



Financial Statements

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MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2004
IN U.S. DOLLARS

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Management's Discussion and Analysis

A. Operating Results

The following discussion and review of our results of operating, financial conditions and prospects contains various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and within the Private Securities Litigation Reform Act of 1995, as amended. Such forward-looking statements reflect our current view with respect to future events and financial results. Forward-looking statements usually include the verbs "anticipates," "believes," "estimates," "expects," "intends," "plans," "projects," "understands" and other verbs suggesting uncertainty. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Further, our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 3.D. "Key Information—Risk Factors" of our Annual Report on Form 20-f for the year ending on December 31, 2003. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

The following discussion of our results of operations and financial condition should be read in conjunction with our consolidated financial statements and the related notes thereto attached hereto.

General

We are engaged in the development, manufacture, marketing and sales of computerized security systems, which automatically detect, locate and identify the nature of unauthorized intrusions. We also supply video monitoring services through Smart Interactive Systems, Inc., or Smart, a subsidiary established in the U.S. in June 2001. Our products are currently used in more than 75 countries worldwide to protect national borders, airports, correctional facilities, nuclear power stations and other sensitive facilities from terrorism, theft and other threats. We have subsidiaries in the U.S., Canada, United Kingdom, Germany, Mexico, Romania and an office in China.

Economic and Other Factors

Following the terrorist attacks of September 11, 2001, heightened global security concerns have increased the demand for products such as ours, which protect aircraft, national borders and sensitive facilities from terrorism, and we have experienced an increase in inquiries from prospective customers regarding our products. Although we expect demand for our products to increase, because our products are primarily sold to government agencies, government authorities and government-owned companies, many of which have complex and time-consuming procurement procedures, we may not make major sales of our products and may not experience a significant increase in our revenues until, at the earliest, the end of 2005.

The continued state of hostility between the State of Israel and the Palestinian Authority has caused the State of Israel to increase its efforts to protect its facilities and installations from unauthorized intrusions. In 2002, the Israeli Government announced the construction of a perimeter system to seal off parts of the West Bank to prevent Palestinian terrorists from entering Israel. In September 2002, we won 80% of the bids published by the Israeli Ministry of Defense, or MOD, for the installation of intrusion detection systems along the seam line between Israel and the West Bank. We received orders having a value of approximately \$19 million to install intrusion detection systems along approximately 150 kilometers. As of December 31, 2004, this project was completed. In 2003, the Israeli Government resolved to extend the perimeter system and to continue construction along most of the remaining parts of the seam-line. However, following the UN resolution to refer the question of the legality of the seam-line perimeter systems to the International Court of Justice in Hague, an international opposition to the route selected by the Israeli government arose, causing the Israeli Government to change and shorten the route of the seam-line perimeter system. This opposition as well as certain resolutions of the Israeli Supreme Court caused a halt in the building of the seam-line fence during 2004. Recently, the Israeli government approved a new seam-line fence route. Such resolution is expected to signal the renewal of work in the southern parts of the seam-line. According to recent reports in the Israeli press, the MOD is expected to shortly publish orders for the work on the southern segments of the seam-line fence and it is widely believed that the majority of the remaining segments of the fence will be completed during 2005. Although we believe that we will participate in the new construction, we cannot assure you that Israel will follow through with its decision to build the perimeter system along the seam-line, or if such perimeter system is constructed or rebuilt, that our products will be utilized.

During 2004, we continued to incur losses relating to Smart's operations.

Business Challenges/Areas of Focus

Our primary business challenges and areas of focus include:

- continuing the growth of revenues and profitability of our perimeter security system line of products;
- enhancing the introduction and recognition of our new products into the markets;
- penetrating into new markets and strengthening our presence in existing markets; and
- succeeding in selling our comprehensive turnkey solutions.

Results of Operations

Due to the nature of our customers and products, our revenues are often generated from a relatively small number of large orders. Consequently, individual orders from individual customers can represent a substantial portion of our revenues in any one period and significant orders by any customer during one period may not be followed by further orders from the same customer in subsequent periods. Our revenues and operating results may, therefore, vary substantially from period to period. Consequently, we do not believe that our revenues and operating results should necessarily be judged on a quarter-to-quarter comparative basis.

The following table presents, for the periods indicated, certain financial data expressed as a percentage of revenues:

	Year Ended December 31,				
	2000	2001	2002	2003	2004
Revenues	100%	100%	100%	100%	100%
Cost of revenues	53	52	56	56	55
Gross profit	47	48	44	44	45
Operating expenses:					
Research and development, net	8	8	7	8	8
Selling and marketing, net	18	19	20	20	21
General and administrative	12	12	11	9	9
Award granted by principal shareholders	—	—	—	—	2
Operating income	9	9	6	7	5
Financial income (expenses), net	(1)	—	—	(2)	(1)
Income before taxes on income	8	9	6	5	4
Taxes on income	1	1	2	1	2
Net income	7%	8%	4%	4%	2%

Years ended December 31, 2004 and 2003

Revenues. Revenues increased by 2.7% to \$61 million in the year ended December 31, 2004, as compared with \$59.4 million in the year ended December 31, 2003. Revenues from sales of perimeter systems were \$46.3 million in 2004, as compared with \$51.1 million in 2003, a decrease of 9%, as a result of decrease of approximately \$10.4 million in the seam-line project, which made a major contribution to our revenues in 2003 and was halted in 2004 due to litigation in Israel. Revenues from security turnkey projects increased by 69% to \$11.4 million in 2004, as compared with \$6.7 million in 2003. One of our main projects in 2004 was the protection of the Otopeni International Airport in Romania.

Cost of revenues. Cost of revenues reached \$33.7 million in the year ended December 31, 2004, as compared with \$33.4 million in the year ended December 31, 2003. Cost of revenues as a percentage of revenues was 55% in 2004, as compared with 56% in 2003.

Gross profit. Gross profit increased to \$27.2 million in the year ended December 31, 2004, as compared with \$26.0 million for the year ended December 31, 2003, primarily as a result of our increased revenues.

Research and development expenses, net. Research and development expenses, net for the year ended December 31, 2004 were \$4.7 million, as compared with \$4.8 million for the year ended December 31, 2003, a decrease of 2%. Research and development expenses, net amounted to 7.7% of revenues in 2004, as compared with 8% in 2003. Royalty bearing grants and investment tax credits decreased to \$405,000 in 2004 compared to \$355,000 in 2003.

Selling and marketing expenses, net. Selling and marketing expenses, net were \$12.7 million for the year ended December 31, 2004, as compared with \$11.6 million for the year ended December 31, 2003, an increase of 9.4%. The increase in selling and marketing expenses in 2004 was primarily due to increased marketing and selling expenses for our newly developed products, especially the DreamBox®, and the increase in our revenues from projects, mainly our project in Otopeni International Airport in Romania. Selling and marketing expenses amounted to 20.8% of revenues in 2004, as compared with 19.5% in 2003.

General and administrative expenses. General and administrative expenses were \$5.8 million for the year ended December 31, 2004 compared to \$5.3 million for the year ended December 31, 2003. General and administrative expenses amounted to 9.5% of revenues in 2004, compared to 8.9% in 2003. The increase in general and administrative expenses was due to an \$0.2 million increase in the amortization of deferred stock compensation and an increase in expenses incurred by Smart due to a \$0.2 million increase in rent and depreciation expenses arising from its relocation to a new facility.

Award granted by principal shareholders. Award expenses granted by principal shareholders amounted to US\$1.2 million in 2004 reflecting the net award expenses paid to all of our employees by our two principal shareholders out of their personal funds in celebration of our twentieth anniversary. According to generally accepted accounting principles in the United States, such grant was recorded in our second quarter statement of income as an expense, although it did not affect our shareholders' equity nor our statement of cash flows.

Financial income (expenses), net. Financial expenses, net for the year ended December 31, 2004 were \$762,000, as compared with \$ 1 million for the year ended December 31, 2003. This decrease in financial expenses was due to the decrease in the rate of devaluation of the U.S. dollar against the Canadian Dollar and the NIS. Our major operations are located in Canada and Israel.

Years ended December 31, 2003 and 2002

Revenues. Revenues increased by 38% to \$59.4 million in the year ended December 31, 2003, as compared with \$43 million in the year ended December 31, 2002. Revenues from sales of perimeter systems were \$51.1 million in 2003, as compared with \$36.4 million in 2002, an increase of 40%. Revenues from security turnkey projects increased by 26% to \$6.7 million in 2003, as compared with \$5.3 million in 2002. Our main projects in 2003 included the installation of intrusion detection systems along the seam line between Israel and the West Bank and the protection of the Otopeni International Airport in Romania. The devaluation of the U.S. dollar against the Canadian dollar and the NIS increased by approximately \$2 million the revenues that are linked to those currencies in terms of U.S. dollars.

Cost of revenues. Cost of revenues reached \$33.4 million in the year ended December 31, 2003, as compared with \$23.9 million in the year ended December 31, 2002. Cost of revenues as a percentage of revenues was 56% in 2003, remaining at the same level as in 2002.

Gross profit. Gross profit increased to \$26.0 million in the year ended December 31, 2003, as compared with \$19.0 million for the year ended December 31, 2002, primarily as a result of our increased revenues.

Research and development expenses, net. Research and development expenses, net were \$4.8 million in the year ended December 31, 2003, as compared with \$3.1 million for the year ended December 31, 2002, an increase of 53%. Research and development expenses, net amounted to 8% of revenues in 2003, as compared with 7% of revenues in 2002. Royalty bearing grants and investment tax credits decreased to \$355,000 in 2003, as compared with \$622,000 in 2002 due to the decrease of royalty bearing grants received from the Office of Chief Scientists of the Ministry of Industry, trade of Labor, or the OCS. The increase in our research and development expenses was attributable to our development of three new products that were launched in the beginning of 2004.

Selling and marketing expenses, net. Selling and marketing expenses, net were \$11.6 million in the year ended December 31, 2003, as compared with \$8.6 million in the year ended December 31, 2002, an increase of 34%. The increase in selling and marketing expenses in 2003 was primarily due to the increase in our revenues. Selling and marketing expenses amounted to 20% of revenues in both 2003 and 2002.

General and administrative expenses. General and administrative expenses were \$5.3 million in the year ended December 31, 2003, as compared with \$4.9 million in the year ended December 31, 2002. General and administrative expenses amounted to 9% of revenues in 2003, compared to 11% in 2002.

Financial income (expenses), net. Financial expenses, net were \$1.0 million in the year ended December 31, 2003, as compared with financial income of \$199,000 in the year ended December 31, 2002. This increase in financial expenses was due to the devaluation of the U.S. dollar against the Canadian Dollar and the NIS. Our major operations are located in Canada and Israel.

Quarterly Results of Operation

The following table presents unaudited consolidated quarterly financial information for each of the four quarters for the year ended December 31, 2004. This information has been prepared on the same basis as the audited consolidated financial statements.

	(US Dollars in thousands, except per share data)				
	Q1/2004	Q2/2004	Q3/2004	Q4/2004	FY
Revenues	14,215	14,500	15,271	16,988	60,974
Cost of sales	7,945	7,990	8,443	9,347	33,725
Gross profit	6,270	6,510	6,828	7,641	27,249
% Gross profit	44.1	44.9	44.7	45.0	44.7
Operating Expenses :					
R & D – net	1,131	1,162	1,193	1,197	4,683
Selling expenses	2,621	3,076	3,031	3,951	12,679
G & A expenses	1,301	1,417	1,415	1,638	5,771
	5,053	(*)5,655	5,639	6,786	(*)23,133
Operating income	1,217	(*)855	1,189	855	(*)4,116
Financial expenses, net	93	258	223	188	762
Income before taxes	1,124	(*)597	966	667	(*)3,354
Taxes on income	437	136	303	225	1,101
Net income	687	(*)461	663	442	(*)2,253
no. shares (diluted)	8,595	8,716	8,706	8,659	8,636
EPS	0.08	0.05	0.08	0.07	0.26

* Excluding US\$1.2 million award expenses given by the major shareholders to employees.

The company's operating results may be subject to significant fluctuations in future periods. The company's operating results for any particular quarter are not necessarily indicative of any future results. The company's quarterly operating results may be subject to significant fluctuations due to various factors, including the length of the sale cycles, the timing and size, mix of products and general economic conditions.

Seasonality

Our operating results are characterized by a seasonal pattern, with a higher volume of revenues towards the end of the year. This pattern, which is expected to continue, is mainly due to two factors:

- our customers are mainly budget-oriented organizations with lengthy decision processes which tend to mature late in the year; and
- due to weather and other conditions, revenues are often postponed from the first quarter to subsequent quarters.

Impact of Devaluation on Results of Operations, Liabilities and Assets

Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results. In 2001 and 2002, the rate of devaluation of the NIS against the dollar was 9.3% and 7.3%, respectively, while in 2003 and 2004 the NIS was revaluated in relation to the dollar by 7.6% and 1.6%, respectively. A portion of our expenses, primarily labor expenses, is incurred in NIS and a part of our revenues are quoted in NIS. Additionally, certain assets especially trade receivables, as well as part of our liabilities are denominated in NIS. Our results may be adversely affected by devaluation of the NIS in relation to the dollar (or if such devaluation is on lagging basis), if our revenues in NIS are higher than our expenses in NIS and/or the amount of our assets in NIS are higher than our liabilities in NIS. On the contrary, our results may be adversely affected by the revaluation of the NIS in relation to the dollar (or if such revaluation is on a lagging basis), if the amount of our expenses in NIS are higher than the amount of our revenues in NIS and/or the amount of our liabilities in NIS are higher than our assets in NIS.

We are also subject to exchange rate fluctuations related to our activities in Canada.

During the three years ended December 31, 2004, foreign currency fluctuations had an adverse impact on our results of operations, and our foreign exchange gains (losses), net were \$478,000, (\$569,000) and (\$120,000), respectively. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

We periodically enter into foreign exchange contracts to offset the risk of currency exchange rate fluctuations in connection with certain revenues. During 2003 and 2004, we entered into forward contracts in order to hedge a portion of our forecasted revenues denominated in euro. These forward contracts are designated as cash flows hedges, as defined by SFAS No. 133, as amended, and we believe are effective as a hedge for these revenues when the revenues are recorded. The effective portion of the derivative instruments is included in revenues and in financial expenses in the statements of operations.

We expect that during the next 12 months we will reclassify \$649,000 of net losses on derivative instruments from unrealized losses on forward contracts to earnings due to actual sales and related payments.

Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. In 1979 Israel signed a peace agreement with Egypt under which full diplomatic relations were established. In October 1994 a peace treaty was signed between Israel and Jordan which provides, among other things, for the commencement of full diplomatic relations between the two countries. To date, there are no peace treaties between Israel and Syria or Lebanon.

Since 1993, several agreements have been signed between Israel and the Palestinian representatives concerning conditions in the West Bank and Gaza and outlining several interim Palestinian self-government arrangements. The implementation of these agreements have been subject to difficulties and delays.

Since September 2000, relations between Israel and the Palestinian Authority have deteriorated and there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. Recently, the Israeli government has resolved to unilaterally evacuate all the Jewish settlements in Gaza Strip, and few settlements in the West Bank. In addition, following the death of Yasser Arafat the Palestinian Authority has established new regime who vowed to take active actions against terrorism and caused all Palestinian terror organizations to co mitt to halt execution of acts of terror in Israel. Such commitment has not been completely observed. However, there is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price.

Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

In addition, some of our employees in Israel are subject to being called upon to perform military service in Israel, and their absence may have an adverse effect upon our operations. Generally, unless exempt, male adult citizens and permanent residents of Israel under the age of 40 are obligated to perform up to 36 days of military reserve duty annually and all such residents are subject to being called to active duty at any time under emergency circumstances. While we have operated effectively under these requirements since we began operations, we cannot assess the full impact of these requirements on our workforce or business if conditions should change, and we cannot predict the effect on us of any expansion or reduction of these obligations.

To date, no executive officer or key employee has been recruited for military service for any significant time period. Any further escalation of the hostilities between Israel and the Palestinian Authority into a full-scale conflict might require more significant military reserve service by some of our employees, which may have a material adverse effect on our business.

Economic Conditions

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting all banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers.

The domestic security situation in Israel and the global slowdown in demand for high-tech imports continued to be the main factors affecting economic activity in Israel in 2002 and 2003. Nevertheless, in the second half of 2003, the business sector's activity showed signs of recovery, based on the rise in export and private consumption. Toward the end of 2003, budgetary restraint was exercised as a result of the economic program. The economic program placed much emphasis on immediately reducing the deficit and on measures expected to lead to its permanent reduction, and it therefore boosted the credibility of the fiscal policy and placed the economy on a declining budget deficit path.

During 2004, the expansion of the economic activity and growth that the Israeli economy experienced since the second half of 2003 continued and unemployment decreased slightly. During this period inflation reached a rate of 1.2%, and the level expected by the Bank of Israel for the next 12 months is between 1% and 3%. Interest rates have remained level throughout the year at approximately 4.1%.

The Israeli government's monetary policy contributed to relative price and exchange rate stability in recent years, despite fluctuating rates of economic growth and a high rate of unemployment. There can be no assurance that the Israeli government will be successful in its attempts to keep prices and exchange rates stable.

Trade Agreements

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from the U.S., Australia, Canada and Japan. These preferences allow Israel to export products covered by such programs either duty-free or at reduced tariffs.

Israel and the European Union Community concluded a Free Trade Agreement in July 1975 which confers certain advantages on Israeli exports to most European countries and obligates Israel to lower its tariffs on imports from these countries over a number of years. In 1985, Israel and the U.S. entered into an agreement to establish a free trade area. The free trade area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, which includes Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinition of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

Israel receives significant amounts of economic assistance from the United States, averaging approximately \$3 billion annually over the last several years. We cannot assure you that U.S. economic assistance will continue at or near amounts received in the past. If U.S. economic assistance is eliminated or reduced significantly, the Israeli economy could suffer material adverse consequences which could have a material adverse impact on our financial condition and results of operations.

Effective Corporate Tax Rate

As of December 31, 2004 the general tax rate applicable to Israeli companies was 35% of taxable income. However, certain of our manufacturing facilities have been granted "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended, commonly referred to as the Investment Law, and, consequently, are eligible, subject to compliance

with specified requirements, for tax benefits beginning when such facilities first generate taxable income. The tax benefits under the Investment Law are not available with respect to income derived from products manufactured outside of Israel. We have derived, and expect to continue to derive, a substantial portion of our income from our Approved Enterprise facilities. Subject to certain restrictions, we are entitled to a tax exemption in respect of income derived from our approved facilities for a period of two to four years, commencing in the first year in which such income is earned, and will be entitled to a reduced tax rate of 15% to 25% for an additional three to eight years if we qualify as a foreign investors' company. If we do not qualify as a foreign investors' company, we will instead be entitled to a reduced rate of 25% for an additional five years, rather than eight years.

Our effective corporate tax rate may substantially exceed the Israeli tax rate. Our U.S. subsidiaries will generally be subject to applicable federal, state, local and foreign taxation, and we may also be subject to taxation in the other foreign jurisdictions in which we own assets, have employees or conduct activities. Because of the complexity of these local tax provisions, it is not possible to anticipate the actual combined effective corporate tax rate, which will apply to us.

As of December 31, 2004, our subsidiaries in the U.S. and the United Kingdom had total net available carry forward tax losses of approximately \$8 million. A full valuation allowance was recorded due to the uncertainty of the tax assets' future realization. Utilization of U.S. net operating losses may be subject to a substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state tax law provisions. The annual limitation may result in the expiration of net operating losses before utilization.

B. Liquidity and Capital Resources

General

Our ongoing liquidity requirements arise primarily from our need to service debt and provide working capital. From our inception until our initial public offering in March 1993, we financed our activities mainly through cash flow from operations and bank loans.

In March 1993, we received proceeds of \$9,837,000 from an initial public offering of 1,380,000 ordinary shares. In February 1997, we raised an additional \$9,440,000 from a follow-on offering of an additional 2,085,000 ordinary shares. The proceeds from these offerings together with cash flow from operations and our credit facilities are our main sources of working capital.

Our working capital at December 31, 2004 was \$21.6 million compared to \$21.4 million at December 31, 2003. Cash and cash equivalents amounted to \$12 million at December 31, 2004 compared to \$4.4 million at December 31, 2003. Short-term and long-term bank deposits and structured notes amounted to \$6 million at December 31, 2004 compared to \$12.1 million at December 31, 2003. Our cash and cash equivalents, short and long-term bank deposits and a structured note are held mainly in U.S. dollars.

We expect to fund our short-term liquidity needs, including our obligations under our credit facilities, other contractual agreements and any other working capital requirements, from cash and cash equivalents, operating cash flow and our credit facilities. We believe that our current cash and cash equivalents, including bank deposits, structured note and our expected cash flow from operations in 2005 will be sufficient to meet our planned and potential cash requirements in 2005, but we intend to raise additional equity in 2005 to fund our future growth.

Net cash provided from operating activities was \$3.7 million for the year ended December 31, 2004 compared to \$1.7 million for the years ended December 31, 2003 and net cash used from operating activities of \$1.9 million for the year ended December 31, 2002. The increase in cash from operations was primarily due to interest received on short and long term bank deposits,

payments received from trade receivable mainly from the MOD and a customer in Azerbaijan and a decrease in inventories. Purchases of property and equipment in 2002, 2003 and 2004 were \$1.5 million, \$3.2 million and \$4.9 million, respectively. Capital expenditures in 2001, 2002 and 2003 were principally for equipment for Smart, computers and other machinery and equipment.

We estimate that our capital expenditures for 2005 will total approximately \$5.5 million, of which 8% will be spent in Israel, 90% in the U.S. and Canada and 2% in other countries. We expect to finance these expenditures primarily from our cash and cash equivalents, operating cash flow and our credit facilities. However, the actual amount of our capital expenditures for 2005 will depend on a variety of factors, including general economic conditions, changes in the demand for our products and the risks and uncertainties involved in doing business in Israel.

Credit Lines and Other Debt

We and our subsidiaries currently have credit lines totaling \$33.2 million in the aggregate. As of December 31, 2004, we and our subsidiaries had approximately \$6.4 million available under our credit lines. There are no restrictions as to our use of each of these credit lines.

We agreed not to pledge any of our assets without the consent of these banks. In addition, in connection with two of these credit lines, a fixed charge was placed on our physical plant in Israel. In connection with our non-mortgage related loans we placed a \$3 million fixed charge on our deposits with the bank. Our US subsidiary has two notes payable in the aggregate amount of \$1 million, collateralized by the assets of our US subsidiary, Perimeter Products Inc., or PPI, and both have covenants that require us to maintain \$1 million in deposits at all times, otherwise the interest rate on the notes become the bank's rate plus 0.25% until the minimum deposit is maintained. We are also required to maintain tangible net worth and subordinated debt in an amount of not less than \$170,000 for one note and not less than \$100,000 for the second note. In connection with the mortgage loan, our subsidiary has granted the bank a first mortgage on its premises. In addition, we have guaranteed the full amount of this mortgage loan.

We have undertaken to maintain certain financial ratios and terms in respect of our credit lines. As of December 31, 2004, we were in compliance with these ratios and terms. If we fail to fulfill our undertakings and covenants as aforesaid, these three banks will be entitled to demand the immediate repayment of any of our outstanding indebtedness to them and may terminate our credit lines with them. Our loans under these credit lines are generally denominated in U.S. dollars. However, we may occasionally have short-term NIS-denominated loans.

Our Canadian subsidiary, has undertaken to maintain general covenants and certain financial ratios and terms in respect of its used credit lines. As of December 31, 2004, our Canadian subsidiary was in compliance with these ratios and terms.

C. Research and Development, Patents and Licenses

Government Grants

We participate in programs sponsored by the Israeli Government for the support of research and development activities. Through 2004, we had obtained royalty-bearing grants from the OCS, of \$228,000 for certain of our research and development projects.

We are obligated to pay royalties to the OCS, amounting to 3%-4.5% of revenues derived from sales of the products funded with these grants, up to 100% of the grants received, linked to the U.S. dollar and grants received after January 1, 1999 will also bear interest at the rate of LIBOR. The obligation to pay these royalties is contingent on actual sales of the products, and in the absence of such sales no payment is required.

Royalties paid to the OCS amounted to \$131,000, \$80,000 and \$61,000 in the years ended December 31, 2002, 2003 and 2004, respectively.

As of December 31, 2004, we had a remaining contingent obligation to pay royalties to the OCS in the amount of approximately \$1.9 million upon the successful sale of products developed using such research and development programs sponsored by the OCS.

The Israeli Government, through the Fund for the Encouragement of Marketing Activities, awarded us grants for overseas marketing expenses. We are obligated to pay royalties to this fund at the rate of 3% of the increase in export sales, up to the amount of the grants we received. To date, we received \$253,000 in grants from the fund and, during 2002, 2003 and 2004, we paid the fund \$53,000, \$0 and \$0, respectively, in royalties. As of December 31, 2004, we had a remaining contingent obligation to the fund of \$95,000.

Investment Tax Credit

Senstar is eligible for investment tax credits on its research and development activities and on certain current and capital expenditures. During 2002, 2003 and 2004, Senstar recognized \$304,000, \$216,000 and \$176,000, respectively, of investment tax credits as a reduction of research and development expenses.

Senstar has available investment tax credits of approximately \$436,000 to reduce future federal income taxes payable. These credits will expire at various dates from 2012 through 2014.

D. Trend Information

We cannot assure you that the MOD, IDF or any of our other major customers will maintain their volume of business with us or that, if such volume is reduced, other customers of similar volume will replace the lost business. The loss of one or more of these existing customers without replacement by a customer or customers of similar volume would have a material adverse effect on our financial results.

E. Off-Balance Sheet Arrangements

At December 31, 2004, we have guaranteed the advance payments and the performance of our work to our customers (usually government entities). Such guarantees are required by contract for our performance during the installation and operational period of projects throughout Israel and the rest of the world. The guarantees for installation typically expire soon after certain milestones are met and guarantees for operations typically expire proportionally over the contract period. Our maximum potential amount of future payments we could be required to make under our guarantees at December 31, 2004 was \$2.9 million. This figure includes guarantees of performance for our subsidiary in Germany in the amount of \$136,000. We have not recorded any liability for such amounts, as we expect that our performance will be acceptable and to date, no guarantees were exercised against us.