizing the Company's dependence on a single vendor. For select raw materials, which are in shorter supply or require longer lead times, the Company undertakes to maintain appropriate inventories to meet the demands of manufacturing. A delay in the supply of, or shortage of, raw materials could impede or delay the production of the Company's products and the Company may be unable to find alternative suppliers.

The Company purchases raw materials from a large number of suppliers.

The Company has written agreements with many of the vendors that it orders from on a regular basis. For vendors that the Company orders from on a one-time basis, the Company submits a purchase order to these vendors as needed.

For some particular component the Company currently uses a single supplier. The lead-time for these components is relatively long. The Company cannot assure its continued supply from this particular supplier but is of the opinion that, if needed, it could find an alternative supplier for these same components within a reasonable period of time. The Company is currently investigating a second source for these components.

In addition, the Company purchases machinery and equipment from third parties both in Israel and overseas.

*Raw Materials Inventory Policy*

The policy of the Company is to maintain approximately three months of raw materials inventory. The entire raw materials and work in process inventory is maintained by the Company in Israel.

The Company will endeavor to take advantage of opportunities and or market conditions to increase the volume of raw materials purchasing in order to realize cost savings to the Company.

*Finished Goods Inventory Policy*

As a rule, the Company's policy is to manufacture products according to orders ("build to order") and not for inventory. The Company therefore does not maintain extensive inventories of its finished goods. The majority of finished goods inventory that the Company has is held by its subsidiaries.

**<u>Description of Company Policy of Warranty</u>**

The Company limits its liability for product warranty as follows:

- Most of the products sold by the Company have a 24-month warranty from the date of shipment to the customer against defects in material or workmanship, although some have a 36-month warranty.

- Batteries and software are not covered under the Company's warranty.

- The Company repairs or replaces products found to be defective in material or workmanship. The cost of fulfilling its warranty obligations includes labor required to repair the defect, material cost and return shipping and insurance costs.

- A product, even though defective, will not be covered by the Company's warranty if the product is altered, tampered with or improperly repaired or serviced by anyone other than the Company or an entity or individual approved by the Company in writing.

- Other than intentional misconduct, the Company further limits its liability by placing a maximum limit on the amount for which it can be held liable in the event of a claim for loss or damage due to a product defect, such limit being the price of the alleged defective product.

- The Company disclaims all other warranties, other than those explicitly set forth in its written agreement including, but not limited to, the warranty of merchantability or fitness for a particular purpose.

The Company's product warranty is a part of the Company's standard sales agreement. Because the Company conducts business in many countries, the enforceability of the product warranty may be governed by different countries laws.

**Regulatory Provisions**

In each country in which it does business, the Company is subject to the applicable statutes and provisions in relation to its business. These include provisions on technical safety and environmental protection, provisions concerning the reporting, registration, labeling and handling of products, labor law provisions, and industrial and occupational safety provisions. The Company's products comply with the safety standard requirements of the European Union and are entitled to be marked as "CE". Most of the Company's products also meet the safety standards set by the UL (Underwriters Laboratories), including the *infinite* product line which is in the process of obtaining UL approval, and the communication standards set by the FCC (Federal Communications Commission) in the United States.

**Insurance**

The Company and its subsidiaries have group insurance (property damage and business interruption insurance) insuring them against the physical loss or damage, including total destruction or partial damage of their plants and other property and loss resulting from interruption to operations as a result of such physical loss or damage. In addition, the Company and its subsidiaries have insurance protection under group insurance, including environmental insurance caused by an accidental occurrence and product liability insurance policies, as well as other property and liability policies. Directors' and Officers' insurance is in place on a group basis to protect all office holders, including the members of the Company's governing bodies and including all subsidiaries. In the Company's opinion, the sums insured and limits of liability under all policies provide adequate insurance protection in line with industry standards.

RESEARCH AND DEVELOPMENT, PATENTS AND TRADEMARKS

**Research and Development**

The Company considers R&D to be an essential part of its operating discipline and strategy. The Company intends to continue to invest substantial resources in R&D.

The Company conducts surveys of both its customers and the end user to solicit feedback on its products and services. In addition, the Company monitors the market, industry trends and its competitors to anticipate future functionality requirements and to develop new products and services that meet the needs of both its customers and their end users.

The R&D team is 60 people strong and is comprised of both employees and outsourced professionals with multi-disciplinary qualifications in electronics, assimilation of systems, physics, optics and software development. In addition, the Company utilizes sub-contractors from time to time to complement its in-house skills. The R&D team has developed numerous products including, the leading *infinite* wireless platform, and currently has several other product offerings in various stages of development.

The know-how and technology developed by the Company is used solely for the Company's products and services. The Company does not engage in the sale or licensing of its know-how.

**The Chief Scientist**

Certain products are developed using financing, in part, provided by the Chief Scientist of the Israel Ministry of Industry and Trade (the "Chief Scientist"), which is responsible for implementing the Israeli government's policy regarding the support and encouragement of industrial research and development within Israel.

In order to repay the amount of grants received from the Chief Scientist and in accordance with the letters of approval originally issued to Metis in 1998 and earlier, the Company pays royalties to the Chief Scientist at the rate of 2% - 3.5% of sales for those products that were developed in part or in whole with funds from the Chief

Scientist. The total royalties paid shall not exceed the amounts of the grant as linked to the U.S dollar. As of the date of this Report, the Company (and earlier Metis) received grants totaling approximately U.S.$ 1.67 million of which a total of U.S.$ 425,000 has already been refunded to the Chief Scientist.

The participation of the Chief Scientist in R&D expenses is conditioned on the fact that the R&D efforts are undertaken in Israel, unless the Chief Scientist approves another arrangement. A separate agreement is required from the Chief Scientist to transfer technologies outside of Israel, which were developed with governmental funding. These restrictions do not apply to the export for sale of products that were developed with the Chief Scientist's funds. The Company is also required to notify the Chief Scientist of any change of 25% or more in the shares of the Company and/or a change in the means of control: (1) Voting rights in meetings of the Company; (2) the right to appoint officers to the Company; and (3) the right to participate in profits of the Company. Furthermore, according to the letter of approval, any transferring of control to a foreign resident or to a foreign company requires the advanced written approval of the Research Committee of the Chief Scientist office.

**R&D Agreement**

**Intangible Assets**

*Patents*

As of the date of this Report, the Company has four registered and two pending patents.

The following is a list of patents, registered in favor of the Company and/or its subsidiaries or patents to which the Company and/or its subsidiaries has an exclusive right of use thereof as of December 31, 2007

| **The Patent** | **The Country of Registration** | **Status** | | **Expiration Date** |
|---|---|---|---|---|
| Burglary infra red detector and methods | Israel (127407)<br>United States (6,642,846) | Registered<br>Registered | Fee due 6-Dec-08<br>Fee due 4-Jul-11 | Dec 6, 2018<br>Dec 6, 2019 |
| Methods of practical implementation and sorting, mainly of a Doppler effect detector and burglary detector systems | Israel (127438)<br>United States (6,509,835) | Registered<br>Registered | Fee due 7-Dec-08<br>Fee due 21-Jul-10 | Dec 7, 2018<br>Dec 6, 2019 |
| A system and method for the detection of moving objects during burglary. | Israel (130398)<br>United States (6,348863) | Registered<br>Registered | Fee due 9-Jun-09<br>Fee due 19-Aug-09 | Jun 9, 2019<br>Aug 8, 2020 |
| Method and apparatus for detecting moving objects, particularly intrusions | United States (CIP) (6,774,791) | Registered | Fee due 10-Feb-12 | Jun 5, 2021 |
| System for remote secured operation, monitoring and control of security | United States (11/433,954) | Pending | Awaiting office action | May 15, 2026 |
| Remote configuration of security – oriented devises | United States (11/603,906) | Pending | Awaiting office action | Nov 24, 2026 |

The Company shall be able to continue with its ongoing operations and business notwithstanding the expiration or invalidity of any of the patents listed above.

*Trademarks*

EL-UK registered the trade name of "*infinite*" on March 20, 2003.

The Company has filed for the following trademarks or service marks:

- Electronics Line with logo - Madrid Protocol Countries (includes USA), China, Turkey, Norway, the Russian Federation and Bulgaria
- *infinite* – Madrid Protocol Countries (includes USA), China, Turkey, Norway, and the Russian Federation
- *infinite* Triangle Logo - Madrid Protocol Countries (includes USA), China, Turkey, Norway, and the Russian Federation
- E.L. - China
- SecTecGLOBAL – USA (SecTec Global, Inc. is a wholly owned subsidiary of the Company)
- iConnect logo –In Israel, china, European union, United state.

*Domain Names*

The Company has the following internet domain names:

- www.electronics-line.com,
- www.electronics-line.co.il,
- www.electronics-line.co.uk,
- www.electronics-line.eu,
- www.elecline.com,
- www.sectecglobal.com,
- www.el-usa.com,
- www.espuk.com,
- www.sectecusa.com,
- www.sectecus.com,
- www.setecglobal.net,
- www.sectecglobal.org,
- www.el3000.com.cn.
- www.infinitebroadband.net/

**OPERATING AND FINANCIAL REVIEW for 2008**

**General Results Review**

The Company is facing internal and external challenges due to the recent developments in the global economy. These global economic developments and new challenges have affected the Company's 2008 results; mainly the results of Q4 2008.

The Company's US subsidiary has been undergoing a transition phase severely influencing the Company's 2008 results as well as the US subsidiary's cash and cash-flow situation. The Company is taking the necessary measures to address this issue and prevent further losses. . In addition the Company believes that in the midst of the global economic crises, conservatism is needed, therefore the company has decided to increase the provision for slow moving inventory by US$300,000.

The provision for bad debts was also increased by US$240,000 in order to account for potential losses due to potentially reduced customer creditability.

The Company decided to write off US$521,000 in a deferred tax asset, most of it resulting from the consolidation of that asset from the US subsidiary, taking into account the developments in global markets over the past few months. The management believes that this write off is necessary, due to the current economic situation of the US subsidiary; the Company may be able to use this deferred tax asset based on expected profit levels.

In light of the global situation, the Company has been implementing an efficiency plan from December 1st 2008, which mainly will affect 2009 results.

The Company's revenues in the Reported Year amounted to US$ 36.4 million, compared to revenues of US$ 34.4 million for 2007. The Company's 2008 increase in revenues is mainly attributed to a 29% increase in sales from the Company's headquarters. However, revenues from the Company's U.S. subsidiary were significantly lower than in 2007.

Gross margins in the Reported Year amounted to 36% compared to gross margins of 39% in the comparable year. The reduction in the Gross margin is due to the Company's decision to increase the provision for slow moving inventory by US$300,000, the changes in the exchange rates and reclassification of freight according to international accounting policies, and the above mentioned transition of the Company's US subsidiary.

Gross margins in the Reported Year amounted to 36% compared to gross margins of 39% in the comparable year. The reduction in the gross margin is due to changes in the exchange rates and reclassification of freight according to international accounting policies, and the above mentioned transition of the Company's US subsidiary.

The gross profit in the Reported Year amounted to US$13.1 million compared to US$13.3 million for the fiscal year of 2007.

Changes in exchange rates, mainly a 13% devaluation of the US Dollar against the New Israeli Shekel (average value of 3.58 NIS per $ during the Reported Year, compared to 4.1 NIS per $ for the comparable year of 2007), resulted in an erosion and created much pressure on expenses in general and on the gross margins in particular.

Research and development costs and know-how, amounted to US$3.6 million compared to US$2.0 million for the year 2007. The increase in expenses is due to two main reasons: firstly, the strengthening of the R&D team with new, highly qualified staff, which will allow the Company to continue developing new solutions and remain at the forefront of the market, quickly reacting to emerging market demands; secondly, a new Company policy, announced during the final quarter of 2007, to no longer capitalize R&D expenses. Q1 2008 was the first quarter in which these costs were expensed directly to the R&D expenses account.

Sales and marketing expenses amounted to US$7.4 million during the Reported Year and US$8.6 million for 2007. The main reduction is driven by reclassifying of the freight according to the international accounting policies, and reduction in travel expenses. The Company continues to develop and expand its marketing and sales capabilities with a focus on targeting strategic customers.

General and administrative expenses amounted to US$3.3 million during the Reported Year and to US$2.6 million for 2007. The increase in the Reported Years mainly derives from an increase in salaries and related expenses.

The Company’s operating loss amounted to US$1.2 million during the Reported Year, compared to an operating loss of US$ 6.1 million (US$48,000 excluding the US$6.1 million impairment of intangible assets) for 2007.

Financing and other expenses, net amounted to US$1.0 million during the Reported Year, compared to US$1.4 million for 2007.

Part of these costs, as well as payments in NIS to local suppliers, have been hedged against the US Dollar from the middle of the second quarter. Nevertheless the influence of the strengthening of all currencies against the US Dollar negatively influenced operating loss.

Loss before taxes on income amounted to US$ 2.2 million during the Reported Year, compared to a US$ 7.5 million loss for 2007 (US$ 1.4 million loss excluding the US$ 6.1 million expense for impairment of intangible assets).

Tax expense amounted to US$ 704,000 during the Reported Year, compared to US$ 194,000 tax benefits for 2007. As mentioned above, the Company has decided to write off US$ 521,000 of a deferred tax asset, most of it resulting from the consolidation of the US subsidiary, taking into account the developments in global markets over the past few months. The management believes that this write off is necessary due to the current economic situation of the US subsidiary. As the market situation improves, the Company may be able to use this deferred tax asset based on expected profit levels.

The Company ended the Reported Year with a net loss of US$ 2.9 million, compared to a US$ 7.3 million loss (US$1.1 million loss excluding the US$6.1 million expense for impairment of intangible assets) for 2007.

## Move from Prime Standard to General Standard

Following the Board resolution dated February 8th 2009 to move from the Prime Standard to the General Standard, the Deutsche Boerse has announced Electronics Lines 3000's revocation from the Prime Standard on March 17th 2009.

The revocation does not affect the admission to the regulated market (General Standard). It has the objective of reducing the costs and the administration efforts associated with the listing and will take effect three months after the announcement of the revocation by the executive of the German Stock Exchange in the internet on www.deutsche-boerse.com. i.e – June 18th 2009.

On June 18th 2009, all Electronics Line 3000 shares will be traded on the General Standard for the first time.

## The Company's Financial Position

The Company's cash and cash equivalents as of December 31, 2008 (hereinafter: "the Reported Date") were US$ 2.3 million, compared to US$ 3.1 million on December 31, 2007.

The Company's trade receivables on the Reported Date were US$ 6.6 million, compared to US$ 8.3 million on December 31, 2007.

The Company's prepaid expenses, other accounts receivables, advance payments to suppliers and income tax receivables on the Reported Date were US$ 1.4 million, compared to US$1.3 million on December 31, 2007.

The Company's inventories on the Reported Date were US$ 6.7 million compared to US$ 8.6 million on December 31, 2007.

Net investment in non-current assets, less amortization, on the Reported Date amounted to US$ 4.7 million, and a US$5.8 million investment on December 31, 2007, comprising of the following:

- Net investment in property, plant and equipment less amortization was US$ 4.4 million on the Reported Date, compared to US$ 5.0 million on December 31, 2007.
- Deferred taxes were US$ 215,000 as of the Reported Date, compared to US$ 788,000 on December 31, 2007.
- Security deposits were US$ 86,000 as of the Reported Date, compared to US$ 85,000 on December 31, 2007.

The short term credit balance from banks and others on the Reported Date amounted to US$ 8.1 million, compared to US$ 9.8 million on December 31, 2007.

The Company's trade payables as of the Reported Date were US$ 4.0 million compared to US$ 4.1 million on December 31, 2007.

Other current liabilities, accrued expenses and income tax payable were US$ 2.5 million, compared to US$ 2.8 million on December 31, 2007.

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Long term loans were US$ 77,000 on the Reported Date compared to US$ 85,000 on December 31, 2007.

## Financial Ratios

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Current Ratio | 1.1 | 1.3 |
| Quick Ratio | 0.7 | 0.8 |

## Cash Flow

During the Reported Year, net cash provided by operating activities was US$ 1.8 million compared to US $974,000 used during the entire year of 2007. Most of the increase in cash provided by operating activities derives from the decrease in inventories, a decrease in current liabilities and a decrease in trade receivables.

During the Reported Year, the Company directed US$ 365,000 towards investment activities, compared to US$ 1.5 million during the entire year of 2007.

During the Reported Year, cash used in financing activities amounted to US$ 2.1 million, compared to US$ 2.7 million that were provided in financing activities during the fiscal year of 2007.

## Financing Sources

Shareholders' equity as of December 31, 2008 amounted to US$ 5.9 million, a ratio of 27 % to the total balance sheet, compared to US$ 9.7 million and 36%, respectively, as of December 31, 2007.

On December 31, 2008, short and long term credit from banks and other creditors designated for financing working capital and investments in fixed assets and rental property was US$ 14.8 million, compared to a credit balance of US$ 16.9 million on December 31, 2007.

### General Israeli Tax Law Information

The provisions of the Israeli *Income Tax Law (Inflationary Adjustments), 1985* apply to the Company. Various adjustments, required under this law, are intended to adjust the results for tax purposes from par value into real values.

The Company is an industrial company in accordance with the Israeli *Encouragement of Industry Law (Taxes), 1969*, and therefore it is entitled to the benefits stated by law, the principal benefit of which is a deduction in depreciation according to increased rates and permitting deduction of expenses of the issuing of shares registered for trade on the stock exchange.

The Company is entitled to various tax benefits based on its status as an "Approved Enterprise" in accordance with the *Encouragement of Capital Investments Law, 1959.*

Up until December 31, 2003 the normal tax rate applying to the income of the Company (which is not entitled to benefits due to an "Approved Enterprise") was 36%. In July 2004, the Law for the Amendment of the Income Tax Ordinance was published in the official gazette of the State of Israel and provided that the rate of taxation for companies shall gradually decrease as follows: in 2004 – 35%, in 2005 – 34%, in 2006 – 32%, and in 2007 and henceforth – 30%.

On July 25, 2005, the Knesset (Israeli Parliament) passed the Law for the Amendment of the Income Tax Ordinance (No. 147), 2005, which provides for a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

Final tax assessments have not yet been issued to the Company.

**Law for the Encouragement of Capital Investments, 1959**

Under the Income Tax (Inflationary Adjustments) Law, 1985, the Company's results for tax purposes are measured in accordance with the changes in the Israeli CPI.

In February 2008, the "Knesset" (Israeli parliament) passed the Income Tax (Inflationary Adjustments) Law (Amendment No. 20), 2008, which limits the scope of the Income Tax (Inflationary Adjustments) Law starting 2008. Pursuant to the amended law and under the transition provisions prescribed therein, the adjustment of results for tax purposes to the changes in the Israeli Consumer Price Index ("CPI") will be discontinued starting 2008 and the results will be measured in nominal values, excluding certain adjustments for changes in the CPI carried out up to December 31, 2007. The amended law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting 2008.

**Tax benefits under the Israeli Law for The Encouragement of Industry (Taxes), 1969:**

The Company is an "industrial company" as defined by the Israeli Law for the Encouragement of Industry (Taxes), 1969 and, as such, is entitled to certain tax benefits, primarily accelerated depreciation and the right to claim public offering expenses as a deduction for tax purposes.

**Tax benefits under the Israeli Law for The Encouragement of Capital Investments, 1959:**

Metis was accorded the status of an Approved Enterprise under the Israeli Law for Encouragement of Capital Investments, 1959. On December 31, 2002 (see Note 1), the benefits deriving from this status were transferred to the Company. These benefits include an exemption from income taxes on income from the Approved Enterprise for a period of four years beginning with the first year in which it reports taxable income (started in 2000) and a reduced tax rate of 25% for the following three years (starting 2004).

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above law, regulations published there under, and the instruments of approval for the specific investments in "Approved Enterprise". In the event of failure to comply with these conditions, the benefits may be canceled, and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2008, management believes that the Company is meeting all of the aforementioned conditions.

**Approved Enterprise Status**

The Offices of the Israeli Chief Scientist

The Company is obligated to pay royalties of 2% -3.5% of the revenues from products in the development of which the Chief Scientist participated. The royalties are limited to the amount of the grant received, linked to the U.S dollar. Total grants received as of December 31, 2008 and 2007 amounted to approximately $ 1,670 and the balance of contingent royalties amounts to approximately $ 1,238 and $ 1,239, respectively.

Under the conditions of an agreement for participation by the Bi-National Fund for Research and Development (BIRD) in joint R&D programs between the Group and a U.S. company, BIRD granted grants to the Group. In consideration for this grant, BIRD is entitled to royalties of between 2.5% and 5% of the gross sales of products resulting from this research, up to the amount of the grant, linked to the U.S dollar. Thereafter, BIRD will be entitled to royalties of 2.5% of sales up to an additional amount equaling half of the grant received. On January 1, 2003, the benefits and the obligations deriving from this agreement were transferred to the Company from Metis. The grants received by the Company and the balance of contingent royalties as of December 31, 2008 and 2007 amounted to approximately $ 340.

It was also agreed with BIRD that should one of the companies register a patent on a product developed, the Group will also pay royalties to BIRD at the rate of 1.5% of the gross sales of the product resulting from the research, for the duration of the patent.

The benefits under the Encouragement of Capital Investments Law are conditional upon compliance with conditions set out in that law and in the Letters of Approval in accordance with which the investments were made in the approved enterprises. Non-compliance with the conditions may lead to a cancellation of the benefits, in whole or in part, and to the repayment of the amounts of the benefits with interest. In the opinion of the management of the Company, the Company is in compliance with the aforesaid conditions.

A dividend that is distributed from the income of an approved plant is liable for tax at a rate of 15% by the recipient thereof, including by a company that is resident in Israel (unless its recipient is entitled under an international convention to a lower rate of tax). If a dividend is distributed from exempt income from an approved enterprise, the Company, although previously exempt, will be liable for tax, which it received an exemption from paying, on the amount of the grossed-up dividend which will be distributed, and this is in addition to the tax at the rate of 15% that is payable when the dividend is distributed.

The Company believes that its Approved Enterprises currently operate in compliance with all applicable conditions and criteria, but there can be no assurance that it will remain in compliance in the future.

# Additional information/additional balance

No event has occurred since December 31, 2008 which may have a major impact on the company’s activities.

# Risk report

**Risks related to the Company**

*Dependence on Sub-contractors*

The Company depends on sub-contractors who perform research and development services, quality assurance testing and prepare production files on its behalf. In the event that the relationship with any of the sub-contractors is terminated, the Company may incur a delay in developing new products and in producing and supplying its products until such time as the Company is able to locate and establish a relationship with alternative sub-contractor(s) or alternatively, perform such work in-house. Additional time would be needed before such new sub-contractor(s) or internal personnel could render effective development services and prepare production files previously provided by the original sub-contractor(s). This time delay could affect the Company’s ability to launch new products or introduce new versions of products in a timely manner which could adversely affect the Company’s market share. In addition, any arrangement with a new sub-contractor or a decision to perform any such work in-house may increase the Company’s costs and affect its gross margins.

*The Dependence on Integrators, Service Providers, Distributors and Installers of Systems*

Currently, the Company does not typically sell its solutions to end users. The Company’s traditional customers are integrators, service providers, distributors and installers of systems. Therefore, the Company is dependent, and has little control over, the customers who are, in fact, third-party installers of the Company’s products. The Company has virtually no contact with end users of the product. The Customers are responsible, for the most part, for the sale, installation and technical support of the Company’s products with the end user. Due to this extended channel of distribution, the business results of the Company could be significantly harmed through changes in the business conditions of the Customers which are beyond the ability of the Company to control. Installation and/or service problems could arise that might affect the sale of products to end users and because the Company does not perform the installation or service of its Products at the end user facility, it might be difficult for the Company to positively impact or resolve such issues between the Customer and the end user. Furthermore, the Company may not be able to preserve its current relationships or to develop new relationships with different Customers. Any such change in its relationships with Customers is liable to significantly harm the business affairs of the Company, affect the Company's sales and its financial condition and business results.

*Dependence on Key Customers*

The Company's sales to its largest four customers accounted for approximately 29.5% of its total revenues in 2008and approximately 24.9% of its total revenues during 2007. The Company does not have long-term purchase contracts with its customers, and sales arrangements with some of these customers do not have minimum purchase requirements. The Company cannot assure that these major customers or any other customer will continue to purchase its products at all or in the same volumes or on the same terms as they have in the past. Their failure to do so may significantly reduce the Company's revenues.

*Delay or Discontinuation of the Supply of Raw Materials*

Currently, the Company receives sales forecasts from the majority of its customers. Based on these sales forecasts and incoming orders, the Company purchases raw materials needed for production. The Company generally maintains a sufficient inventory of long-lead time items in order to meet its production schedule. The Company does purchase several components from a sole source supplier. This makes the Company dependent on a single supplier. In the event the sole source supplier ceases to supply the Company or materially raises its price, or the Company incurs substantial delay in delivery, the Company may need to seek a new supplier for these components. The search process can be time consuming, costly, and could potentially delay production until the new suppliers components are tested and approved.

There may be a delay in supply of, or a shortage of, raw materials or component(s) that could impede or delay the production of the Company's products, particularly with respect to raw materials supplied by a sole source supplier. The Company may be unable to quickly locate alternative sources for needed components at reasonable prices and at the time needed to meet the Company's production cycle. In the event of i) a delay in supply, or ii) shortage of raw materials, customers may cancel their orders or turn to the Company's competitors to fill their orders. In addition, in the event the Company is compelled to find new sources of supply, this could cause delay in shipments of its products, which could increase its costs in order to meet the Company's commitments to its customers.

The Company may choose to maintain inventories of certain components that exceed what is necessary for the short term in order to have a small buffer stock to compensate for shortages or cessation in the supply of components. In such event, the Company will incur additional costs to maintain this excess inventory, which could affect its gross margins.

*Changes in Rates of Exchange*

At certain points in time, the financial statements can be exposed to fluctuations created due to the fact that some of the financial balances are linked to different currencies other than the U.S. dollar as opposed to the financial statements of the Company, which are denominated in U.S. dollars. In the event of depreciation in the U.S. dollar vis-à-vis other currencies, the Company will incur additional financial expenses, which would have a negative impact on the Company's operations and its financial condition. The Company endeavors to mitigate its exposure to such currency fluctuations by entering into transactions in different currencies with customers and suppliers.

In addition, the Company is exposed to exchange rate fluctuations between the U.S. dollar and other currencies, which may negatively affect its earnings. A substantial majority of the Company's revenues are denominated in U.S. dollars; however, a significant portion of the expenses associated with the Company's Israeli operations, including personnel, are incurred in NIS. The Company cannot predict any future trends in the exchange rates of the NIS against the U.S. dollar. In addition, exchange rate fluctuations in currency exchange rates in countries other than Israel where the Company operates may also negatively affect the Company's earnings. These currencies currently include the Euro and the British Pound.

The Company has established certain hedging policies to protect itself against the impact of currency fluctuations going forward.

*Intellectual Property*

The Company's ability to protect its proprietary technology is critical to the Company's future. The Company relies on a combination of patent, copyright, trademark and trade secret laws in order to protect its intellectual property rights. The Company currently has been issued four patents and has filed an additional provisional patent.

The process of seeking patent protection can be long, expensive and sometimes unsuccessful. Therefore, the Company has chosen to file for protection of its intellectual property in certain selected markets, although not in all markets in which the Company sells its products. There can be no assurance that the Company's pending or future patent applications will result in patents being issued or that the Company's existing patents or any future patents which may be granted will provide meaningful protection or commercial advantages to the Company. A patent only affords partial protection to intellectual property as much depends on the climate of enforcement within the country granting the patent. In addition, any issued patent may be challenged, invalidated or legally (or illegally) circumvented by third parties, and the Company cannot be certain that its patents will be upheld as valid, be enforceable or prevent the development of competitive products. Moreover, the Company sells and markets its products in some countries; *e.g.*, China, with potentially weak enforcement of intellectual property rights. If competitors are able to develop, manufacture and sell products that directly compete with the Company's products, the Company's sales and gross margins could be adversely affected.

In addition, competitors could purchase one of the Company's systems and attempt to replicate some or all of the competitive advantages the Company derives from its development efforts or design around the Company's protected proprietary technology or develop their own competitive technologies that fall outside of the Company's protected intellectual property rights. If the Company's intellectual property is not adequately protected against use by competitors and other third parties, its competitive position could be eroded and its business could be adversely affected.

In addition to the risks of third-party infringement of the Company's intellectual property, there is also the risk that the Company may inadvertently and innocently infringe on the intellectual property of a third party, which would expose the Company to possible patent infringement claims which are often lengthy and costly disputes. The Company may be required to obtain licenses from third parties or otherwise redesign its products so as not to utilize such intellectual property, which may be uneconomical or otherwise impossible.

*Risks Pertaining to Product Liability and Product Warranty*

The products developed by the Company may contain latent defects that may only be discovered after the products have been installed and are in use. Such defects could cause a reduction in the satisfaction of customers, harm the reputation of the Company or the need to introduce costly changes to the product. In addition, the Company could be exposed to potential product liability claims. This could involve significant costs to the Company. Although the Company has a Corporate General Liability insurance policy, this policy does not cover costs the Company may incur to change the product, and there is no guarantee that the Company's insurance policy will fully cover any and all types of claims pertaining to product liability or afford coverage to the full extent of such claims that may be filed against the Company.

The Company provides a limited product warranty for the use and operation of its products, many of which also contain components manufactured by third parties. In effect, the Company is warranting components which it does not manufacture. This could give rise to a situation whereby the Company provides a more extensive warranty on these third party components than the Company receives from such third party manufacturers, thus creating some warranty exposure for the Company.

*Marketing and Product Risk*

The Company spends significant time and money to understand the needs of the market; however, the Company may misjudge market needs. The Company may design products and solutions that do not meet market demands or are not priced correctly or are not delivered to the market in a timely manner. For example, the Company may develop complementary products for its security solution with remote management capability that the market determines is not necessary. In case this event happens, the Company's costs would increase without a corresponding increase in revenues. This may have a negative impact on the Company's operations and its financial condition.

*International Markets*

The Company sells its products globally, primarily in Western Europe, the United States and Asia. As a result of operating internationally, the Company may face the following risks due to its international operations, any one of which may affect sales or the Company's profitability:

- Changes in governmental requirements and regulations and differences in various country's requirements;
- Difficulty in collecting accounts receivables;
- Differences in customs in each country;
- Differences in taxation in different countries;
- Political and/or economic instability;
- Disruption in trade caused by civil disturbances and/or war;
- Local labor strikes that affect the Company's ability to sell or deliver products in a particular country; and
- Weakening economies in target markets.

*Additional financing.*

In order to operate the business, we may need to obtain additional surety bonds, maintain working capital, or make significant capital expenditures. In order to do any of those things, we may need to obtain additional capital. Therefore, our ability to operate and grow is dependent upon, and may be limited by, among other things, the availability of financing arrangements. If we are not able to obtain the additional capital necessary to pursue new projects or maintain our operations, we may not be able to grow as quickly as we plan. In addition, even if we are able to obtain additional financing, the additional financing may not be on terms which are favorable to us and could hamper our profitability. In addition our customers are experiencing a slowdown in sales and are stretching their payables and this, in turn, affects our sales and cash flow

## Risks Related to the Industry

*Changes in Prices of Raw Materials*

The raw materials of the Company (mainly electronic, metal and plastic components) are purchased from various suppliers throughout the world. The capacity, supply and demand for such raw materials is subject to cyclical forces and market factors as well and may fluctuate significantly and, as a result, the Company may have limited ability to control its costs in securing raw materials. In addition, prices of raw materials may be subject to fluctuation. The Company cannot assure that it will be able to pass on to customers the increased costs associated with the procurement of raw materials. To the extent that increases in costs of raw materials cannot be passed on to customers or there is a delay in passing on the increased costs to customers, the Company is likely to absorb the increase in the cost of raw materials which may materially reduce its margin of profitability.

*Delay or Discontinuation of the Supply of Raw Materials*

Currently, the Company receives sales forecasts from the majority of its customers. Based on these sales forecasts and incoming orders, the Company purchases raw materials needed for production. The Company generally maintains a sufficient inventory of long lead-time items in order to meet its production schedule. The Company does purchase several components from a sole source supplier. This makes the Company dependent on a single supplier. In the event the sole source supplier ceases to supply the Company or materially raises its price, or the Company incurs substantial delay in delivery, the Company may need to seek a new supplier for these components. The search process can be time consuming, costly, and could potentially delay production until the new suppliers components are tested and approved.

There may be a delay in supply of, or a shortage of, raw materials or component(s) that could impede or delay the production of the Company's products, particularly with respect to raw materials supplied by a sole source supplier. The Company may be unable to quickly locate alternative sources for needed components at reasonable prices and at the time needed to meet the Company's production cycle. In the event of (1) a delay in supply, or (2) shortage of raw materials, customers may cancel their orders or turn to the Company's competitors to fill their orders. In addition, in the event the Company is compelled to find new sources of supply, this could cause delay in shipments of its products, which could increase its costs in order to meet the Company's commitments to its customers.

The Company may choose to maintain inventories of certain components that exceed what is necessary for the short term in order to have a small buffer stock to compensate for shortages or cessation in the supply of components. In such event, the Company will incur additional costs to maintain this excess inventory, which could affect its gross margins.

*Competition and Pressure to Develop New Products*

The Company participates in a competitive market environment. Competition, whether direct or indirect, may adversely affect the income and profits of the Company through pressure exerted on prices, the loss of market share or other factors. Some of the Company's current and potential competitors are large companies or conglomerates that have vast resources (including abilities in the fields of finance, technology, production, marketing and distribution), including, for example, General Electric, Tyco, Bosch and Honeywell. The Company may not be able to position its solutions as distinct from those of its competitors or be able to invest the same amount of resources in order to penetrate the market or successfully develop and introduce new products at the same pace of its competitors. These large competitors may also be able to respond quickly to the Company's marketing or technological initiatives due to their vast resources, which would materially affect the Company's competitive position and its ability to increase its sales.

In addition, new competitors, such as service providers, utility companies, cable companies, and non-security distributors, may enter into the competitive market in which the Company operates.

The Company's products deal with evolving technology. The Company must continually invest in product development in order to stay on the cutting edge of technology in its market and secure its market position. The Company's sales may be affected by newer technologies offered by competitors that are not available from the Company.

**Risks Related to Israel**

*Dependence on Governmental Programs and Tax Benefits*

Pursuant to the *Encouragement of Capital Investments Law*, 1959, the Company is obligated to continuously fulfill certain requirements, including the receipt of additional approvals for the execution of certain investments in fixed assets, employing a certain number of employees and maintaining a certain level of exports from its total sales. The Company has received a formal approval which indicates that it has met all necessary terms and requirements with respect to its current approved plans. However, if the Company fails to meet such requirements, the benefits may be cancelled and the Company may be required to return to the State of Israel taxes and other receipts, plus interests tied to the Israeli consumer price index.

In connection with the private placement in July 2005, the Company on November 6, 2005, obtained approval of the private placement from the Investment Center of the Ministry of Industry, Trade and Employment of the State of Israel which is the branch of the Ministry which implements and coordinates the *Encouragement of Capital Investments Law, 1959* (the "Investment Center"). In addition, the Company has taken steps to obtain approval of the sale of New Shares and the Over-allotment Shares contemplated in this Report by the Investment Center of the Ministry of Industry and Trade. In the event the Investment Center does not approve the sale of shares contemplated by this Report, the Company may be required to return all benefits that it has received from the Investment Center.

Any changes or reductions of certain programs and tax benefits that currently benefit the Company, especially those available as a result of the Company's "Approved Enterprise" status, would increase the Company's tax rate up from 31% to the full rate of taxation applicable to companies in Israel, which is currently 34%, which would adversely affect the Company's profitability.

*Chief Scientist*

Certain of the Company's products are developed using financing, in part, provided by the Chief Scientist of the Israel Ministry of Industry and Trade (the "Chief Scientist"), who is responsible for implementing the Israeli government's policy regarding the support and encouragement of industrial research and development.

The participation of the Chief Scientist in R&D expenses is based on certain conditions, unless the Chief Scientist approves a different arrangement (see page 26).In the event the Company does not comply with the terms of the Chief Scientist grants, the Company may be required to return the grants, which may have a material adverse effect on the Company.

*Security, Political and Economic Instability in Israel*

The principal offices of the Company are located in Israel. Accordingly, security, political and economic conditions in Israel may directly affect the Company's business. Over the past several decades, a number of armed conflicts have occurred between Israel and its neighbors. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect the Company's operations. Since October 2000, terrorist violence in Israel increased significantly, primarily in the West Bank and Gaza Strip. Thus far in 2005, there has been a noticeable decline in terrorist activity. Israel's recent unilateral withdrawal from the Gaza Strip has stimulated the local economy and opened potential contacts with countries which had no previous diplomatic contact with Israel. However, the ongoing hostilities and violence, future armed conflicts, political developments in other countries in the region or continued or increased terrorism could disrupt the Company's operations or make conducting the Company's operations in Israel more difficult. Any of these factors could have the effect of increasing the Company's costs, adversely affecting the Company's financial results and the expansion of the Company's business and delaying deliveries to Customers.

Furthermore, several countries continue to restrict business with Israel, in general, and with Israeli companies, in particular, which may limit the Company's ability to make sales to these countries. These boycotts and embargos may have an adverse impact on the operations, financial condition or the further expansion of the Company's business.

*Reserve Military Service in Israel*

Unless exempted, all male, adult Israeli citizens that served in the Israeli armed forces and meet certain age restrictions are obligated to perform annual military duty for a period of several weeks. Additionally, they can be called to active duty at any time under emergency circumstances. Should the hostilities in the region escalate, some of the Company's employees could be called to active military duty possibly resulting in interruptions in the Company's business and operations. Any disruption to the Company's operations could harm its business.

*Labor Strikes*

During 2008, a general strike at Israel's ports caused a shortage of raw materials and also resulted in a delay in the Company's shipments to customers, resulting in increased operating costs. Although earlier this year a privatization of the Israeli sea ports was instituted, a further strike or labor disruption at Israel's ports may still have an adverse effect on the Company's business.

**Global Risks**

*The volatility and disruption of the capital and credit markets and adverse changes in the economy may negatively impact our ability to access financing, and to generate revenues and earnings.*

The capital and credit markets have been experiencing extreme volatility and disruption for more than 12 months. In the third and fourth quarters of 2008, such volatility and disruption have reached unprecedented levels. The markets have exerted downward pressure on availability of liquidity and credit capacity for many issuers, including us.

While we intend to finance our operations with existing cash, cash flow from operations and borrowing under our existing senior credit facility, we may require additional financing to support our continued growth. However, due to the existing uncertainty in the capital and credit markets, access to capital may be limited on terms acceptable to us, or unavailable. Our customers may also come under greater budgetary pressure as a result of economic and financial market conditions, which could negatively impact our cash revenues and earnings.

# Outlook

*Future Projections*

Going forward, the Company expects an increase in revenues from its strategic markets, in particular, Northern and Western Europe, Latin America and China. In these locations, the Company intends to address non-traditional marketing channels, in addition to the traditional security channels. Non-traditional marketing channels include utility companies, cable providers, telcos and other service providers.

The Company plans to focus on its new iConnect product line that will support a wide range of solutions and services that the Company offers to its customers. The Company believes that the new solution will be well received in the market place.

The Company is undergoing a strategic transition, becoming a provider of integrated security and control solutions while developing a strong value proposition for large-scale business partners. The Company will continue this shift from working with traditional security distribution channels to a new focus on prominent service providers and value-added resellers.

Among its goals, the Company will also continue its efforts to obtain and maintain international standard approvals for its products.