



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

MAGAL SECURITY SYSTEMS LTD.

We have audited the accompanying consolidated balance sheets of Magal Security Systems Ltd. (the "Company") and its subsidiaries as of December 31, 2003 and 2004, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2004. Our audits included the financial statement schedule listed in the Index at Item 2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2003 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Tel-Aviv, Israel
February 13, 2005

KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2003	2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 4,389	\$ 11,964
Short-term bank deposits	9,000	-
Trade receivables (net of allowance for doubtful accounts of \$ 187 and \$320 as of December 31, 2003 and 2004, respectively)	14,885	13,232
Unbilled accounts receivable	5,072	7,465
Other accounts receivable and prepaid expenses	3,857	3,858
Deferred income taxes	454	488
Inventories	11,777	12,702
Total current assets	<u>49,434</u>	<u>49,709</u>
LONG-TERM INVESTMENTS AND TRADE RECEIVABLES:		
Long-term trade receivables	300	344
Long-term bank deposits	-	2,994
Structured notes	3,051	3,000
Severance pay fund	1,960	2,142
Total long-term investments and trade receivables	<u>5,311</u>	<u>8,480</u>
PROPERTY AND EQUIPMENT, NET	<u>11,505</u>	<u>14,659</u>
DEFERRED INCOME TAXES	<u>335</u>	<u>186</u>
INTANGIBLE ASSETS, NET	<u>713</u>	<u>656</u>
GOODWILL	<u>4,145</u>	<u>4,286</u>
Total assets	<u>\$ 71,443</u>	<u>\$ 77,976</u>

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

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands (except share and par value data)

	December 31,	
	2003	2004
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit	\$ 12,597	\$ 15,618
Current maturities of long-term debt	3,841	1,849
Trade payables	5,077	3,189
Other accounts payable and accrued expenses	6,518	7,450
	28,033	28,106
TOTAL CURRENT LIABILITIES		
LONG-TERM LIABILITIES:		
Unrealized losses on hedging forward contracts	561	650
Long-term debt	1,873	3,500
Accrued severance pay	1,992	2,172
	4,426	6,322
TOTAL LONG-TERM LIABILITIES		
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital:		
Ordinary shares of NIS 1 par value:		
Authorized: 19,748,000 shares at December 31, 2003 and 2004;		
Issued and outstanding: 8,035,779 and 8,672,448 shares at December 31, 2003 and 2004, respectively		
	2,683	2,825
Additional paid-in capital	24,098	32,526
Deferred stock compensation	-	(477)
Accumulated other comprehensive income	479	1,639
Retained earnings	11,724	7,035
	38,984	43,548
TOTAL SHAREHOLDERS' EQUITY		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 71,443	\$ 77,976

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

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF INCOME

U.S. dollars in thousands (except per share data)

	Year ended December 31,		
	2002	2003	2004
Revenues	\$ 42,966	\$ 59,361	\$ 60,974
Cost of revenues	23,924	33,378	33,725
Gross profit	19,042	25,983	27,249
Operating expenses:			
Research and development, net	3,128	4,773	4,683
Selling and marketing, net	8,642	11,585	12,679
General and administrative	4,938	5,305	5,771
Award granted by principal shareholders	-	-	1,200
Total operating expenses	16,708	21,663	24,333
Operating income	2,334	4,320	2,916
Financial income (expenses), net	199	(1,003)	(762)
Income before taxes on income	2,533	3,317	2,154
Taxes on income	645	913	1,101
Net income	<u>\$ 1,888</u>	<u>\$ 2,404</u>	<u>\$ 1,053</u>
Basic net earnings per share	<u>\$ 0.24</u>	<u>\$ 0.30</u>	<u>\$ 0.12</u>
Diluted net earnings per share	<u>\$ 0.23</u>	<u>\$ 0.30</u>	<u>\$ 0.12</u>

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

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands

	Ordinary shares	Additional paid-in capital	Deferred stock compensation	Accumulated other comprehensive income (loss)	Retained earnings	Total comprehensive income	Total shareholders' equity
Balance as of January 1, 2002	\$ 2,583	\$ 21,670	\$ (20)	\$ (1,294)	\$ 9,761		\$ 32,700
Exercise of stock options	13	125	-	-	-		138
Exercise of warrants	4	(4)	-	-	-		-
Amortization of deferred stock compensation	-	-	17	-	-		17
Comprehensive income:							
Net income	-	-	-	-	1,888	\$ 1,888	1,888
Foreign currency translation adjustments	-	-	-	288	-	288	288
Total comprehensive income						<u>\$ 2,176</u>	
Balance as of December 31, 2002	2,600	21,791	(3)	(1,006)	11,649		35,031
Declared dividend	-	-	-	-	(401)		(401)
Exercise of stock options	30	432	-	-	-		462
Amortization of deferred stock compensation	-	-	3	-	-		3
Stock dividend	53	1,875	-	-	(1,928)		-
Comprehensive income:							
Net income	-	-	-	-	2,404	\$ 2,404	2,404
Unrealized losses on forward contracts, net	-	-	-	(807)	-	(807)	(807)
Foreign currency translation adjustments	-	-	-	2,292	-	2,292	2,292
Total comprehensive income						<u>\$ 3,889</u>	
Balance as of December 31, 2003	\$ 2,683	\$ 24,098	\$ -	\$ 479	\$ 11,724		\$ 38,984
Exercise of stock options	51	916	-	-	-		967
Deferred stock compensation related to officers' options grant	-	661	(661)	-	-		-
Amortization of deferred stock compensation related to officers' options grant	-	-	184	-	-		184
Award granted by principal shareholders	-	1,200	-	-	-		1,200
Stock dividend	91	5,651	-	-	(5,742)		-
Comprehensive income:							
Net income	-	-	-	-	1,053	\$ 1,053	1,053
Unrealized gains on forward contracts, net	-	-	-	103	-	103	103
Foreign currency translation adjustments	-	-	-	1,057	-	1,057	1,057
Total comprehensive income						<u>\$ 2,213</u>	
Balance as of December 31, 2004	<u>\$ 2,825</u>	<u>\$ 32,526</u>	<u>\$ (477)</u>	<u>\$ 1,639</u>	<u>\$ 7,035</u>		<u>\$ 43,548</u>
Accumulated unrealized losses on forward contracts, net				\$ (704)			
Accumulated foreign currency translation adjustments				2,343			
Accumulated other comprehensive income as of December 31, 2004				<u>\$ 1,639</u>			

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

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2002	2003	2004
Cash flows from operating activities:			
Net income	\$ 1,888	\$ 2,404	\$ 1,053
Adjustments required to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,096	1,378	1,966
Gain on sale of property and equipment	(15)	(9)	(18)
Decrease (increase) in accrued interest on short-term and long-term bank deposits	133	(199)	657
Amortization of deferred stock compensation	17	3	184
Decrease (increase) in trade receivables	(2,861)	(4,103)	2,049
Decrease in related parties receivables	1	28	-
Decrease (increase) in unbilled accounts receivable	(2,101)	2,708	(2,373)
Decrease (increase) in other accounts receivable and prepaid expenses	(1,822)	(836)	16
Decrease (increase) in deferred income taxes	444	(88)	178
Decrease (increase) in inventories	468	(2,586)	(588)
Decrease (increase) in long-term trade receivables	705	1,210	(44)
Increase (decrease) in trade payables	786	10	(1,956)
Increase (decrease) in other payables and accrued expenses	(532)	1,727	880
Accrued severance pay, net	(72)	77	(2)
Award granted by principal shareholders	-	-	1,200
Realized losses on hedging forward contract	-	-	476
Net cash provided by (used in) operating activities	<u>(1,865)</u>	<u>1,724</u>	<u>3,678</u>
Cash flows from investing activities:			
Purchase of long-term bank deposits	(8,389)	-	(3,000)
Purchase of structured notes	-	(3,000)	-
Proceeds from sale of short-term bank deposits	7,748	3,505	8,400
Proceeds from sale of property and equipment	35	33	59
Purchase of property and equipment	(1,527)	(3,194)	(4,858)
Purchase of know-how and patents	(14)	(48)	(89)
Acquisition of the business activity of Dominion Wireless Inc.(a)	-	(902)	-
Net cash used in investing activities	<u>(2,147)</u>	<u>(3,606)</u>	<u>512</u>

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

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2002	2003	2004
<u>Cash flows from financing activities:</u>			
Short-term bank credit, net	\$ 3,911	\$ 3,098	\$ 2,895
Proceeds from long-term bank loans	-	43	-
Principal payment of long-term bank loans	(158)	(103)	(365)
Proceeds from exercise of employee stock options	138	462	967
Dividend paid	-	-	(401)
	3,891	3,500	3,096
Net cash provided by financing activities	3,891	3,500	3,096
Effect of exchange rate changes on cash and cash equivalents	(98)	252	289
Increase (decrease) in cash and cash equivalents	(219)	1,870	7,575
Cash and cash equivalents at the beginning of the year	2,738	2,519	4,389
Cash and cash equivalents at the end of the year	\$ 2,519	\$ 4,389	\$ 11,964
<u>Supplemental disclosures of cash flows activities:</u>			
(i) Cash paid during the year for:			
Interest	\$ 932	\$ 1,099	\$ 1,093
Taxes	\$ 1,415	\$ 1,544	\$ 1,164
(ii) Non-cash activities:			
Declared dividend	\$ -	\$ 401	\$ -
(a) Acquisition of the business activity of Dominion Wireless Inc.:			
Net fair value of the assets acquired at the acquisition date was as follows:			
Inventory		\$ 376	
Property and equipment		90	
Technology		436	
		\$ 902	

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 1:- GENERAL

- a. Magal Security Systems Ltd. (the "Company") and its subsidiaries (together "the Group") are engaged in the development, manufacturing, marketing and sales of complex computerized security systems used to automatically detect and deter human intrusion for both civilian and military markets. A majority of the Group's sales is generated in the U.S.A., Canada, Europe and Israel.

As for major customer data, see Note 14b.

b. Acquisition of the business activity of Dominion Wireless Inc.:

On July 1, 2003, the Company's subsidiary acquired the business activity of Dominion Wireless Inc. ("DW") for a total consideration of \$902 (including \$74 of transaction costs) paid in cash.

The Asset Purchase Agreement with DW, stipulated for additional payments to be made conditioned upon the achievement of operating income milestones during the periods ending on December 31, 2003, 2004 and 2005. Since such goals have not been met, no additional payments were due for the periods ending December 31, 2003 and 2004. Should DW reach the earn out goals as of December 31, 2005, an additional payment will become due. Such payment will be recorded as additional goodwill in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 141 "Business Combinations".

DW develops manufactures, sells and supports personal duress alarm systems that locate an individual with accuracy and reliability in correctional and other institutions. The acquisition of the business activity of DW has expanded the Company's product line offerings and enabled it to provide its customers a comprehensive range of security systems.

The acquisition was accounted for under the purchase method of accounting in accordance with SFAS No. 141, and accordingly, the purchase price has been allocated to the assets acquired based on their estimated fair values at the date of acquisition.

Based upon a valuation of tangible and intangible assets acquired, the Company's subsidiary allocated the total cost of the acquisition to the assets acquired, as follows:

	At July 1, 2003
	Unaudited
Inventories	\$ 376
Property and equipment	90
Technology	436
	<u>\$ 902</u>

The value assigned to the tangible and intangible assets has been determined as follows:

- a. DW's inventories and property and equipment are presented at current replacement cost.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 1:- GENERAL (Cont.)

- b. The value assigned to technology was determined using the Income Approach on the basis of the present value of cash flows attributable to the intellectual property over its expected future life. Technology is amortized on a straight-line basis over a period of 8 years.

The results of operations of DW have been included in the consolidated financial statements since July 1, 2003.

The following unaudited pro forma information does not purport to represent what the Group's results of operations would have been had the acquisition been consummated on January 1, 2002 and 2003, nor does it purport to represent the Group's results of operations for any future period. Pro forma results of operations for the period:

	Year ended December 31,	
	2002	2003
Revenues	<u>\$ 47,474</u>	<u>\$ 59,933</u>
Net income	<u>\$ 680</u>	<u>\$ 1,910</u>
Basic net earnings per share	<u>\$ 0.09</u>	<u>\$ 0.24</u>
Diluted net earnings per share	<u>\$ 0.08</u>	<u>\$ 0.24</u>

c. Award granted by principal shareholders:

In June 2004, two principal shareholders awarded the Group's employees an amount of net \$1.2 million. The award was allocated among the employees according to their position and seniority. The Group recorded the award expense against additional paid in capital in accordance with Staff Accounting Bulletin ("SAB") Topic 5T "Accounting for Expenses or Liabilities Paid by Principal Stockholder".

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ("US GAAP").

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that effect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

Significant portion of the Company's revenues is generated in U.S. dollars ("dollars"). Financing and investing activities including credit, loans, equity transactions and cash investments are executed in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar.

The dollar was also determined to be the functional currency of the Company's U.S. subsidiaries.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with SFAS No. 52, "Foreign Currency Translation". All transaction gains and losses from the remeasured monetary balance sheet items are reflected in the statement of income as financial income or expenses, as appropriate.

The financial statements of all foreign subsidiaries whose functional currency is their local currency, excluding the U.S. ones, have been translated into dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of income amounts have been translated using the average exchange rate for the year. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany balances and transactions including intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible into cash with original maturities of three months or less at the date acquired.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. **Short-term and long-term bank deposits:**

Short-term bank deposits are deposits with maturities of more than three months and less than one year, and presented at their cost.

Bank deposits with maturities of more than one year are included in long-term bank deposits, and presented at their cost. The deposits are in U.S. dollars and bear interest at an average rate of 2.3% and mature in 2006.

f. **Structured Notes:**

During 2003, the Company purchased structured notes ("the Notes") at par value totaling \$3 million to be settled in 2013. Under the terms of the Notes, the Notes bear interest at 10% over the first year. Thereafter, interest is determined based on six months LIBOR rates using the following formula: 10% minus two times six months LIBOR rate. The Notes are callable immediately after accumulating 12% interest payments.

The Company accounts for investment in structured notes in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and FASB Emerging Issues Task Force Issue ("EITF") No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes". Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Structured notes securities are classified as held-to-maturity since management believes the Company has the intent and ability to hold these securities to maturity and are stated at amortized cost. As of December 31, 2003 and 2004, the investments in the Notes approximate their fair market value.

g. **Inventories:**

Inventories are stated at the lower of cost or market value. The Group periodically evaluates the quantities on hand relative to historical and projected sales volumes, current and historical selling prices and contractual obligations to maintain certain levels of parts. Based on these evaluations, inventory write-offs are provided to cover risks arising from slow-moving items, discontinued products, excess inventories, market prices lower than cost and adjusted revenue forecasts. Such write-offs are included in cost of revenues.

Cost is determined as follows:

Raw materials, parts and supplies - using the "first-in, first-out" method.

Work in progress and finished products - on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

During 2002, 2003 and 2004, the Group recorded inventories write-offs in the amount of \$244, \$601 and \$224, respectively. A significant portion of the 2003 write-off was attributed to discontinued products.

h. Long-term trade receivables:

Long-term trade receivables derive from operating lease arrangements and from long-term payment arrangements.

i. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets at the following annual rates:

	%
Buildings	4
Machinery and equipment (including machinery and equipment leased to customers under operating leases)	10-33 (mainly at 10)
Motor vehicles	15
Promotional display	25-50
Office furniture and equipment	6-33
Leasehold improvements	By the shorter of the term of the lease and the life of the assets

j. Intangible assets:

Intangible assets are amortized over their useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets".

Know-how is amortized over 8 to 10 years, patents are amortized over a period of 10 years and technology is amortized over 8 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Impairment of long-lived assets:

The Group's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long- Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of a group of assets may not be recoverable. Recoverability of a group of assets to be held and used is measured by a comparison of the carrying amount of the group to the future undiscounted cash flows expected to be generated by the group. If such group of assets is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. During 2002, 2003 and 2004, no impairment losses have been identified.

l. Goodwill:

Goodwill represents excess of the costs over the net fair value of the assets of the businesses acquired. Under SFAS No, 142, goodwill acquired in a business combination on or after July 1, 2001, shall not be amortized, and goodwill acquired in prior periods ceased to be amortized since January 1, 2002.

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital for each of the reportable units. During 2002, 2003 and 2004, no impairment losses have been identified.

Differences between the balance of goodwill as of December 31, 2003 and 2004 derive from functional currency translation adjustments. The entire goodwill balance relates to the Perimeter segment.

m. Revenue recognition:

The Group generates its revenues mainly from (1) installation of comprehensive security systems for which revenues are generated from long-term fixed price contracts; (2) sales of security products; and (3) services and maintenance, which are performed either on fixed-price basis or a time-and-materials basis contracts.

Revenues from installation of comprehensive security systems are generated from fixed price contracts according to which the time between the signing of the contract and the final customer acceptance is over a period generally exceeding one year.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Fees are payable upon completion of agreed upon milestones, and subject to customer acceptance. Following customer acceptance for certain milestone and only thereafter, services could be performed for the next milestone. Such revenues are recognized in accordance with Statement of Position ("SOP") No. 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," using contract accounting on a percentage of completion method, in accordance with the "Input Method". The amounts of revenues recognized are based on the total fees under the agreement and the percentage to completion achieved.

Project costs include material purchased to produce the system, related labor and overhead expenses and subcontractor's costs. The percentage to completion is measured by monitoring costs and efforts devoted using records of actual costs incurred to date in the project compared to the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of installing and integrating security systems, a history of no collection issues, delivery and acceptance of similar services and a history of no cancellation problems, which are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract.

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

The Group believes that the use of the percentage of completion method is appropriate as the Group has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and the terms of settlement, including in cases of terminations for convenience. In all cases the Group expects to perform its contractual obligations and its customers are expected to satisfy their obligations under the contract.

Amounts recognized in advance of contractual billing are recorded as unbilled accounts receivable.

The Group sells security products to customers according to customers' orders without installation work. The customers are not entitled to return the products. Revenues from security product sales are recognized in accordance with SAB No. 104 "Revenue Recognition in Financial Statements", when delivery has occurred, persuasive evidence of an agreement exists, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

Services and maintenance are performed under either fixed-price basis or time-and-materials basis contracts. Under fixed-price contracts, the Group agrees to perform certain work for a fixed price. Under time-and-materials contracts, the Group is reimbursed for labor hours

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

at negotiated hourly billing rates and for materials. Such service contracts are not in the scope of SOP No. 81-1, and accordingly, related revenues are recognized in accordance with SAB No. 104, as those services are performed or over the term of the related agreements provided that, an evidence of an arrangement has been obtained, fees are fixed and determinable and collectibility is reasonably assured.

One of the Company's subsidiaries provides security video monitoring services. The majority of contracts executed are for a five year term and do not include terms that result in the transfer of title of the equipment to the customer. Under the contracts service is not dependent on specific equipment. The subsidiary's obligation is related to the provision of monitoring services. In accordance with EITF No. 01-08 "Determining Whether an Arrangement Contains a Lease" and SFAS No. 13 "Accounting for Leases," the service contract does not meet the definition of a lease and as such the subsidiary recognizes monthly service fees over the term of the agreement.

Deferred revenue includes unearned amounts under installation services, service contracts and maintenance agreements.

n. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principle Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," and FASB Interpretation ("FIN") No. 44, "Accounting for Certain Transactions Involving Stock Compensation," in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

The Company adopted the disclosure provisions of SFAS No. 148 "Accounting for Stock-Based Compensation transition and disclosure", which amended certain provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation, effective as of the beginning of the prior fiscal year. The Company continues to apply the provisions of APB No. 25 in accounting for stock-based compensation.

Proforma information regarding net income and net earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

The fair value for options granted in 2004 is amortized over their vesting period and estimated at the grant date using the Black and Scholes option pricing model with the following weighted-average assumptions for 2004: risk-free interest rate of 2.46%, dividend yields of 0%, a volatility factor of the expected market price of the Company's Ordinary shares of 0.979, and a weighted average life of the option of 1.5 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Proforma information under SFAS No. 123:

	Year ended December 31,		
	2002	2003	2004
Net income as reported:	\$ 1,888	\$ 2,404	\$ 1,053
Add: stock based compensation expenses determined under the intrinsic value based method included in the reported net income	17	3	184
Deduct: stock based compensation expenses determined under fair value based method for all awards	(246)	(111)	(198)
Proforma net income	<u>\$ 1,659</u>	<u>\$ 2,296</u>	<u>\$ 1,039</u>
Basic net earnings per share—as reported	<u>\$ 0.24</u>	<u>\$ 0.30</u>	<u>\$ 0.12</u>
Diluted net earnings per share—as reported	<u>\$ 0.23</u>	<u>\$ 0.30</u>	<u>\$ 0.12</u>
Proforma basic net earnings per share	<u>\$ 0.21</u>	<u>\$ 0.29</u>	<u>\$ 0.12</u>
Proforma diluted net earnings per share	<u>\$ 0.21</u>	<u>\$ 0.29</u>	<u>\$ 0.12</u>

o. Research and development costs:

Research and development costs incurred in the process of developing product improvements or new products, are charged to expenses as incurred, net of grants received and investment tax credit.

p. Warranty costs:

The Group provides a warranty for up to 24 months, at no extra charge. The Group estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs at the time product revenue is recognized in accordance with FIN No. 45 “Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” and SFAS No. 5 “Accounting for Contingencies”. Factors that affect the Group's warranty liability include the number of units, historical and anticipated rates of warranty claims and cost per claim. The Group periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. A tabular reconciliation of the changes in the Group's aggregate product warranty liability is not provided due to immateriality.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

q. **Royalty-bearing grants:**

Royalty-bearing grants from the Government of Israel for funding research and development projects are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred and recorded as a reduction of research and development costs. Research and development grants recognized amounted to \$318, \$128 and \$228 in 2002, 2003 and 2004, respectively.

The Company also received royalty-bearing grants from the Fund for Encouragement of Marketing Activity. These grants are recognized at the time the Company is entitled to such grants on the basis of the costs incurred and included as a deduction of selling and marketing expenses. Total grants recognized amounted to \$82, \$0 and \$0 in 2002, 2003 and 2004, respectively.

r. **Net earnings per share:**

Basic net earnings per share is computed based on the weighted average number of shares of Ordinary shares outstanding during each year. Diluted net earnings per share is computed based on the weighted average number of shares of Ordinary shares outstanding during each year, plus dilutive potential shares of Ordinary shares considered outstanding during the year, in accordance with SFAS No. 128, "Earnings Per Share."

s. **Concentrations of credit risk:**

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents, short-term and long-term bank deposits, structured notes, unbilled accounts receivable, trade receivables and long-term trade receivables.

Cash and cash equivalents, short-term and long-term bank deposits and structured notes are mainly invested in major Israeli and U.S. banks. Cash and cash equivalents in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Group's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The short-term and long-term trade receivables of the Group, as well as the unbilled accounts receivable, are derived from sales to large and solid organizations and government authorities located mainly in Israel, the United States, Canada and Europe. The Group performs ongoing credit evaluations of its customers and to date have not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Group has determined to be doubtful of collection and in accordance with an aging key. In certain circumstances, the Group may require letters of credit, other collateral or additional guarantees.

The Group has no significant off-balance sheet concentration of credit risks, such as foreign exchange contracts or foreign hedging arrangements, except derivative instruments, which are detailed in Note 2x.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

t. **Income taxes:**

The Group accounts for income taxes in accordance with SFAS No. 109 "Accounting for Income Taxes." This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Group provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

u. **Severance pay:**

The Company's liability for its Israeli employees severance pay is calculated pursuant to Israel's Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for its employees in Israel is fully provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance expenses for the years ended December 31, 2002, 2003 and 2004, amounted to approximately \$60, \$313 and \$306, respectively.

v. **Fair value of financial instruments:**

The following methods and assumptions were used by the Group in estimating its fair value disclosures for financial instruments:

- (i) The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables, unbilled accounts receivable, short-term bank credit and trade payables approximate their fair value due to the short-term maturity of such instruments.
- (ii) The carrying amount of the Group's long-term trade receivables, long-term bank deposits and structured notes approximate their fair value. The fair value was estimated using discounted cash flows analyses, based on the Group's investment rates for similar type of investment arrangements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- (iii) The carrying amounts of the Group's long-term debt are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. As of December 31, 2003, the fair value of the Group's long-term borrowing was \$5,564, compared to the carrying amount of \$5,714. As of December 31, 2004, the fair value of the Company's long-term borrowing was \$5,318, compared to the carrying amount of \$5,349.
- (iv) The fair value of foreign currency contracts (used for hedge purposes) is estimated by obtaining current quotes from investment bankers.

w. **Advertising expenses:**

Advertising costs are charged to the statement of income as incurred. Advertising expenses for the years ended December 31, 2002, 2003 and 2004, were \$372, \$422 and \$495, respectively.

x. **Derivative instruments:**

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", requires a company to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged.

To protect against the change in value of forecasted foreign currency cash flows resulting from certain sale arrangements, the Company has entered during 2003 and 2004 into forward contracts in order to hedge portions of its forecasted revenue and unbilled accounts receivable denominated in euro.

For derivative instruments designated as cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk). The effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings. For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the same line item associated with the hedged item in current earnings during the period of the change in fair values.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

As of December 31, 2004, the Company expects to reclassify \$649 of net losses on derivative instruments from unrealized losses on forward contracts to earnings during the next 12 months due to actual sales and related payments.

y. **Reclassification:**

Certain amounts from prior years have been reclassified to conform to the previous year's presentation. The reclassification had no effect on previously reported net loss, shareholders' equity or cash flows.

z. **Impact of recently issued accounting standards:**

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4." SFAS No. 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of SFAS No. 151 will have a material effect on its financial position or results of operations.

On December 16, 2004, the FASB issued SFAS No. 123(R) (revised 2004), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." Generally, the approach in Statement 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for the Company in the first interim period beginning after June 15, 2005. The adoption of SFAS 123(R) will not have a significant effect on the Company's results of operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 3:- INVENTORIES

	December 31,	
	2003	2004
Raw materials	\$ 6,843	\$ 6,806
Work in progress	2,513	2,320
Finished products	2,421	3,576
	\$ 11,777	\$ 12,702

NOTE 4:- PROPERTY AND EQUIPMENT, NET

a. **Composition:**

	December 31,	
	2003	2004
Cost:		
Land and buildings	\$ 8,215	\$ 8,790
Machinery and equipment	4,170	4,411
Machinery and equipment leased to customers under operating leases	2,083	4,952
Motor vehicles	1,414	1,341
Promotional display	3,659	4,236
Office furniture and equipment	2,609	2,924
Leasehold improvements	23	784
	22,173	27,438
Accumulated depreciation:		
Buildings	2,098	2,404
Machinery and equipment	2,648	2,958
Machinery and equipment leased to customers under operating leases	292	845
Motor vehicles	738	833
Promotional display	2,891	3,322
Office furniture and equipment	1,980	2,356
Leasehold improvements	21	61
	10,668	12,779
Depreciated cost	\$ 11,505	\$ 14,659

b. Depreciation expenses amounted to \$1,014, \$1,241 and \$1,822 for the years ended December 31, 2002, 2003 and 2004, respectively.

c. As for charges, see Note 9g.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 5:- OTHER INTANGIBLE ASSETS, NET

a. **Composition:**

	December 31,	
	2003	2004
Cost:		
Know-how	\$ 1,502	\$ 502
Patents	2,381	2,639
Technology	436	436
	<u>4,319</u>	<u>3,577</u>
Accumulated amortization:		
Know-how	1,342	396
Patents	2,237	2,443
Technology	27	82
	<u>3,606</u>	<u>2,921</u>
Amortized cost	<u>\$ 713</u>	<u>\$ 656</u>

b. Amortization expenses related to intangible assets amounted to \$82, \$137 and \$144 for the years ended December 31, 2002, 2003 and 2004, respectively.

c. Estimated amortization of intangible assets for the years ended:

	December 31,
2005	148
2006	139
2007	77
2008	74
2009	73
	<u>511</u>

NOTE 6:- SHORT-TERM BANK CREDIT

a. Classified by currency, linkage terms and interest rates:

	Interest rate		December 31,	
	2003	2004	2003	2004
	%			
In or linked to U.S. Dollars (1)	3.02	4.08	\$ 4,300	\$ 8,600
In or linked to NIS (1)	6.83	5.47	6,613	5,556
In or linked to Canadian Dollars (2)	5.01	4.75	<u>1,684</u>	<u>1,462</u>
			<u>\$ 12,597</u>	<u>\$ 15,618</u>
Weighted average interest rates at the end of the year			<u>5.28%</u>	<u>4.64%</u>
Total authorized credit lines approximate				<u>\$ 33,245</u>
Unutilized credit lines approximate				<u>\$ 6,352</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 6:- SHORT-TERM BANK CREDIT (Cont.)

(1) The Company has undertaken to maintain the following financial ratios and terms in respect of its used credit line:

1. A ratio of at least 40% of consolidated shareholders' equity out of the consolidated total assets.
2. Minimal annual consolidated net income in the amount of \$ 1,000.
3. The same shareholders maintain the core of control in the Company.

As of December 31, 2004, management believes that the Company was in compliance with these ratios and terms.

(2) The loan to a subsidiary is collateralized by a general security agreement and has undertaken to maintain general covenants and the following financial ratios, with respect to the subsidiary's financial statements, and terms in respect of its used credit lines:

1. A quick ratio of not less than 1.25.
2. A ratio of total liabilities to tangible net worth of not greater than 0.75.
3. Tangible net worth of at least \$9 million.

As of December 31, 2004, management believes that the subsidiary was in compliance with these ratios and terms.

b. As for charges, see Note 9g.

NOTE 7:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2003	2004
Employees and payroll accruals	\$ 1,951	\$ 1,380
Accrued expenses	2,116	3,911
Deferred revenues	324	81
Unrealized losses on hedging forward contracts	489	781
Government authorities	-	308
Declared dividend	401	-
Income tax payable	641	3
Others	596	986
	\$ 6,518	\$ 7,450

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 8:- LONG-TERM DEBT

a. Classified by currency, linkage terms and interest rates:

	Linkage terms	Interest rate		December 31,	
		2003	2004	2003	2004
		%			
Bank loan	U.S. \$	4.60	3.10	\$ 2,500	\$ 2,500
Bank loan	U.S. \$	4.60	-	250	-
Bank promissory note (1)	U.S. \$	2.87	3.05	500	500
Bank promissory note (1)	U.S. \$	5.66	3.50	500	500
				3,750	3,500
Mortgage payable	U.S. \$	8.25	8.25	1,964	1,849
				5,714	5,349
Less - current maturities				3,841	1,849
				\$ 1,873	\$ 3,500
Weighted average interest rates at the end of the year				5.80%	4.91%

(1) As for financial ratios and terms in respect of long-term loans, the two \$500 promissory notes both have covenants that require the Group 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. The Group is also required to maintain tangible net worth and subordinated debt of not less than \$170 for one note and not less than \$100 for the second note.

As of December 31, 2004, management believes that the Group was in compliance with these ratios and terms.

b. As of December 31, 2004, the aggregate annual maturities of the long-term loans are as follows:

2005	\$ 1,849
2006	3,500
	\$ 5,349

c. As for charges, see Note 9g.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES

a. **Royalty commitments to the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade (“OCS”):**

Under the research and development agreements of the Company with the OCS and pursuant to applicable laws, the Company is required to pay royalties at the rate of 3%-4.5% of sales of products developed with funds provided by the OCS, up to an amount equal to 100% of the OCS research and development grants received, linked to the U.S. dollars plus interest on the unpaid amount received based on the 12-month LIBOR rate applicable to dollar deposits. The Company is obligated to repay the Israeli Government for the grants received only to the extent that there are sales of the funded products.

Royalties paid amounted to \$131, \$80 and \$61 for the years ended December 31, 2002, 2003 and 2004, respectively. As of December 31, 2004, the Company had remaining contingent obligations to pay royalties in the amount of approximately \$1,868.

b. **Royalty commitments to the Fund of Encouragement of Marketing Activities:**

The Israeli Government, through the Fund for the Encouragement of Marketing Activities, awarded the Company grants for participation in expenses for foreign marketing. The Company is committed to pay royalties at the rate of 3% of the increase in export sales, up to the amount of the grants received.

Royalties paid during the years ended December 31, 2002, 2003 and 2004, amounted to \$53, \$0 and \$0, respectively. As of December 31, 2004, the aggregate contingent obligation amounted to \$95.

c. **Royalty commitments to third party:**

During 2002, the Company entered into a development agreement for planning, developing and manufacturing a security system with a third party. Under the agreement, the Company agreed to pay the third party royalty fees, based on a formula as defined in the agreement. Under this agreement the Company has also committed to purchase a certain volume of products at a minimum amount of approximately \$300 over 2.5 years after achievement of certain milestones. As of December 31, 2004, no royalty commitment, under the agreement, exists.

d. **Lease commitments:**

The Group rents its facilities and some of its motor vehicles under various operating lease agreements, which expire on various dates, the latest of which is in 2008.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

Future minimum lease payments under non-cancelable operating lease agreements as of December 31, are as follows:

2005	\$	441	
2006		290	
2007		156	
2008		99	
		986	
	\$	986	

Total rent expenses for the years ended December 31, 2002, 2003 and 2004, were approximately \$183, \$368 and \$671, respectively.

e. Guarantees:

1. As of December 31, 2004, the Group obtained bank performance guarantees and advance payment guarantees from several banks mainly in Israel in the amount of \$2,935.
2. As of December 31, 2004, the Company obtained bank guarantees in an amount of \$1,849 in order to secure mortgage payable by a subsidiary.
3. As of December 31, 2004, the Group issued a letter of credit in the amount of \$902, as per suppliers' demand.

f. Legal proceedings:

1. In April 2003, a competitor filed a civil action suit against the Company and others. The plaintiff alleged that the failure of its perimeter systems in field trials executed by the Ministry of Defense during 1996 and 1997, resulted from intentional damage to the fence and diversion of the results of certain tests by a former employee of the Company, who was then a soldier in the Israeli Defense Force. The plaintiff alleged that the Company, which was the employer of this employee during 1995, still employed him as an agent during the field trials, and directed the actions of the former employee. The plaintiff requested the courts to annul the field trial and sought, approximately \$760 in damages. The Company denied all of the above allegations and claimed that the plaintiff's perimeter system failure was not the result of the former employee's actions. The Company's legal counsel believes that, the Company has valid defenses against the aforementioned claims and, therefore, no provision was recorded in the financial statements. The action is in the preliminary stage.
2. In June 2000, Rapiscan Security Products Inc. ("Rapiscan") filed a lawsuit against the Company claiming \$1,600 was due it in the context of an agreement between Rapiscan and the Company. The Company filed a counter-claim in the amount of approximately \$1,350. The financial statements as of December 31, 2003 included a reserve computed by management for this litigation of approximately \$1,000. On February 18, 2004, the court approved a settlement agreement between the Company and Rapiscan, according to which, the Company paid Rapiscan approximately \$653. The reduction of \$347 of the \$1,000 estimated reserve was recorded in operations during the first quarter of 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

g. **Charges:**

As collateral for all of the Group liabilities to banks:

1. A fixed charge has been placed on the Company's property.
2. The Company agreed not to pledge any of its assets without the consent of several banks.
3. A fixed charge in the amount of \$3,000 has been placed on the Company's bank deposits.
4. The Company's subsidiary has two bank promissory notes in the aggregate amount of \$1,000 due on April 15, 2006, collateralized by substantially all of the subsidiary's assets, and a \$1,849 mortgage note payable, collateralized by a first mortgage on its land and building.

NOTE 10:- SHAREHOLDERS' EQUITY

a. **Pertinent rights and privileges conferred by Ordinary shares:**

The Ordinary shares of the Company are listed for trade on NASDAQ National Market and in Israel, on the Tel-Aviv Stock Exchange. The Ordinary shares confer upon their holders the right to receive notice to participate and vote in the General Meetings of the Company and the right to receive dividends, if declared.

b. **Stock Option Plan:**

On October 27, 2003, the Company's Board of Directors approved the 2003 Israeli Share Option Plan ("the 2003 Plan"). Under the 2003 Plan, stock options will be periodically granted to employees, directors, officers and consultants of the Company or its subsidiaries, in accordance with the decision of the Board of Directors of the Company (or a committee appointed by it). The Board of Directors has the authority to determine the number of options, if any, which will be granted to each of the aforementioned, the dates of the grant of such options, the date of their exercise as well as their rate of conversion into shares in respect of each stock option, and the purchase price thereof. The 2003 Plan is effective for ten years and shall terminate on October 2013. Any options that are cancelled or forfeited before expiration become available for future grant.

As of December 31, 2004, there were 537,606 options available for future grant.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

A summary of the Company's stock options activities in 2002, 2003 and 2004, is as follows:

	Year ended December 31,					
	2002		2003		2004	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of Options	Weighted average exercise price
Outstanding at the beginning of the year	412,400	\$ 3.93	358,234	\$ 4.23	223,216	\$ 4.61
Granted	-	\$ -	-	\$ -	100,000	\$ 7.66
Adjustment as a result of stock dividend	11,232	\$ -	10,256	\$ -	7,652	\$ -
Exercised	(63,750)	\$ 2.17	(137,446)	\$ 3.55	(225,338)	\$ 4.61
Forfeited	(1,648)	\$ -	(7,828)	\$ -	(530)	\$ -
Outstanding at the end of the year	<u>358,234</u>	<u>\$ 4.23</u>	<u>223,216</u>	<u>\$ 4.61</u>	<u>105,000</u>	<u>\$ 7.66</u>
Exercisable options at the end of the year	<u>118,450</u>	<u>\$ 2.14</u>	<u>223,216</u>	<u>\$ 4.61</u>	<u>-</u>	<u>\$ -</u>

All options outstanding as of December 31, 2004 have an exercise price of \$7.66 and a weighted average remaining contractual life of 1.5 years.

Where the Company has recorded deferred stock compensation for options issued with an exercise price below the fair market value of the Ordinary shares, the deferred stock compensation has been amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expense of approximately \$17, \$3 and \$184 were recognized during the years ended December 31, 2002, 2003 and 2004, respectively.

c. Dividends:

1. Dividends, if any, will be declared and paid in U.S. dollars. Dividends paid to shareholders in Israel will be converted into NIS on the basis of the exchange rate prevailing at the date of payment. The Company has determined that it will not distribute dividends out of tax-exempt profits.
2. The Company's Board of Directors decided on a distribution of stock dividends of 3%, 3% and 5% in May 2002, May 2003 and July 2004, respectively. All shares, options and net earnings per share data have been retroactively adjusted to reflect the stock dividend.
3. At the Annual General Meeting of Shareholders held on July 29, 2004, the shareholders approved the payment of an interim cash dividend in the amount of \$0.05 per Ordinary Share of NIS 1 par value each, which was declared in December 2003.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

d. **Warrants to underwriters:**

In connection with the 1997 follow-on Offering, the Company issued to the underwriters, 200,000 warrants to purchase 200,000 Ordinary shares of the Company. The warrants were initially exercisable at an exercise price of 120% of the 1997 offering price per share (\$5.50) for a period of four years, commencing one year from the date of the 1997 offering. As of December 31, 2002, all 200,000 warrants were exercised on a net cash basis and 60,703 Ordinary shares of NIS 1 par value were issued.

e. In May 2002, the Company's Board of Directors approved an increase in the authorized Ordinary share capital to 19,748,000 shares of NIS 1 par value.

NOTE 11:- BASIC AND DILUTED NET EARNINGS PER SHARE

	Year ended December 31,		
	2002	2003	2004
Numerator:			
Net income	\$ 1,888	\$ 2,404	\$ 1,053
Denominator:			
Denominator for basic net earnings per share - weighted-average number of shares outstanding	7,866,477	7,947,778	8,581,348
Effect of diluting securities:			
Employee stock options and warrants to underwriters	202,661	80,848	55,031
Denominator for diluted net earnings per share - adjusted weighted average shares and assumed exercises	8,069,138	8,028,626	8,636,379

NOTE 12:- TAXES ON INCOME

a. Tax benefits in Israel under the Law for the Encouragement of Capital Investments, 1959, (the "Law"):

The Company has been granted the status of an "Approved Enterprise" under the Law. Currently, there are three expansion programs under which the Company is entitled to tax benefits:

1. In 1992, a program of the Company was granted the status of an "Approved Enterprise". The Company has elected to enjoy the "alternative benefits" track - waiver of grants in return for tax exemption - and, accordingly, the Company's income from this program was tax-exempt for a period of four years, and was subject to a reduced tax rate of 15%-25% for a period ranging between three to six years (depending on the percentage of foreign ownership of the Company). The period of benefits under this program began in 1994 and terminated in 2003.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 12:- TAXES ON INCOME (Cont.)

2. On March 18, 1997, a program of the Company was granted the status of an "Approved Enterprise". The Company elected to enjoy the "alternative benefits" track - waiver of grants in return for tax exemption and accordingly, the Company's income from this program was tax-exempt for a period of four years, and is subject to a reduced tax rate of 15%-25% for a period ranging between three to six years (depending on the percentage of foreign ownership of the Company). The period of benefits under this program began in 1998 and will terminate in 2007.
3. On August 13, 2002, a program of the Company was granted the status of an "Approved Enterprise". The Company elected to enjoy the "alternative benefits" track - waiver of grants in return for tax exemption - and, accordingly, the Company's income from this program is tax-exempt for a period of two years, and is subject to a reduced tax rate of 15%-25% for a period of five to eight years (depending upon the percentage of foreign ownership of the Company). The benefit period for this program began in 2003 and will terminate in 2012.

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the Law, regulations published there under and the letters of approval for the specific investments in "approved enterprises". 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, 2004, management believes that the Company is in compliance with all of the aforementioned conditions.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from the commencement of production or 14 years from receiving the approval.

Income from sources other than "Approved Enterprise", during the benefit period will be subject to tax at regular rate of 35%.

By virtue of the Law, the Company is entitled to claim accelerated depreciation on equipment used by the "Approved Enterprise" during five tax years.

Since the Company is operating under more than one approval and since part of its taxable income is not entitled to tax benefits under the aforementioned law and is taxed at regular rates (currently 35%), its effective tax rate is the result of a weighted combination of the various applicable rates and tax-exemptions. The computation is made for income derived from each program on the basis of formulas determined in the law and in the approvals.

The tax-exempt income attributable to the "Approved Enterprises" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If the retained tax-exempt income is distributed in a manner other than in the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not chosen the alternative tax benefits (currently - 15%).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 12:- TAXES ON INCOME (Cont.)

b. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

Under the Income Tax (Inflationary Adjustments) Law, 1985, results for tax purposes are measured in real terms, in accordance with the changes in the Israeli Consumer Price Index ("Israeli CPI"). Accordingly, until 2002, results for tax purposes were measured in terms of earnings in NIS after certain adjustments for increases in the Israeli CPI. Commencing in taxable year 2003, the Company has elected to measure its taxable income and file its tax return under the Israeli Income Tax Regulations (Principles Regarding the Management of Books of Account of Foreign Invested Companies and Certain Partnerships and the Determination of Their Taxable Income), 1986. Such an elective obligates the Company for three years. Accordingly, commencing taxable year 2003, results for tax purposes are measured in terms of earnings in dollar.

c. Tax benefits (in Israel) under the Law for the Encouragement of Industry (Taxes), 1969:

The Company is an "industrial company" as defined by this law and, as such, is entitled to certain tax benefits including accelerated depreciation, deduction of the purchase price of patents and know-how and deduction of public offering expenses.

d. Tax rates:

1. On June 29, 2004, the Israeli Government passed the Amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004, which progressively reduces the tax rates applicable to companies from 36% to 35% in 2004 to a rate of 30% in 2007. The amendment had no impact on the Company's financial statements.
2. The tax rates of the Company's subsidiaries range between 25%-40%.

e. Investment tax credit:

One of the Company's subsidiaries is eligible for investment tax credits on its research and development activities and on certain current and capital expenditures. During fiscal year 2004, the subsidiary recognized \$176 of investment tax credits as a reduction of research and development expenses. In total, the subsidiary has investment tax credits available to reduce future federal income taxes payable, amounting to \$436, which will expire at various dates from 2012 through 2014.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 12:- TAXES ON INCOME (Cont.)

- f. **Reconciliation between the theoretical tax expense, assuming all income is taxed at the Israeli statutory rate, and the actual tax expense, is as follows:**

	Year ended December 31,		
	2002	2003	2004
Income before taxes as reported in the statements of income	\$ 2,533	\$ 3,317	\$ 2,154
Tax rate	36%	36%	35%
Theoretical tax expense	\$ 912	\$ 1,194	\$ 754
Increase (decrease) in taxes:			
Tax adjustments in respect of inflation in Israel	11	-	-
Non-deductible items, net	(24)	17	(400)
Deferred taxes on losses for which valuation allowance was provided	442	298	1,163
Tax exemption applicable to "Approved Enterprises" and exempted income	(293)	(443)	(281)
Taxes in respect of prior years	(279)	(107)	(23)
Other	(124)	(46)	(112)
Taxes on income in the statements of income	\$ 645	\$ 913	\$ 1,101
Per share amounts (basic and diluted) of the tax benefit resulting from "Approved Enterprises"	\$ 0.04	\$ 0.06	\$ 0.03

- g. **Taxes on income included in the statements of income:**

	Year ended December 31,		
	2002	2003	2004
Current taxes:			
Domestic	\$ 269	\$ 398	\$ 428
Foreign	211	534	518
Deferred income taxes:			
Domestic	(30)	-	(70)
Foreign	474	88	248
Taxes in respect of prior years:			
Domestic	(279)	(107)	-
Foreign	-	-	(23)
Taxes on income	\$ 645	\$ 913	\$ 1,101

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 12:- TAXES ON INCOME (Cont.)

h. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Group deferred tax assets are as follows:

	December 31,	
	2003	2004
Operating loss carryforward	\$ 1,813	\$ 2,992
Reserves and tax allowances	658	(26)
	2,471	2,966
Total deferred assets before valuation allowance	(1,682)	(2,292)
	\$ 789	\$ 674
Net deferred tax assets		
Domestic	\$ 212	\$ 288
Foreign	577	386
	\$ 789	\$ 674

During 2004, the Company's subsidiaries have increased the valuation allowance in the amount of approximately \$300, as a result of change in circumstances that caused a change in judgment about the certainty of realization of related deferred tax assets in future years. The total net change in valuation allowance during 2004 amounted to \$610

i. The domestic and foreign components of income before taxes are as follows:

	Year ended December 31,		
	2002	2003	2004
Domestic	\$ 2,217	\$ 2,217	\$ 2,137
Foreign	316	1,100	17
	\$ 2,533	\$ 3,317	\$ 2,154

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 12:- TAXES ON INCOME (Cont.)

j. **Net operating losses carryforward:**

The Company's subsidiaries in the U.S. and the U.K. have estimated total available carryforward tax losses of \$7,139 and \$795, respectively, to offset against future taxable profit for 16 to 20 years, and an indefinite period, respectively. As of December 31, 2004, the Company recorded a full valuation allowance 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 provisions. The annual limitation may result in the expiration of net operating losses before utilization.

NOTE 13:- RELATED PARTIES TRANSACTIONS

	Year ended December 31,		
	2002	2003	2004
Sales to related parties (1)	\$ 188	\$ 196	\$ 386

(1) Sales to related parties represent services provided by the Company's subsidiary.

NOTE 14:- SEGMENTS INFORMATION

The Group adopted SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information". The Group operates in three major reportable segments, which represent the Group's operating segments as follows:

1. Perimeter security systems - The Group's line of perimeter security systems consists of the following: Microprocessor-based central control units, taut wire perimeter intrusion detection systems, INNO Fences, vibration detection systems, field disturbance sensors, and other.
2. Security turnkey projects - The Group is executing turnkey projects based on the Company's security management system and acting as an integrator.
3. Video monitoring services - The Group supplies video monitoring services through Smart Interactive Systems, Inc., a subsidiary established in the U.S. in June 2001.

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 14:- SEGMENTS INFORMATION (Cont.)

b. Major customer data (percentage of total revenues):

	Year ended December 31,		
	2002	2003	2004
Israel's Ministry of Defense and Israel's Defense Forces	15.9%	27.2%	*) -%
C.N. Aeroportul international Bucuresti Otopeni	*) -%	*) -%	15.6%

*) Less than 10% of total revenues.

c. Geographical information:

The following is a summary of revenues within geographic areas based on end customer's location and long-lived assets:

	Year ended December 31,		
	2002	2003	2004
1. Revenues:			
Israel	\$ 11,350	\$ 20,503	\$ 10,123
Romania	1,023	5,151	9,521
Europe (excluding Romania)	5,376	5,465	9,150
USA	12,641	13,292	17,871
Canada	4,324	6,338	4,068
Others	8,252	8,612	10,241
	\$ 42,966	\$ 59,361	\$ 60,974
	December 31,		
	2002	2003	2004
2. Long-lived assets:			
Israel	\$ 3,802	\$ 3,626	\$ 3,211
Europe	786	980	1,069
USA	6,299	8,655	11,518
Canada	2,392	2,998	3,649
Others	47	104	154
	\$ 13,326	\$ 16,363	\$ 19,601

**MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 15:- SELECTED STATEMENTS OF INCOME DATA

a. **Research and development expenses, net:**

	Year ended December 31,		
	2002	2003	2004
Expenses	\$ 3,750	\$ 5,128	\$ 5,088
Less - royalty-bearing grants and investment tax credit	622	355	405
	\$ 3,128	\$ 4,773	\$ 4,683

b. **Financial income (expenses):**

Financial expenses:			
Interest on long-term debt	\$ (371)	\$ (298)	\$ (289)
Interest on short-term bank credit	(640)	(808)	(849)
Foreign exchange losses	(6)	(692)	(161)
	(1,017)	(1,798)	(1,299)
Financial income:			
Interest on short-term and long-term bank deposits and structured notes	732	672	496
Foreign exchange gains	484	123	41
	1,216	795	537
	\$ 199	\$ (1,003)	\$ (762)

NOTE 16:- SUBSEQUENT EVENTS (UNAUDITED)

In 2005, the Company intends to raise additional equity to fund future growth.
