

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

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2006**

**IN U.S. DOLLARS**

**INDEX**

	<u>Page</u>
<b>Report of Independent Registered Public Accounting Firm</b>	<b>2</b>
<b>Consolidated Balance Sheets</b>	<b>3 - 4</b>
<b>Consolidated Statements of Operations</b>	<b>5</b>
<b>Statements of Changes in Shareholders' Equity</b>	<b>6</b>
<b>Consolidated Statements of Cash Flows</b>	<b>7 - 8</b>
<b>Notes to Consolidated Financial Statements</b>	<b>9 - 42</b>

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**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, 2005 and 2006, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.


We did not audit the financial statements of a certain subsidiary, whose assets constitute approximately 3.2% and 4.1% of total consolidated assets as of December 31, 2005 and 2006, respectively, and whose revenues constitute approximately 5.2% and 11.1% of total consolidated revenues for the years ended December 31, 2005 and 2006, respectively. The financial statements of this company were audited by other auditors, whose report has been furnished to us, and our opinion, insofar as it relates to amounts included for this subsidiary, is based solely on the report of the other auditors.

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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included 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 and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, 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, 2005 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2n to the consolidated financial statements, in 2006 the Company adopted Statement of Financial Accounting Standard Board No. 123 (revised 2004) "Share Based Payment".

Tel-Aviv, Israel  
June 28, 2007

  
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**

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 10,099	\$ 4,908
Marketable securities (Note 3)	-	3,067
Short-term bank deposits	17,053	14,186
Trade receivables (net of allowance for doubtful accounts of \$ 306 and \$ 493 at December 31, 2005 and 2006, respectively)	24,012	28,027
Unbilled accounts receivable	8,596	5,389
Other accounts receivable and prepaid expenses (Note 4)	4,455	3,995
Deferred income taxes	1,187	1,604
Inventories (Note 5)	11,110	13,971
<b>Total current assets</b>	<b>76,512</b>	<b>75,147</b>
<b>LONG-TERM INVESTMENTS AND RECEIVABLES:</b>		
Long-term trade receivables	290	224
Long-term loan (Note 11i)	-	622
Long-term bank deposits	1,800	4,800
Severance pay fund	2,070	2,401
<b>Total long-term investments and receivables</b>	<b>4,160</b>	<b>8,047</b>
<b>PROPERTY AND EQUIPMENT, NET (Note 6)</b>	<b>15,587</b>	<b>14,366</b>
<b>DEFERRED INCOME TAXES</b>	<b>828</b>	<b>686</b>
<b>OTHER INTANGIBLE ASSETS, NET (Note 7)</b>	<b>569</b>	<b>1,150</b>
<b>GOODWILL</b>	<b>4,186</b>	<b>4,285</b>
<b>Total assets</b>	<b>\$ 101,842</b>	<b>\$ 103,681</b>

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 per share data)**

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Short-term bank credit (Note 8)	\$ 18,068	\$ 17,026
Current maturities of long-term bank debt (Note 10)	3,647	795
Trade payables	6,360	6,001
Customer advances	3,990	1,230
Other accounts payable and accrued expenses (Note 9)	8,914	9,782
Unrealized losses on hedging forward contracts	79	596
	<u>41,058</u>	<u>35,430</u>
<b>LONG-TERM LIABILITIES:</b>		
Unrealized losses on hedging forward contracts	50	-
Long-term bank debt (Note 10)	1,653	7,399
Long-term accounts payable (Note 11d)	-	178
Accrued severance pay	2,131	2,524
	<u>3,834</u>	<u>10,101</u>
<b>COMMITMENTS AND CONTINGENT LIABILITIES (Note 11)</b>		
<b>SHAREHOLDERS' EQUITY (Note 12):</b>		
Share capital -		
Ordinary shares of NIS 1 par value -		
Authorized: 19,748,000 shares at December 31, 2005 and 2006;		
Issued and outstanding: 10,372,448 and 10,391,548 shares at		
December 31, 2005 and 2006, respectively	3,220	3,224
Additional paid-in capital	47,509	47,681
Deferred stock compensation	(38)	-
Accumulated other comprehensive income	2,435	2,314
Foreign currency translation (Company's stand alone financial statements)	-	297
Retained earnings	3,824	4,634
	<u>56,950</u>	<u>58,150</u>
<b>Total shareholders' equity</b>	<u>56,950</u>	<u>58,150</u>
<b>Total liabilities and shareholders' equity</b>	<u>\$ 101,842</u>	<u>\$ 103,681</u>

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

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

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Revenues	\$ 60,468	\$ 61,282	\$ 66,958
Cost of revenues	33,226	39,154	40,231
Gross profit	27,242	22,128	26,727
Operating expenses:			
Research and development, net (Note 17a)	4,683	5,265	5,378
Selling and marketing, net	12,519	13,180	12,079
General and administrative	5,771	5,961	6,533
Award granted by principal shareholders (Note 1b)	1,200	-	-
Total operating expenses	24,173	24,406	23,990
Operating income (loss)	3,069	(2,278)	2,737
Financial expenses, net (Note 17b)	762	800	851
Income (loss) before income taxes	2,307	(3,078)	1,886
Income taxes (tax benefit) (Note 14)	1,133	(23)	948
Income (loss) from continuing operations	1,174	(3,055)	938
Loss from discontinued operations, net (Note 18)	(121)	(156)	(128)
Net income (loss)	<u>\$ 1,053</u>	<u>\$ (3,211)</u>	<u>\$ 810</u>
Basic net earnings (loss) per share from continuing operations	\$ 0.13	\$ (0.31)	\$ 0.09
Basic net loss per share from discontinued operations	(0.01)	(0.01)	(0.01)
Basic net earnings (loss) per share (Note 13)	<u>\$ 0.12</u>	<u>\$ (0.32)</u>	<u>\$ 0.08</u>
Diluted net earnings (loss) per share from continuing operations	\$ 0.13	\$ (0.31)	\$ 0.09
Diluted net loss per share from discontinued operations	(0.01)	(0.01)	(0.01)
Diluted net earnings (loss) per share (Note 13)	<u>\$ 0.12</u>	<u>\$ (0.32)</u>	<u>\$ 0.08</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 (except share data)

	Number of shares	Ordinary shares	Additional paid-in capital	Deferred stock compensation	Accumulated other comprehensive income (loss)	Foreign currency translation -the Company	Retained earnings	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 2004	8,035,779	\$ 2,683	\$ 24,098	\$ -	\$ 479	\$ -	\$ 11,724		\$ 38,984
Exercise of stock options	225,338	51	916	-	-	-	-		967
Deferred stock compensation related to officers' options grant	-	-	661	(661)	-	-	-		-
Amortization of deferred stock-based compensation	-	-	-	184	-	-	-		184
Award granted by principal shareholders	-	-	1,200	-	-	-	-		1,200
Stock dividend	411,331	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	8,672,448	2,825	32,526	(477)	1,639	-	7,035		43,548
Issuance of share capital, net	1,700,000	395	14,793	-	-	-	-		15,188
Amortization of deferred stock-based compensation	-	-	-	439	-	-	-		439
Deferred taxes on stock options	-	-	190	-	-	-	-		190
Comprehensive income (loss):									
Net loss	-	-	-	-	-	-	(3,211)	\$ (3,211)	(3,211)
Unrealized gains on forward contracts, net	-	-	-	-	709	-	-	709	709
Foreign currency translation adjustments	-	-	-	-	87	-	-	87	87
Total comprehensive loss								<u>\$ (2,415)</u>	
Balance as of December 31, 2005	10,372,448	3,220	47,509	(38)	2,435	-	3,824		56,950
Reclassification of deferred stock compensation into additional paid-in capital upon adoption of SFAS 123(R)	-	-	(38)	38	-	-	-		-
Amortization of deferred stock-based compensation	-	-	51	-	-	-	-		51
Exercise of stock options	19,100	4	159	-	-	-	-		163
Comprehensive income (loss):									
Net income	-	-	-	-	-	-	810	\$ 810	810
Unrealized losses on forward contracts, net	-	-	-	-	(36)	-	-	(36)	(36)
Unrealized loss from available-for-sale securities, net	-	-	-	-	(13)	-	-	(13)	(13)
Foreign currency translation adjustments from change of functional currency, net	-	-	-	-	-	(355)	-	-	(355)
Foreign currency translation adjustments	-	-	-	-	(72)	652	-	(72)	580
Total comprehensive income								<u>\$ 689</u>	
Balance as of December 31, 2006	<u>10,391,548</u>	<u>3,224</u>	<u>47,681</u>	<u>\$ -</u>	<u>\$ 2,314</u>	<u>\$ 297</u>	<u>4,634</u>		<u>\$ 58,150</u>
Accumulated unrealized losses on forward contracts, net					\$ (31)				
Accumulated unrealized losses from available-for-sale securities, net					(13)				
Accumulated foreign currency translation adjustments					2,358				
Accumulated other comprehensive income as of December 31, 2006					<u>\$ 2,314</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**

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<u>Cash flows from operating activities:</u>			
Net income (loss)	\$ 1,053	\$ (3,211)	\$ 810
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Loss from discontinued operations	121	156	128
Depreciation and amortization	1,966	1,964	2,155
Loss (gain) on sale of property and equipment	(18)	(10)	7
Decrease (increase) in accrued interest on marketable securities, short-term and long-term bank deposits	657	(322)	293
Accrued interest and exchange rate changes of long-term loans	-	-	(58)
Amortization of deferred stock compensation	184	439	51
Decrease (increase) in trade receivables, net	3,956	(8,998)	(3,956)
Decrease (increase) in unbilled accounts receivable	(4,130)	(2,819)	3,482
Decrease (increase) in other accounts receivable and prepaid expenses	16	(599)	533
Decrease (increase) in deferred income taxes	178	(1,020)	(134)
Decrease (increase) in inventories	(552)	1,676	(2,728)
Decrease (increase) in long-term trade receivables	(44)	54	66
Increase (decrease) in trade payables	(1,953)	3,096	(681)
Increase in other accounts payable and accrued expenses	880	2,194	741
Increase (decrease) in customer advances	-	3,990	(2,760)
Accrued severance pay, net	(2)	31	60
Award granted by principal shareholders	1,200	-	-
Unrealized losses (gains) on hedging forward contract	476	(441)	431
Net cash provided by (used in) continuing operations	3,988	(3,820)	(1,560)
Net cash provided by (used in) discontinued operations	(310)	(319)	184
Net cash provided by (used in) operating activities	3,678	(4,139)	(1,376)
<u>Cash flows from investing activities:</u>			
Purchase of short-term deposits	-	(16,731)	(13,726)
Proceeds from sale of short-term bank deposits	8,400	-	13,645
Purchase of long-term bank deposits	(3,000)	-	(3,000)
Proceeds from sale of long-term deposits	-	1,194	3,000
Purchase of marketable securities	-	-	(8,219)
Proceeds from sale of marketable securities	-	-	5,202
Redemption of structured notes	-	3,000	-
Investment in long-term loan	-	-	(622)
Proceeds from sale of property and equipment	59	71	215
Purchase of property and equipment	(4,858)	(2,736)	(1,420)
Purchase of know-how and patents	(89)	(46)	(323)
Net cash provided by (used in) investing activities	512	(15,248)	(5,248)

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<u>Cash flows from financing activities:</u>			
Short-term bank credit, net	2,895	2,402	(1,369)
Proceeds from long-term bank loans	-	1,800	3,200
Principal payment of long-term bank loans	(365)	(1,849)	(306)
Proceeds from exercise of employee stock options	967	-	163
Proceeds from issuance of shares, net	-	14,916	-
Dividend paid	(401)	-	-
Net cash provided by financing activities	<u>3,096</u>	<u>17,269</u>	<u>1,688</u>
Effect of exchange rate changes on cash and cash equivalents	<u>289</u>	<u>253</u>	<u>(255)</u>
Increase (decrease) in cash and cash equivalents	7,575	(1,865)	(5,191)
Cash and cash equivalents at the beginning of the year	<u>4,389</u>	<u>11,964</u>	<u>10,099</u>
Cash and cash equivalents at the end of the year	<u>\$ 11,964</u>	<u>\$ 10,099</u>	<u>\$ 4,908</u>
<u>Supplemental disclosures of cash flows activities:</u>			
(a) Cash paid during the year for:			
Interest	<u>\$ 1,093</u>	<u>\$ 828</u>	<u>\$ 1,518</u>
Income taxes	<u>\$ 1,164</u>	<u>\$ 887</u>	<u>\$ 1,486</u>
(b) Non-cash activities:			
Purchase of know-how	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 430</u>

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**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, manufacture, marketing and sale 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 are generated in the U.S., Canada, Europe, Mexico and Israel.

As for major customer data, see Note 16b.

- b. Award granted by principal shareholders:

In June 2004, two principal shareholders of the Company awarded the Group's employees an award in the net amount of \$ 1,200. 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".

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ("U.S. 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 affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

- b. Financial statements in U.S. dollars:

Statement of the Financial Accounting Standards Board ("SFAS") No. 52, "Foreign Currency Translation" sets the standards for translating foreign currency financial statements of consolidated subsidiaries. The first step in the translation process is to identify the functional currency for each entity included in the financial statements. The accounts of each entity are then "remeasured" in its functional currency. All transaction gains and losses from the remeasurement of monetary balance sheet items are reflected in the statement of operations as financial income or expenses, as appropriate.

After the remeasurement process is complete the financial statements are translated into the reporting currency, which is the U.S. dollar ("dollar"), using the current rate method. Equity accounts are translated using historical exchange rates. All other balance sheet accounts are translated using the exchange rates in effect at the balance sheet date. Statement of operations 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).

In accordance with U.S. Securities and Exchange Commission Regulation S-X 3-20 ("SX 3-20"), the Company has determined its reporting currency to be the dollar. The measurement process of SX 3-20 is conceptually consistent with that of SFAS 52.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

The Company has determined that as of October 1, 2006 its functional currency has changed from the dollar to the New Israeli Shekel ("NIS"). Translation adjustments resulting from translating the Company's financial statements from the NIS to the dollar are reported as a separate component in shareholders' equity.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany transactions and balances including profits from intercompany sales not yet realized outside the Company, 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.

e. Marketable securities:

The Company accounts for investments in debt securities in accordance with Statement of Financial Accounting Standard 115, "Accounting for Certain Investments in Debt and Equity Securities" ("FAS 115"). Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. The debt securities are classified as "available-for-sale" since the Company does not have the intent to hold the securities to maturity, and are stated at fair value. Available-for-sale securities are carried at fair value with unrealized gains, and are reported as a separate item under "other comprehensive loss".

f. 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.

A bank deposit with maturities of more than one year is included in long-term bank deposits, and presented at cost.

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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

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.

During 2004, 2005 and 2006, the Group recorded inventory write-offs from continued operations in the amount of \$ 218, \$ 420 and \$ 760, respectively. Such write-offs were included in cost of revenues.

During 2004, 2005 and 2006, the Group recorded inventory write-off from discontinued operations in the amount of \$ 6, \$ 87 and \$ 62, respectively. Such write-off were included in loss from discontinued operations, net.

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	3 - 4
Machinery and equipment (including machinery and equipment leased to customers under operating leases)	10 - 33 (mainly 10%)
Motor vehicles	15 - 33
Promotional displays	25 - 50
Office furniture and equipment	6 - 33
Leasehold improvements	By the shorter of the term of the lease or 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" ("SFAS No. 142").

Know-how is amortized over 5 to 10 years, patents are amortized over a period of 10 years, customer list is amortized over an average period of three years and technology is amortized over 8 years.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**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 2004, 2005 and 2006, 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. SFAS No. 142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired, rather than being amortized. 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 2004, 2005 and 2006, no impairment losses have been identified.

Differences between the balance of goodwill as of December 31, 2005 and 2006 derive from functional currency translation adjustments. The entire goodwill balance relates to the Perimeter security systems 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 a fixed-price basis or as time-and-materials based 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 usually over one year. Such contracts require significant customization for each customer specific needs and, as such, revenues from these type of contracts 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. Accounting for long-term contracts using the percentage-of-completion method stipulates that revenue and expense are recognized throughout the life of the contract, even though the project is not completed and the purchaser does not have possession of the project. Percentage of completion is calculated based on the "Input Method".

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

Project costs include materials 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. The amounts of revenues recognized are based on the total fees under the agreements and the percentage to completion achieved. 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.

Fees are payable upon completion of agreed upon milestones and subject to customer acceptance. Amounts of revenues recognized in advance of contractual billing, are recorded as unbilled accounts receivable. The period between most instances of advanced recognition of revenues and the customers' billing generally ranges between one to six months.

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 Staff Accounting Bulletin ("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 collectibility is probable.

Services and maintenance are performed under either fixed-price based or time-and-materials based 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 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

One of the Company's subsidiaries provides security video monitoring services. The majority of its contracts 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 Emerging Issues Task Force ("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:

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)") which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), under which the Company previously accounted for its share based awards granted to employees and directors, for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statement. Prior to the adoption of SFAS 123(R), the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123").

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company's fiscal year 2006. Under that transition method, compensation cost recognized in 2006, includes only compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123. The Company did not grant stock options in 2006. Results for prior periods have not been restated.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting, based on the accelerated attribution method over the vesting period, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

As a result of adopting SFAS 123(R) on January 1, 2006, the Company's net income for the year ended December 31, 2006, is approximately \$ 15 lower than if it had continued to account for stock-based compensation under APB 25. The influence on the basic and diluted net earnings per share for the year ended December 31, 2006 is immaterial.

Prior to January 1, 2006, the Company applied the intrinsic value method of accounting for stock options as prescribed by APB 25, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price at the grant date of the award.

During the years ended December 31, 2004, 2005 and 2006, the Company recognized stock-based compensation expenses related to employee stock options in the amounts of \$ 184, \$ 439 and \$ 51, respectively.

The Company estimates the fair value of stock options granted using the Black-Scholes-Merton option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements.

The expected option term represents the period that the Company's stock options are expected to be outstanding. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term. The Company has no foreseeable plans to pay dividends.

Fair values were estimated using the following weighted average assumptions:

	<u>2004</u>	<u>2005</u>
Dividend yield	0%	0%
Expected volatility	97.9%	83.4%
Risk-free interest	2.46%	4%
Expected life of up to	1.5 years	2.5 years

The Company did not grant stock options in 2006.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

A summary of employee option activity under the Company's stock option plans as of December 31, 2006 and changes during the year ended December 31, 2006 are as follows:

	<b>Number of options</b>	<b>Weighted- average exercise price</b>	<b>Weighted- average remaining contractual life (in months)</b>	<b>Aggregate intrinsic value (in thousands)</b>
Outstanding at January 1, 2006	343,000	\$ 8.35		
Granted	-	\$ -		
Exercised	(19,100)	\$ 8.56		
Forfeited	(1,800)	\$ 8.56		
Outstanding at December 31, 2006	<u>322,100</u>	<u>\$ 8.34</u>	<u>40.3</u>	<u>\$ 218</u>
Exercisable at December 31, 2006	<u>317,100</u>	<u>\$ 8.26</u>	<u>40.1</u>	<u>\$ 218</u>
Vested and expected to vest at December 31, 2006	<u>322,100</u>	<u>\$ 8.34</u>	<u>40.3</u>	<u>\$ 218</u>

The weighted-average grant-date fair value of options granted during the years ended December 31, 2004 and 2005 was \$ 7.92 and \$ 4.39, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of the fourth quarter of fiscal 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount changes based on the fair market value of the Company's stock. Total intrinsic value of options exercised for the year ended December 31, 2006 was approximately \$ 71. As of December 31, 2006, there was approximately \$ 13 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of 0.97 years. Total grant-date fair value of options that vested during the year ended December 31, 2006 was approximately \$ 713.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

The following table illustrates the effect on the net income (loss) and net earnings (loss) per share, assuming that the Company had applied the fair value recognition provision of SFAS 123 on its stock-based employee compensation for all prior periods:

	<b>Year ended December 31,</b>	
	<b>2004</b>	<b>2005</b>
Net income (loss) as reported:	\$ 1,053	\$ (3,211)
Add: stock-based compensation expenses determined under the intrinsic value based method included in the reported net income	184	439
Deduct: stock-based compensation expenses determined under fair value based method for all awards	(198)	(1,493)
Pro forma net income	\$ 1,039	\$ (4,265)
Basic net earnings (loss) per share, as reported	\$ 0.12	\$ (0.32)
Diluted net earnings (loss) per share, as reported	\$ 0.12	\$ (0.32)
Pro forma basic net earnings (loss) per share	\$ 0.12	\$ (0.43)
Pro forma diluted net earnings (loss) per share	\$ 0.12	\$ (0.43)

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 FASB interpretation ("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.

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 \$ 228, \$ 8 and \$ 0 in 2004, 2005 and 2006, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

- r. Net earnings (loss) per share:

Basic net earnings (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net earnings (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential 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, marketable securities, short-term and long-term bank deposits, trade receivables, unbilled accounts receivable, long-term trade receivables and long-term loan.

Cash and cash equivalents, short-term and long-term bank deposits 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.

Marketable securities comprised of investments in U.S. government debentures. Management believes that the U.S. government is financially sound, and accordingly minimal credit risk exists with respect to these marketable securities.

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 governmental authorities located mainly in Israel, the United States, Canada, Mexico 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 policy. During the years ended December 31, 2004, 2005 and 2006, the group recorded \$ 131, \$ (13) and \$ 187 of expenses related to doubtful accounts, respectively. In certain circumstances, the Group may require letters of credit, other collateral or additional guarantees.

The loan granted to a third party is secured by personal guarantee of the beneficial owner (see Note 11i). The management believes that the loan is well secured, and accordingly, minimal credit risk exists with respect to this loan.

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 x. below.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**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, 2004, 2005 and 2006, amounted to approximately \$ 306, \$ 362 and \$ 476, 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, marketable securities, 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 and long-term bank deposits 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.
- (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, 2005, the fair value of the Company's long-term borrowing was \$ 5,259, compared to the carrying amount of \$ 5,300. As of December 31, 2006, the fair value of the Company's long-term borrowing was \$ 8,158, compared to the carrying amount of \$ 8,194.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

w. Advertising expenses:

Advertising costs are expensed as incurred. Advertising expenses for the years ended December 31, 2004, 2005 and 2006, were \$ 495, \$ 420 and \$ 447, 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 the forecasted foreign currency cash flows of certain sale arrangements resulting from changes in the exchange rate, the Company has entered during 2004, 2005 and 2006 into forward contracts in order to hedge portions of its forecasted revenue and unbilled accounts receivable denominated in Euros and Polish Zlotys. The Company has designated the forward instruments as cash flow hedges for accounting purposes.

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.

The Company determined that it is probable that sales arrangement in Polish Zlotys and the related forecasted revenues and accounts receivable will not occur by the end of the specified time period. Accordingly, changes in the fair value of the forward contracts were recorded in financial expenses in the years ended December 31, 2005 and 2006.

On October 1, 2006, the Company changed its functional currency from dollars to NIS (see also Note 2b). From the date of change in functional currency, the hedge of the revenues in Euros is no longer effective. Changes in the fair value of the forward contracts from October 1, 2006 were charged to financial expenses.

The Company recorded \$ 0, \$ 110 and \$ 915 as financial expenses related to forward contracts transactions, in 2004, 2005 and 2006, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

y. Reclassification:

Certain financial statement data for prior years have been reclassified to conform to current year financial statement presentation. The reclassification did not impact net income, working capital or cash flows from operations as previously reported.

z. Impact of recently issued Accounting Standards:

In July 2006, the FASB issued FIN No. 48, "Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement.

FIN 48 applies to all tax positions related to income taxes subject to the Financial Accounting Standard Board Statement No. 109, "Accounting for Income Taxes" ("FAS 109"). This includes tax positions considered to be "routine" as well as those with a high degree of uncertainty.

FIN 48 has expanded disclosure requirements, which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months. These disclosures are required at each annual reporting period unless a significant change occurs in an interim period.

FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 will be reported as an adjustment to the opening balance of retained earnings. For the evaluation of the effect of the adoption of FIN 48 on the financial statements, see note 19.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. The statements does not apply to accounting standard that require or permit measurement similar to fair value but are not intended to measure fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 157.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"), which permits companies to choose to measure certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt SFAS No. 159 no later than January 1, 2008. The Company has not yet determined the effect that the adoption of SFAS No. 159 will have on its consolidated financial statements.

**NOTE 3:- MARKETABLE SECURITIES**

The Company invests in marketable debt securities, which are classified as available-for-sale investments. The following is a summary of marketable debt securities:

	December 31,					
	2005			2006		
	Amortized cost	Unrealized losses	Market value	Amortized cost	Unrealized losses	Market value
<u>Available-for-sale:</u>						
U.S. Government debentures	\$ -	\$ -	\$ -	\$ 3,080	\$ 13	\$ 3,067
<u>Total available-for-sale marketable securities</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,080</u>	<u>\$ 13</u>	<u>\$ 3,067</u>

The unrealized losses on available-for-sale debt securities included in other comprehensive income, as a separate component of shareholders' equity, totaled to \$ 13 as of December 31, 2006.

The unrealized losses on the Company's investments in available-for-sale securities are a result of interest rate changes. Since the Company has the ability and intent to hold these investments until a recovery of fair value, which may be until maturity, the Company does not consider these investments to be other-than-temporarily impaired as of December 31, 2006.

The amortized cost and estimated fair value of available-for-sale investments as of December 31, 2006, by contractual maturity, are as follows:

	December 31,			
	2005		2006	
	Amortized cost	Market value	Amortized cost	Market value
<u>Available-for-sale:</u>				
Matures in one year	\$ -	\$ -	\$ -	\$ -
Matures in one to three years	-	-	3,080	3,067
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,080</u>	<u>\$ 3,067</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 4:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES**

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Government authorities	\$ 1,585	\$ 1,756
Employees	294	207
Prepaid expenses	653	495
Advances to suppliers	1,548	1,159
Others	375	378
	\$ 4,455	\$ 3,995

**NOTE 5:- INVENTORIES**

Raw materials	\$ 4,902	\$ 7,650
Work in progress	1,855	2,213
Finished products	4,353	4,108
	\$ 11,110	\$ 13,971

**NOTE 6:- PROPERTY AND EQUIPMENT**

a. Composition:		
Cost:		
Land and buildings	\$ 8,949	\$ 8,982
Machinery and equipment	7,092	6,775
Machinery and equipment leased to customers under operating leases	7,949	8,352
Motor vehicles	1,324	1,133
Promotional displays	1,244	1,121
Office furniture and equipment	3,190	2,985
Leasehold improvements	780	805
	30,528	30,153
Accumulated depreciation:		
Buildings	2,698	3,144
Machinery and equipment	5,987	5,662
Machinery and equipment leased to customers under operating leases	1,596	2,311
Motor vehicles	954	896
Promotional displays	1,025	1,028
Office furniture and equipment	2,554	2,533
Leasehold improvements	127	213
	14,941	15,787
Depreciated cost	\$ 15,587	\$ 14,366

b. Depreciation expenses amounted to \$ 1,822, \$ 1,823 and \$ 1,952 for the years ended December 31, 2004, 2005 and 2006, respectively.

c. As for charges, see Note 11h.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 7:- OTHER INTANGIBLE ASSETS, NET**

- a. Composition:

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Cost:		
Know-how	\$ 502	\$ 982
Patents	2,787	2,859
Customer list	-	172
Technology	436	436
	3,725	4,449
Accumulated amortization:		
Know-how	446	429
Patents	2,575	2,626
Customer list	-	53
Technology	135	191
	3,156	3,299
Amortized cost	\$ 569	\$ 1,150

- b. Amortization expenses related to intangible assets amounted to \$ 144, \$ 141 and \$ 203 for the years ended December 31, 2004, 2005 and 2006, respectively.
- c. Estimated amortization of intangible assets for the years ended:

<b>December 31,</b>	
2007	\$ 238
2008	204
2009	196
2010	165
2011 and thereafter	347
	\$ 1,150

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 8:- SHORT-TERM BANK CREDIT**

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

	<u>Interest rate</u>		<u>December 31,</u>	
	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>
	%			
In or linked to U.S. dollars (1)	4.14	5.71	\$ 15,100	\$ 13,600
In or linked to NIS (1)	5.00	5.85	1,742	3,426
In or linked to PLN (1)	5.92	-	1,226	-
			<u>\$ 18,068</u>	<u>\$ 17,026</u>
Weighted average interest rates at the end of the year	4.62	5.74		
Total authorized credit lines approximate			<u>\$ 48,895</u>	<u>\$ 54,841</u>
Unutilized credit lines approximate			<u>\$ 15,781</u>	<u>\$ 21,437</u>

(1) The Company has undertaken to maintain the following financial ratios and terms in respect of its used credit line: (i) a ratio of at least 40% of consolidated shareholders' equity out of the consolidated total assets, (ii) minimal annual consolidated net income in the amount of \$ 1,000 and (iii) the same shareholders maintain the core of control in the Company. As of December 31, 2005 and 2006, the Company was not in compliance with the requirement under its credit lines that the Company will have a minimum annual consolidated net income of at least \$ 1,000. Subsequent to the balance sheet date, the banks agreed to waive such requirement as of December 31, 2006 and informed the Company that it will not require the immediate repayment of the Company's outstanding indebtedness as a result of such non-compliance. In addition, the banks agreed to cancel the aforementioned ratios and terms.

b. As for charges, see Note 11h.

**NOTE 9:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	<u>December 31,</u>	
	<u>2005</u>	<u>2006</u>
Employees and payroll accruals	\$ 1,596	\$ 1,799
Provision in respect of demand for bank performance guarantee (1)	1,436	-
Accrued expenses	4,859	5,743
Deferred revenues	284	555
Government authorities	84	528
Income tax payable	249	635
Others	406	522
	<u>\$ 8,914</u>	<u>\$ 9,782</u>

(1) See also Note 11 g(2).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- LONG-TERM BANK DEBT**

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

	<u>Linkage terms</u>	<u>Interest rate</u>		<u>December 31,</u>	
		<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>
		<u>%</u>			
Bank loans	U.S. \$	3.10	5.96	\$ 2,500	\$ 5,540
Bank promissory notes(1)	U.S. \$	5.4	6.215	1,000	1,000
Mortgage payable	U.S. \$	5.45	5.45	<u>1,800</u>	<u>1,654</u>
				5,300	8,194
Less - current maturities				<u>3,647</u>	<u>795</u>
				<u>\$ 1,653</u>	<u>\$ 7,399</u>
Weighted average interest rates at the end of the year		4.33	5.89		

- (1) The promissory notes contain covenants that require the Group to maintain \$ 1,000 in deposits at all times otherwise the interest rate on the notes becomes the bank's rate plus 0.25% until the minimum deposit is maintained. As of December 31, 2006, management believes that the Group was in compliance with these ratios and terms.

- b. As of December 31, 2006, the aggregate annual maturities of the long-term loans are as follows:

2007	795
2008	4,303
2009	813
2010	1,803
2011	<u>480</u>
	<u>\$ 8,194</u>

- c. As for charges, see Note 11h.

- d. As for financial ratios in respect of the Company's used credit line, see Note 8a(1).

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11:- 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 \$ 61, \$ 83 and \$ 79 for the years ended December 31, 2004, 2005 and 2006, respectively. As of December 31, 2006, the Company had remaining contingent obligations to pay royalties in the amount of approximately \$ 1,652.

- b. Royalty commitments to the Fund for 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.

No royalties were paid during the years ended December 31, 2004, 2005 and 2006. As of December 31, 2006, the Company's aggregate contingent obligation amounted to \$ 82.

- 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 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, 2006, royalty commitments under the agreement amounted to \$ 22.

- d. In September 2006, the Company signed with a third party a non exclusive agreement for the rights to use certain intangible assets such as know-how and patents for the production, selling and marketing of perimeter security system based on fiber-optic that is used mainly to protect marine sites. The contract period is 2 years and the Company has the right to extend the contract for additional 5 years. The consideration for the license is \$ 548, payable in 24 monthly installments. In addition, the Company will pay royalties based on a formula as defined in the agreement.

In addition, the parties have signed an unlimited agreement that grants the Company the rights to provide maintenance and support for the systems sold previously by the third party. The Company agreed to pay royalties based on a formula as defined in the agreement.

No royalties were paid or accrued as of December 31, 2006.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

e. 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 2010.

Future minimum lease payments under non-cancelable operating lease agreements are as follows:

2007	\$	596
2008		460
2009		252
2010		68
		<u>68</u>
	\$	<u>1,376</u>

Total rent expenses for the years ended December 31, 2004, 2005 and 2006, were approximately \$ 671, \$ 593 and \$ 700, respectively.

f. Guarantees:

As of December 31, 2006, the Group obtained bank performance guarantees and advance payment guarantees and bid bond guarantees from several banks mainly in Israel in the amount of \$ 6,488.

g. 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 \$ 714 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. In July 2005, the parties agreed to appoint a mediator, as proposed by the court. As a result of the mediation, on December 5, 2006, the Company paid the competitor \$ 29.

2. In May 2005, the Company entered into an agreement to supply comprehensive security solutions for a sensitive site in Europe. As part of the agreement, the Company received an advance payment, in the amount of \$ 3,990, secured by a bank advance payment guarantee, which was to be reduced proportionally according to the progress of the execution of the project. In addition, the Company issued to the customer a bank performance guarantee in the amount of \$ 1,436. The Company commenced the execution of the project and delivered part of the equipment and other deliverables to the customer. In April 2006, the customer informed the Company that it was canceling the agreement due to errors in the design documents submitted by the Company.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

In addition, the customer did not make the payments required under the agreement. The Company believes that there are no factual or legal grounds for the cancellation and, accordingly, the agreement is still valid. Based on the cancellation of the agreement, the customer collected on June 20, 2006 \$ 3,181 related to an advance payment that was secured by a bank guarantee .

On April 28, 2006, the Company commenced arbitration proceedings against the customer. In these proceedings, the Company asked the arbitrators to find that the agreement is valid and to enforce the payment of the amounts due pursuant to the agreement. The customer denied the Company's allegations and filed a counter claim for liquidated damages in a foreign currency, which on December 31, 2006, was equal to approximately \$ 4.5 thousand. The hearing of the arbitration has been concluded and the case is still pending resolution of the arbitration panel.

Due to this uncertainty, the Company did not recognize any revenues from this project.

On July 11, 2006, the customer made a demand for the payment under the performance bank guarantee in the amount of approximately \$ 1,436. Upon the Company's motion, the District Court in Haifa, Israel has issued a temporary injunction against the payment of such guarantee pending a hearing in August 2006. In view of the above, and due to the uncertainty in preventing the forfeiture of the performance bank guarantee, the Company included in its financial statements as of December 31, 2005, a provision in respect of this guarantee, in the amount of \$ 1,436. At the hearing, the Company reached a settlement according to which the Company paid the customer 50% of the performance guarantee, and the balance is subject to the results of the arbitration and will be repaid only if pursuant to the arbitration award the Company will be found liable for damages that exceed the amount already paid by the Company.

Based on the opinion of the Company's legal counsel, the Company believes that there is a good likelihood to obtain judgment dismissing all claims raised by the customer. In view of the above, in 2006 the Company cancelled the balance of the provision made in its financial statements regarding the performance guarantee, and did not record any provision regarding the counter claim filed against it.

h. 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. A subsidiary of the Company has two bank promissory notes in the aggregate amount of \$ 1,000 due on July 17, 2008, collateralized by substantially all of the subsidiary's assets.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 11:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)**

- i. In October 2006, the Company signed an agreement with a third party, which consults, markets and implements projects in the security field. According to the agreement, during the first 12 months ("the agreement period"), the parties agreed to cooperate in the development of the business of the third party.

The Company has granted a loan to the third party in the amount of \$ 600. The Company will also provide the third party with additional monthly amounts to fund its activities during the agreement period, that will not exceed \$ 23 per month. The loan and the monthly amounts will bear an annual interest rate of 5%, and shall be paid in October 2011.

The Company received an option to purchase all of the assets of the third party's business, exercisable during the agreement period ("the option"). The Company is obligated to exercise the option if the third party will meet certain milestones. The exercise price of the option is comprised of the outstanding loan and the monthly amounts mentioned above and an additional \$ 400 in cash. In the event that the Company will exercise the option, the beneficial owner of the third party will be entitled to receive 50% of the operating profit of certain projects, as defined in the agreement.

**NOTE 12:- SHAREHOLDERS' EQUITY**

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

The Ordinary shares of the Company are listed for trade on NASDAQ Global 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. Issued and outstanding share capital:

On April 19, 2005, the Company completed a public offering of \$ 16.3 thousand in consideration of 1,700,000 of the Company's Ordinary shares at a price per share of \$ 9.5 and at a price of \$ 9.92 (the closing price of the Ordinary shares on the date of the transaction) to two principal shareholders of the Company.

- c. 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 in October 2013. Any options that are cancelled or forfeited before expiration become available for future grant.

As of December 31, 2006, there were 301,475 options available for future grant.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 12:- SHAREHOLDERS' EQUITY**

A summary of the Company's stock options activities in 2004, 2005 and 2006, is as follows:

	Year ended December 31,					
	2004		2005		2006	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at beginning of year	223,216	\$ 4.61	105,000	\$ 7.66	343,000	\$ 8.35
Granted	100,000	\$ 7.66	238,000	\$ 8.65	-	
Adjustment as a result of stock dividend	7,652	\$ -	-	\$ -	-	
Exercised	(225,338)	\$ 4.61	-	\$ -	(19,100)	\$ 8.56
Forfeited	(530)	\$ -	-	\$ -	(1,800)	\$ 8.56
Outstanding at end of year	<u>105,000</u>	<u>\$ 7.66</u>	<u>343,000</u>	<u>\$ 8.35</u>	<u>322,100</u>	<u>\$ 8.34</u>
Exercisable options at end of year	<u>-</u>	<u>\$ -</u>	<u>231,200</u>	<u>\$ 8.56</u>	<u>317,100</u>	<u>\$ 8.26</u>

The options outstanding as of December 31, 2006 have been separated into ranges of exercise price as follows:

Options outstanding as of December 31, 2006	Exercise price	Weighted average remaining contractual life (in months)	Options exercisable as of December 31, 2006
105,000	\$ 7.66	24.9	105,000
212,100	\$ 8.56	47.7	212,100
<u>5,000</u>	<u>\$ 13.00</u>	<u>47.7</u>	<u>-</u>
<u>322,100</u>	<u>\$ 8.34</u>		<u>317,100</u>

d. Dividends:

- 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.
- The Company's Board of Directors declared 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 dividends.
- 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 by the Board of Directors in December 2003.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 13:- BASIC AND DILUTED NET EARNINGS PER SHARE**

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Numerator:			
Income (loss) from continuing operations	\$ 1,174	\$ (3,055)	\$ 938
Gain (loss) on discontinued operations	(121)	(156)	(128)
Net income (loss)	<u>\$ 1,053</u>	<u>\$ (3,211)</u>	<u>\$ 810</u>
Denominator:			
Denominator for basic net earnings per share - weighted-average number of shares outstanding	8,581,348	9,883,407	10,384,047
Effect of diluting securities: Employee stock options	<u>55,031</u>	<u>16,926</u>	<u>57,777</u>
Denominator for diluted net earnings per share - adjusted weighted average shares and assumed exercises	<u>8,636,379</u>	<u>9,900,333</u>	<u>10,441,824</u>
Basic net earnings (loss) per share from continuing operations	\$ 0.13	\$ (0.31)	\$ 0.09
Basic net loss per share from discontinued operations	<u>(0.01)</u>	<u>(0.01)</u>	<u>(0.01)</u>
Basic net earnings (loss) per share	<u>\$ 0.12</u>	<u>\$ (0.32)</u>	<u>\$ 0.08</u>
Diluted net earnings (loss) per share from continuing operations	\$ 0.13	\$ (0.31)	\$ 0.09
Diluted net loss per share from discontinued operations	<u>(0.01)</u>	<u>(0.01)</u>	<u>(0.01)</u>
Diluted net earnings (loss) per share	<u>\$ 0.12</u>	<u>\$ (0.32)</u>	<u>\$ 0.08</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 14:- 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 two expansion programs under which the Company is entitled to tax benefits:

1. 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.
2. 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, 2006, 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.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export. In order to receive the tax benefits, the Amendment states that a company must make an investment in the Beneficiary Enterprise exceeding a minimum amount specified in the Law. Such investment may be made over a period of no more than three years ending at the end of the year in which a company requested to have the tax benefits apply to the Beneficiary Enterprise ("the Year of Election"). Where a company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Beneficiary Enterprise and the company's effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a Beneficiary Enterprise is required to exceed a certain percentage of the company's production assets before the expansion. The duration of tax benefits is subject to a limitation of the earlier of 7 years from the Commencement Year, or 12 years from the first day of the Year of Election.

On March 3, 2007, the Company received a pre-ruling from the Israeli Tax Authority, for its request for a Benefiting Facility, regarding eligibility for benefits under the Amendment. 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 Company did not yet enjoy the tax benefits from this program.

Income from sources other than "Approved Enterprise", during the benefit period will be subject to tax at regular rate of 31% in 2006 (see e. below).

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 31%), 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 14:- 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. The Company is in a process of tax assessment for the years 2001-2004. The Israeli Tax Authority issued tax assessment for the year 2001 in the amount of approximately \$ 850 including interest and linkage differences. The Company submitted an objection to this assessment and is negotiating with the Israeli Tax Authority. To the management's opinion, the Company has good arguments against this assessment. The Company estimates that it is more likely than not that it will not have to pay this amount, and therefore did not record any provision regarding this assessment.

- e. Tax rates:

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

2. The tax rates of the Company's subsidiaries range between 25%-40%.

- f. Investment tax credit:

Two of the Company's subsidiaries are eligible for investment tax credits on their research and development activities and on certain current and capital expenditures. During the year ended December 31, 2006, the subsidiaries recognized \$ 162 of investment tax credits as a reduction of research and development expenses.

In total, the subsidiaries have investment tax credits available to reduce future federal income taxes payable, amounting to \$ 208, which will expire in 2016-2023.

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

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

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Income (loss) before taxes as reported in the statements of operations	\$ 2,307	\$ (3,078)	\$ 1,886
Tax rate	35%	34%	31%
Theoretical tax expense (tax benefit)	\$ 807	\$ (1,047)	\$ 585
Increase (decrease) in taxes:			
Non-deductible items, net	(400)	25	48
Deferred taxes on losses for which valuation allowance was provided	1,163	579	452
Tax exemption applicable to "Approved Enterprises" and exempted income	(302)	347	(75)
Taxes in respect of prior years	(23)	52	1
Other (1)	(112)	21	(63)
Taxes on income (tax benefit) in the statements of operations	\$ 1,133	\$ (23)	\$ 948
Per share amounts (basic and diluted) of the tax benefit resulting from "Approved Enterprises"	\$ 0.03	\$ (0.04)	\$ 0.01

(1) Including conversion of monetary items for tax purposes.

- h. Taxes on income (tax benefit) included in the statements of operations:

Current:			
Domestic	\$ 460	\$ -	\$ -
Foreign	518	620	1,041
Deferred:			
Domestic	(70)	(642)	248
Foreign	248	(53)	(342)
Taxes in respect of prior years:			
Domestic	-	-	1
Foreign	(23)	52	-
Taxes on income (tax benefit) from continuing operations	1,133	(23)	948
Tax benefit from discontinued operations	(32)	(36)	(34)
Total taxes on income (tax benefit)	\$ 1,101	\$ (59)	\$ 914

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

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

i. 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's deferred tax assets are as follows:

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Operating loss carryforward	\$ 3,923	\$ 4,339
Reserves and tax allowances	963	1,274
Total deferred assets before valuation allowance	4,886	5,613
Valuation allowance	(2,871)	(3,323)
Net deferred tax assets	<u>\$ 2,015</u>	<u>\$ 2,290</u>
Domestic	\$ 1,553	\$ 1,456
Foreign	462	834
	<u>\$ 2,015</u>	<u>\$ 2,290</u>

j. The domestic and foreign components of income (loss) before taxes are as follows:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Domestic	\$ 2,290	\$ (2,998)	\$ 564
Foreign	17	(80)	1,322
	<u>\$ 2,307</u>	<u>\$ (3,078)</u>	<u>\$ 1,886</u>

k. Net operating losses carryforward:

The Company has estimated total available carryforward tax losses of \$ 1,259 to offset against future taxable income.

The Company's subsidiaries in the U.S. and the U.K. have estimated total available carryforward tax losses of \$ 9,802 and \$ 911, respectively, to offset against future taxable income for 16 to 20 years, and an indefinite period, respectively. As of December 31, 2006, the Company recorded a full valuation allowance of the subsidiaries' abovementioned tax assets due to the uncertainty of their 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.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 15:- BALANCES AND TRANSACTIONS WITH RELATED PARTIES**

- a. Balances with related parties:

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Balances with related parties	\$ 290	\$ 59

- b. Sales to related parties:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Sales to related parties (1)	\$ 386	\$ 671	\$ 765

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

**NOTE 16:- SEGMENT 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 executes turnkey projects based on the Company's security management system and acts as an integrator.
3. Video monitoring services - The Group supplies video monitoring services through Smart Interactive Systems, Inc., a U.S. subsidiary.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 16:- SEGMENT INFORMATION (Cont.)**

a. The following data present the revenues, expenditures, assets and other operating data of the Group's operating segments:

	Year ended December 31,														
	2004					2005					2006				
	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total
Revenues	\$ 46,342	\$ 11,375	\$ 2,060	\$ 691	\$ 60,468	\$ 40,143	\$ 17,970	\$ 2,897	\$ 272	\$ 61,282	47,186	16,167	3,358	247	66,958
Depreciation and amortization	\$ 1,252	\$ 11	\$ 698	\$ 5	\$ 1,966	\$ 1,228	\$ 19	\$ 713	\$ 4	\$ 1,964	1,070	133	952	-	2,155
Operating income (loss), before financial expenses and taxes on income	\$ 4,978	\$ 1,430	\$ (2,262)	\$ (1,077)	\$ 3,069	\$ 4,334	\$ (5,290)	\$ (1,375)	\$ 53	\$ (2,278)	3,070	935	(1,130)	(138)	2,737
Financial expenses, net					762					800					851
Taxes on income					1,133					(23)					948
Loss from discontinued operations, net					121					156					128
Net income (loss)					\$ 1,053					\$ (3,211)					\$ 810
	December 31,														
	2004					2005					2006				
	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total
Total long-lived assets	\$ 13,576	\$ 192	\$ 5,814	\$ 19	\$ 19,601	\$ 13,042	\$ 194	\$ 7,087	\$ 19	\$ 20,342	12,451	552	6,778	20	19,801

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 16:- SEGMENT INFORMATION (Cont.)**

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

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Customer A	*) -	23.9%	33.7%
Customer B	15.7%	10.2%	*) -

\*) 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:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
1. Revenues:			
Israel	\$ 9,617	\$ 19,309	\$ 26,385
Romania	9,521	6,244	1,531
Europe (excluding Romania)	9,150	3,691	8,262
USA	17,871	13,185	11,904
Mexico	4,049	3,165	7,456
Canada	4,068	8,759	5,630
Others	6,192	6,929	5,790
	<u>\$ 60,468</u>	<u>\$ 61,282</u>	<u>\$ 66,958</u>
2. Long-lived assets:			
Israel	\$ 3,211	\$ 2,930	\$ 2,763
Europe	1,069	921	1,001
USA	11,518	12,714	12,247
Canada	3,649	3,656	3,648
Others	154	121	142
	<u>\$ 19,601</u>	<u>\$ 20,342</u>	<u>\$ 19,801</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 17:- SELECTED STATEMENTS OF INCOME DATA**

- a. Research and development expenses, net:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Expenses	\$ 5,088	\$ 5,427	\$ 5,540
Less - royalty-bearing grants and investment tax credit	405	162	162
	<u>\$ 4,683</u>	<u>\$ 5,265</u>	<u>\$ 5,378</u>

- b. Financial expenses:

Financial expenses:			
Interest on long-term debt	\$ (289)	\$ (622)	\$ (698)
Interest on short-term bank credit	(849)	(630)	(689)
Forward contracts loss	-	(110)	(915)
Foreign exchange losses	(161)	(314)	(337)
	(1,299)	(1,676)	(2,639)
Financial income:			
Interest on short-term and long-term bank deposits, structured notes and marketable securities	496	707	1,175
Foreign exchange gains	41	169	613
	537	876	1,788
	<u>\$ (762)</u>	<u>\$ (800)</u>	<u>\$ (851)</u>

**NOTE 18:- DISCONTINUED OPERATIONS**

- a. General:

On July 28, 2005, the Company decided to dispose of the indoor security sensors operations ("the operations").

In view of the above, the operating results and cash flows attributed to the operations were presented in the Company's statements of operations and cash flows as discontinued operations, accordingly, the comparative figures were reclassified for all periods presented.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 18:- DISCONTINUED OPERATIONS (Cont.)**

- b. The following are the results of discontinued operations for the years ended December 31, 2004, 2005 and 2006:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Revenues	\$ 506	\$ 427	\$ 48
Cost of revenues	499	470	198
Gross profit (loss)	7	(43)	(150)
Operating expenses:			
Sales and marketing, net	160	149	12
Operating loss	(153)	(192)	(162)
Tax benefit	(32)	(36)	(34)
Net loss	\$ (121)	\$ (156)	\$ (128)

**NOTE 19:- SUBSEQUENT EVENT (UNAUDITED)**

The Company has evaluated the effect of the adoption of FIN 48 (see note 2z) on its financial statements, and expects that the adoption of FIN 48 will have an effect of approximately \$ 200 on its financial statements.

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