

MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2005

IN U.S. DOLLARS

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Management's Discussion and Analysis

The following discussion of our results of operations and financial condition should be read in conjunction with our consolidated financial statements and the related notes thereto included elsewhere in this annual report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 3.D. "Key Information–Risk Factor" of our annual report on Form 20-F for the year ending on December 31, 2005.

We develop, manufacture, market and sell complex computerized security systems. Our systems are used in more than 75 countries to protect aircraft, national borders and sensitive facilities, including military bases, power plant installations, airports, postal facilities, prisons and industrial locations from terrorism, theft and other security threats. Our revenues are principally derived from:

- a line of perimeter security systems, which automatically detect and locate intruders, identify the nature of intrusions and provide emergency notification;
- turnkey projects based on security management, command and control systems, which integrate the management, control and display of various security systems into a single, real-time database and support real-time decision making and wide area command and control; and
- video monitoring services.

We began to market three new products: DreamBox, PipeGuard and Fortis in 2004. DreamBox is a state-of-the-art embedded hardware and software product, which integrates a number of CCTV related applications into one box, including outdoor and indoor video motion detection systems. The system is designed to be economical, as well as compact to save space, while avoiding the use of complicated cable installation and network protocols integration. PipeGuard utilizes an innovative technology to guard buried pipelines, regardless of pipeline length, with the ability to detect potential attack and alert authorities before harm or damage occurs. PipeGuard provides a solution for securing buried assets, gas and oil pipelines and infrastructure of buried communication lines such as fiber optic cables. The target market for PipeGuard includes oil and gas companies, owners and operators of pipelines or communication cables and governmental agencies dealing with security and environment. Fortis is a security management and control system that integrates the management, control and display of various security systems, both outdoor, such as perimeter security systems, and indoor, such as fire detection, entry monitoring and alarm systems, into a single, real-time database, and supports real-time decision making and wide area command and control. These systems were developed to improve the response to real-time security events by sharing video and geographical information between the control center and security personnel acting in the field.

Economic and Other Factors

The continued state of hostility between the State of Israel and the Palestinian Authority has caused the State of Israel to increase its efforts to protect its facilities and installations from unauthorized intrusions. In 2002, the Israeli Government announced the construction of a perimeter system to seal off parts of the West Bank to prevent Palestinian terrorists from entering Israel. In September 2002, we won 80% of the bids published by the MOD for the installation of intrusion detection systems along the seam-line between Israel and the West Bank. We received orders having a value of approximately \$19 million to install intrusion detection systems along approximately 150 kilometers. As of December 31, 2004, this project was completed. In 2003, the Israeli Government resolved to extend the perimeter system and to continue construction along most of the remaining parts of the seam-line. However, following the UN resolution to refer the question of the legality of the seam-line perimeter systems to the International Court of Justice in Hague, an international opposition to the route selected by the Israeli government arose, causing the Israeli Government to change and shorten the route of the seam-line perimeter system. This opposition, as well as certain decisions of the Israeli Supreme Court,

caused a halt in the building of the seam-line fence during 2004. In 2005 the Israeli government approved a new seam-line fence route; consequently the MOD renewed the work on the southern parts of the seam line. According to recent reports in the Israeli press, the majority of the remaining segments of the fence will be completed during 2006. Although we believe that we will record revenues from the seam line project in 2006, we cannot assure you that Israel will follow through with its decision to build the perimeter system along the seam-line, or if such perimeter system is constructed or rebuilt, that our products will be utilized.

During 2005, we continued to incur losses relating to Smart's operations.

Business Challenges/Areas of Focus

Our primary business challenges and areas of focus include:

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

A. Operating Results.

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

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

	Year Ended December 31,				
	2001 (*)	2002 (*)	2003 (*)	2004 (*)	2005
Revenues.....	100%	100%	100%	100%	100%
Cost of revenues.....	52	56	56	55	64
Gross profit	48	44	44	45	36
Operating expenses:					
Research and development, net.....	8	7	8	8	9
Selling and marketing, net.....	19	20	20	21	21
General and administrative	12	11	9	9	10
Award granted by principal shareholders.....	-	-	-	2	-
Operating income.....	9	6	7	5	(4)
Financial income (expenses), net.....	-	-	(2)	(1)	(1)
Income before income taxes	9	6	5	4	(5)
Income taxes (tax benefit).....	1	2	1	2	-
Income from continuing operations	8	4	4	2	(5)
Gain (loss) from discontinued operations, net ..	-	-	-	-	-
Net income.....	8%	4%	4%	2%	(5)%

* Reclassified
- Less than 1%

Years ended December 31, 2005 and 2004

Revenues. Revenues increased by 1.3% to \$61.3 million in the year ended December 31, 2005 as compared with \$60.5 million in the year ended December 31, 2004. Revenues from sales of perimeter systems were \$40.1 million in 2005 as compared with \$46.3 million in 2004, a decrease of 13.4%. Revenues from security turnkey projects increased by 58.0% to \$18.0 million in 2005 as compared with \$11.4 million in 2004. Based on our backlog for 2006 of approximately \$12.5 million and our assessment of the market, we anticipate that revenue in 2006 will increase compared to our revenues in 2005.

Cost of revenues. Cost of revenues increased to \$39.2 million in the year ended December 31, 2005 as compared with \$33.2 million in the year ended December 31, 2004. Cost of revenues as a percentage of revenues was 63.9% in 2005 as compared with 55.0% in 2004 as a result of changes in the mixture of our revenues and expenses incurred in connection with the execution of a project in Eastern Europe that was cancelled, and a provision due to the customer's demand for the payment under a performance bank guarantee in the amount of \$1.4 million. Upon our motion, the District Court in Haifa, Israel has issued a temporary injunction against the payment of such guarantee pending a hearing in August 2006. Although we obtained the temporary injunction, according to our legal counsel, our chances to ultimately prevent the forfeiture of the guarantee remain unclear. In view of the above and due to the uncertainty in preventing the forfeiture of the performance bank guarantee, we included a provision in the amount of \$1.4 million in respect of this guarantee in our financial statements. We anticipate that our cost of revenues as a percentage of revenues will decrease in 2006.

Gross profit. Gross profit decreased to \$22.1 million in the year ended December 31, 2005 as compared with \$27.2 million for the year ended December 31, 2004, primarily as a result of expenses incurred in connection with a project in Eastern Europe that was cancelled. Our expenses related to the project were included in the cost of revenues. Due to the uncertainty, we did not recognize any revenues from this project or reimbursement by the customer for these expenses.

Research and development expenses, net. Research and development expenses, net for the year ended December 31, 2005 were \$5.3 million as compared with \$4.7 million for the year ended December 31, 2004, an increase of 12.4%, mainly due to our continued investment in the products that were launched in 2004 and in new products. Research and development expenses, net amounted to 8.6% of revenues in 2005, compared to 7.7% in 2004. Royalty bearing grants and investment tax credits decreased to \$162,000 in 2005 compared to \$405,000 in 2004. We expect that our net research and development expenditures as a percentage of revenues will decrease in 2006.

Selling and marketing expenses, net. Selling and marketing expenses, net were \$13.2 million for the year ended December 31, 2005 as compared with \$12.5 million for the year ended December 31, 2004, an increase of 5.3%. The increase in selling and marketing expenses in 2005 was primarily due to increased marketing and selling expenses for products first introduced in 2004, especially the DreamBox[®], and the increase in commissions paid in connection with our projects. Selling and marketing expenses amounted to 21.5% and 20.7% of revenues in each of 2005 and 2004, respectively. We expect that our selling and marketing expenses as a percentage of revenues will remain at the same level in 2006.

General and administrative expenses. General and administrative expenses were \$6.0 million for the year ended December 31, 2005 compared to \$5.8 million for the year ended December 31, 2004. General and administrative expenses amounted to 9.7% of revenues in 2005 compared to 9.5% in 2004. The increase in general and administrative expenses was due to an increase of \$255,000 in the amortization of deferred stock compensation. We expect that our general and administrative expenses will increase in 2006 due to the costs associated with our implementation of the internal controls required under Section 404 of the Sarbanes-Oxley Act.

Financial expenses, net. Financial expenses, net for the year ended December 31, 2005 were \$800,000 as compared with \$762,000 for the year ended December 31, 2004.

Income taxes (tax benefit). We recorded a tax benefit of \$23,000 for the year ended December 31, 2005, primarily as a result of the loss incurred in 2005, compared to income taxes of \$1.1 million for the year ended December 31, 2004.

Years ended December 31, 2004 and 2003

Revenues. Revenues increased by 3.1% to \$60.5 million in the year ended December 31, 2004 as compared with \$58.7 million in the year ended December 31, 2003. Revenues from sales of perimeter systems were \$46.3 million in 2004 as compared with \$51.1 million in 2003, a decrease of 9.3%, as a result of a decrease of approximately \$10.4 million in the seam-line project, which made a major contribution to our revenues in 2003 and was halted in 2004 due to litigation in Israel. Revenues from security turnkey projects increased by 69.3% to \$11.4 million in 2004 as compared with \$6.7 million in 2003. One of our main projects in 2004 was the protection of the Otopeni International Airport in Romania.

Cost of revenues. Cost of revenues reached \$33.2 million in the year ended December 31, 2004 as compared with \$32.8 million in the year ended December 31, 2003. Cost of revenues as a percentage of revenues was 55.0% in 2004 as compared with 56.0% in 2003.

Gross profit. Gross profit increased to \$27.2 million in the year ended December 31, 2004 as compared with \$25.8 million for the year ended December 31, 2003, primarily as a result of our increased revenues.

Research and development expenses, net. Research and development expenses, net for the year ended December 31, 2004 were \$4.7 million as compared with \$4.8 million for the year ended December 31, 2003, a decrease of 2.0%. Research and development expenses, net amounted to 7.7% of revenues in 2004 as compared with 8.1% in 2003. Royalty bearing grants and investment tax credits increased to \$405,000 in 2004 compared to \$355,000 in 2003.

Selling and marketing expenses, net. Selling and marketing expenses, net were \$12.5 million for the year ended December 31, 2004 as compared with \$11.4 million for the year ended December 31, 2003, an increase of 9.6%. The increase in selling and marketing expenses in 2004 was primarily due to increased marketing and selling expenses for our newly developed products, especially the DreamBox[®], and increase in commissions paid in connection with our projects. Selling and marketing expenses amounted to 20.7% of revenues in 2004 as compared with 19.5% in 2003.

General and administrative expenses. General and administrative expenses were \$5.8 million for the year ended December 31, 2004 compared to \$5.3 million for the year ended December 31, 2003. General and administrative expenses amounted to 9.5% of revenues in 2004 compared to 9.0% in 2003. The increase in general and administrative expenses was due to an \$0.2 million increase in the amortization of deferred stock compensation expenses and an increase in expenses incurred by our Smart subsidiary due to a \$0.2 million increase in rent and depreciation expenses arising from its relocation to a new facility.

Award granted by principal shareholders. Our two principal shareholders awarded our employees \$1.2 million out of their personal funds in celebration of our twentieth anniversary. According to generally accepted accounting principles in the United States, such award was recorded in our statement of income as an expense, although it did not affect our shareholders' equity nor our statement of cash flows.

Financial income (expenses), net. Financial expenses, net for the year ended December 31, 2004 were \$762,000, as compared with \$1 million for the year ended December 31, 2003 a decrease of 24.0%. This decrease was due to the decrease in the rate of devaluation of the U.S. dollar against the Canadian Dollar and the NIS.

Quarterly Results of Operations

The following tables set forth certain unaudited quarterly financial information for the two years ended December 31, 2005. The data has been prepared on a basis consistent with our audited consolidated financial statements included elsewhere in this annual report and include all necessary adjustments, consisting only of normal recurring adjustments that we consider necessary for a fair presentation. The operating results for any quarter are not necessarily indicative of results for any future periods.

Our 2005 quarterly financial information below includes the reversal of revenues and a corresponding increase in expenses as first reported in our Form 6-K filing of February 2006. As a result of a subsequent to year end cancellation of a turnkey project by a customer in Eastern Europe, we decided to reconsider the revenue recognition of this project in our financial statements for the year ended December 31, 2005. We believe that it is appropriate not to record the revenues from this project in 2005 and to reduce income accordingly.

The results of the fourth quarter of 2005 include an expense of \$1.4 million due to the Eastern Europe customer's formal demand for the payment under a performance bank guarantee. (See Item 8: "Financial information- A. Consolidated Statements and Other Financial Information – Legal proceedings" of our annual report on Form 20-F for the year ending on December 31, 2005 and Note 17 to our consolidated financial statements).

	Three months ended					
	Jun. 30, 2005		Sept. 30, 2005		Dec. 31, 2005	
	As previously reported	As adjusted	As previously reported	As adjusted	As previously reported	As adjusted
Consolidated Statement of Income Data:						
Revenues.....	\$17,138	\$13,238	\$17,721	\$15,761	\$20,038	\$18,557
Cost of revenues	9,705	8,865	10,239	9,817	11,981	13,013
Gross profit.....	7,433	4,373	7,482	5,944	8,057	5,544
Operating expenses:						
Research and development, net.....	1,276	1,276	1,337	1,337	1,496	1,496
Selling and marketing, net	3,882	3,340	3,775	3,503	3,789	3,611
General and administrative	1,438	1,438	1,367	1,367	1,644	1,743
Total operating expenses	6,596	6,054	6,479	6,207	6,929	6,850
Operating income (loss).....	837	(1,681)	1,003	(263)	1,128	(1,306)
Financial income (expenses), net.....	(37)	(37)	(119)	(119)	111	(315)
Income (loss) before income taxes	800	(1,718)	884	(382)	1,239	(1,621)
Income taxes (tax benefit)	294	(170)	260	(27)	412	(144)
Income (loss) from continuing operations	506	(1,548)	624	(355)	827	(1,477)
Loss from discontinued operations, net....	(24)	(24)	(21)	(21)	(80)	(80)
Net income.....	482	(1,572)	603	(376)	747	(1,557)

	Three months ended							
	2004*				2005			
	Mar. 31,	Jun. 30,	Sept. 30,	Dec. 31,	Mar. 31,*	Jun. 30,*	Sept. 30,*	Dec. 31,
Consolidated Statement of Income Data:								
Revenues	\$14,082	\$14,374	\$15,152	\$16,860	\$13,726	\$13,238	\$15,761	\$18,557
Cost of revenues	7,779	7,879	8,346	9,222	7,459	8,865	9,817	13,013
Gross profit	6,303	6,495	6,806	7,638	6,267	4,373	5,944	5,544
Operating expenses:								
Research and development, net	1,131	1,161	1,193	1,198	1,156	1,276	1,337	1,496
Selling and marketing, net	2,587	3,043	2,974	3,915	2,726	3,340	3,503	3,611
General and administrative	1,301	1,417	1,415	1,638	1,413	1,438	1,367	1,743
Award granted by principal shareholders	-	1,200	-	-	-	-	-	-
Total operating expenses	5,019	6,821	5,582	6,751	5,295	6,054	6,207	6,850
Operating income (loss)	1,284	(326)	1,224	887	972	(1,681)	(263)	(1,306)
Financial income (expenses), net	(93)	(258)	(223)	(188)	(329)	(37)	(119)	(315)
Income (loss) before income taxes	1,191	(584)	1,001	699	643	(1,718)	(382)	(1,621)
Income taxes (tax benefit)	451	140	310	232	318	(170)	(27)	(144)
Income (loss) from continuing operations	740	(724)	691	467	325	(1,548)	(355)	(1,477)
Loss from discontinued operations, net	(53)	(14)	(27)	(27)	(31)	(24)	(21)	(80)
Net income	687	(738)	664	440	294	(1,572)	(376)	(1,557)

**Consolidated Statement of Income Data,
expressed as a percentage of revenues:**

Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of revenues	55.2	54.8	55.1	54.7	54.3	67.0	62.3	70.1
Gross profit	44.8	45.2	44.9	45.3	45.7	33.0	37.7	29.9
Operating expenses:						0.0	0.0	0.0
Research and development, net	8.0	8.1	7.9	7.1	8.4	9.6	8.5	8.1
Selling and marketing, net	18.4	21.2	19.6	23.2	19.9	25.2	22.2	19.5
General and administrative	9.2	9.9	9.3	9.7	10.3	10.9	8.7	9.4
Award granted by principal shareholders	-	8.3	-	-	-	-	-	-
Total operating expenses	35.6	47.5	36.8	40.0	38.6	45.7	39.4	36.9
Operating income (loss)	9.1	(2.3)	8.1	5.3	7.1	(12.7)	(1.7)	(7.0)
Financial income (expenses), net	(0.7)	(1.8)	(1.5)	(1.1)	(2.4)	(0.3)	(0.8)	(1.7)
Income (loss) before income taxes	8.5	(4.1)	6.6	4.1	4.7	(13.0)	(2.4)	(8.7)
Income taxes (tax benefit)	3.2	1.0	2.0	1.4	2.3	(1.3)	(0.1)	(0.8)
Income (loss) from continuing operations	5.3	(5.0)	4.6	2.8	2.4	(11.7)	(2.3)	(8.0)
Loss from discontinued operations, net	(0.4)	(0.1)	(0.2)	(0.2)	(0.2)	(0.2)	(0.1)	(0.4)
Net income (loss)	4.9%	(5.1%)	4.4%	2.6%	2.2%	(11.9)%	(2.4)%	(8.4)%

(*) Reclassified.

Seasonality

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

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

Our revenues are dependent on government procurement procedures and practices, and because we receive large product orders from a relatively small number of customers, our revenues and operating results are subject to substantial periodic variations.

Impact of Inflation and Devaluation on Results of Operations, Liabilities and Assets

Exchange rate fluctuations between the NIS and the dollar, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparison of our results. In 2001, 2002 and 2005, the rate of devaluation of the NIS against the dollar was 9.3%, 7.3% and 6.8% respectively, while in 2003 and 2004 the NIS appreciated in value in relation to the dollar by 7.6% and 1.6%, respectively. A portion of our expenses, primarily labor expenses, is incurred in NIS and a part of our revenues are quoted in NIS. Additionally, certain assets, as well as a portion of our liabilities, are denominated in NIS. Our results may be adversely affected by the devaluation of the NIS in relation to the dollar (or if such devaluation is on lagging basis), if our revenues in NIS are higher than our expenses in NIS and/or the amount of our assets in NIS are higher than our liabilities in NIS. Alternatively, our results may be adversely affected by an appreciation of the NIS in relation to the dollar (or if such appreciation is on a lagging basis), if the amount of our expenses in NIS are higher than the amount of our revenues in NIS and/or the amount of our liabilities in NIS are higher than our assets in NIS.

Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results. We are also subject to exchange rate fluctuations related to our activities in Canada. During the three years ended December 31, 2005, foreign currency fluctuations had an adverse impact on our results of operations, and our foreign exchange losses, net were (\$569,000), (\$120,000) and (\$145,000), respectively. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

To protect against the change in the forecasted foreign currency cash flows of certain sale arrangements resulting from changes in the exchange rate, during 2003, 2004 and 2005 we entered into forward contracts in order to hedge portions of our forecasted revenue and unbilled accounts receivable denominated in Euros and Polish Zlotys. We have designated the forward instruments as cash flow hedges for accounting purposes.

For derivative instruments designated as cash flow hedges (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.

During 2005, we recognized no hedge ineffectiveness for the Euro contract cash flows hedge as we concluded that the changes in the cash flows attributable to the changes in the exchange rates were completely offset by the forward contract.

We determined that sales arrangement in Polish Zlotys and the related forecasted revenues and unbilled accounts receivable would not occur by the end of the specified time period. Accordingly, the forward loss was recorded in financial expenses in 2005.

As of December 31, 2005, we expect to reclassify \$6,000 of net income on derivative instruments from other comprehensive income to earnings during the next 12 months due to actual sales and related payments.

Effective Corporate Tax Rate

Israeli companies are generally subject to income tax on their worldwide taxable income. The applicable rate for 2005 was 34%, which was reduced to 31% in 2006, and will be further reduced to 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter. However, certain of our manufacturing facilities have been granted "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended, commonly referred to as the Investment Law, and, consequently, are eligible, subject to compliance with specified requirements, for tax benefits beginning when such facilities first generate taxable income. The tax benefits under the Investment Law are not available with respect to income derived from products manufactured outside of Israel. We have derived, and expect to continue to derive, a substantial portion of our income from our Approved Enterprise facilities. Subject to certain restrictions, we are entitled to a tax exemption in respect of income derived from our approved facilities for a period of two years, commencing in the first year in which such income is earned, and will be entitled to a reduced tax rate of 10% to 25% for an additional five to eight years if we qualify as a foreign investors' company. If we do not qualify as a foreign investors' company, we will instead be entitled to a reduced rate of 25% for an additional five years, rather than eight years. A foreign investors' company is defined in the Investment Law as a company in which more than 25% of its shareholders are non-Israeli residents. Pursuant to the Investment Law, a foreign investors' company may enjoy benefits for a period of up to ten years, (the actual length of the benefits period is graduated based on the percentage of foreign ownership).

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

As of December 31, 2005, our subsidiaries in the United States and the United Kingdom had estimated total available carry forward tax losses of \$8.3 million and \$944,000, respectively, to offset against future taxable income for 16 to 20 years and an indefinite period, respectively. A full valuation allowance was recorded due to the uncertainty of the tax assets' future realization. Utilization of U.S. net operating losses may be subject to a substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state tax law provisions. The annual limitation may result in the expiration of net operating losses before utilization.

B. Liquidity and Capital Resources

General

Our ongoing liquidity requirements arise primarily from our need to service debt and provide working capital. From our inception until our initial public offering in March 1993, we financed our activities mainly through cash flow from operations and bank loans. In March 1993, we received proceeds of \$9.8 million from an initial public offering of 1,380,000 ordinary shares. In February 1997, we raised \$9.4 million from a follow-on offering of 2,085,000 ordinary shares. In April 2005, we raised an additional \$15.2 million from a follow-on offering of 1,700,000 ordinary shares. The proceeds from these offerings together with cash flow from operations and our credit facilities are our main sources of working capital.

Our working capital at December 31, 2005 was \$35.5 million compared to \$21.6 million at December 31, 2004. Cash and cash equivalents amounted to \$10.1 million at December 31, 2005 compared to \$12.0 million at December 31, 2004. Short-term and long-term bank deposits and structured notes amounted to \$18.9 million at December 31, 2005 compared to \$6.0 million at December 31, 2004. Our cash and cash equivalents, short and long-term bank deposits and a structured note are held mainly in U.S. dollars.

We expect to fund our short-term liquidity needs, including our obligations under our credit facilities, other contractual agreements and any other working capital requirements, from cash and cash equivalents, operating cash flow and our credit facilities. We believe that our current cash and cash equivalents, including bank deposits, structured note and our expected cash flow from operations in 2006 will be sufficient to meet our planned and potential cash requirements through 2006.

Cash Flows

The following table summarizes our cash flows for the periods presented:

	Years ended December 31,		
	2003	2004	2005
	(in thousands)		
Net cash provided by (used in) continuing operations	\$1,705	\$3,988	\$(3,820)
Net cash provided by (used in) discontinued operations.....	19	(310)	(319)
Net cash provided by (used in) operating activities	1,724	3,678	(4,139)
Net cash provided by (used in) investing activities.....	(3,606)	512	(15,248)
Net cash provided by financing activities	3,500	3,096	17,269
Effect of exchange rate changes on cash and cash equivalents	252	289	253
Increase (decrease) in cash and cash equivalents.....	1,870	7,575	(1,865)
Cash and cash equivalents at the beginning of the year	2,519	4,389	11,964
Cash and cash equivalents at the end of the year	\$4,389	\$11,964	\$10,099

Net cash used in operating activities was (\$4.1) million for the year ended December 31, 2005 compared to net cash provided by operating activities of \$3.7 million and \$1.7 million for the years ended December 31, 2004 and 2003, respectively. The decrease in cash from operations was primarily due to losses incurred in 2005 as a result of expenses related to the project in Eastern Europe which was cancelled and to the increase in revenues in 2005 attributable to the seam line project. A large portion of the seam line project was recorded in the second half of 2005, and a substantial portion of the billing under this project was collected in the first six months of 2006. Purchases of property and equipment in 2003, 2004 and 2005 were \$3.2 million, \$4.9 million and \$2.7 million, respectively. Capital expenditures in 2003, 2004 and 2005 were principally for equipment for Smart, computers and other machinery and equipment. We estimate that our capital expenditures for 2006 will total approximately \$2.7 million, of which 65% will be spent in Israel, 30% in the U.S. and Canada and 5% in other countries. We expect to finance these expenditures primarily from our cash and cash equivalents, operating cash flow and our credit facilities. However, the actual amount of our capital expenditures for 2006 will depend on a variety of factors, including general economic conditions, changes in the demand for our products and the risks and uncertainties involved in doing business in Israel.

Credit Lines and Other Debt

We currently have credit lines with Bank Leumi Le-Israel B.M., or BLL, Union Bank of Israel Ltd., or Union Bank, Mizrahi Tefahot Bank B.M., or MTB, and Bank Hapoalim B.M. totaling \$39.6 million in the aggregate. There are no restrictions as to our use of any of these credit lines. We agreed not to pledge any of our assets without the consent of these banks. In addition, in connection with two of these credit lines, a fixed charge was placed on our physical plant in Israel by each of BLL and Union Bank, each of which ranks pari-passu with the other.

We have undertaken to maintain the following financial ratios and terms in respect of our credit lines with each of BLL and MTB:

- A ratio of at least 40% of shareholders' equity out of the consolidated total assets;

- Minimal annual consolidated net income in the amount of \$1 million; and
- The same shareholders maintain the core of control in our company.

We have also undertaken to maintain the same financial ratios in respect of our long term credit line with Union Bank, which credit line was not used as of December 31, 2005.

As of December 31, 2005, we were not in compliance with the requirement under our credit lines with BLL and MTB that we will have a minimum annual consolidated net income of \$1 million. BLL has agreed to waive such requirement for 2005 and informed us that it will not require the immediate repayment of our outstanding indebtedness as a result of such non-compliance. While we have not received a formal waiver from MTB to date, we believe that such waiver will be obtained within the next few weeks. As of December 31, 2005, the balance of short-term bank credit due to MTB amounted to approximately \$2.4 million.

If we fail to fulfill our undertakings and covenants as aforesaid, these three banks will be entitled to demand the immediate repayment of any of our outstanding indebtedness to them and may terminate our credit lines with them. Our loans under these credit lines are generally denominated in dollars. However, we may occasionally have short-term NIS-denominated loans.

In addition, our subsidiaries currently have credit lines with Bank Leumi USA, Royal Bank of Canada and Deutsche Bank totaling \$9.3 million in the aggregate.

Our Canadian subsidiary, Senstar Stellar Corporation, or Senstar, has undertaken to maintain general covenants and the following financial ratios and terms in respect of its outstanding credit lines:

- A quick ratio of not less than 1.25;
- A ratio of total liabilities to tangible net worth of not greater than 0.75; and
- Tangible net worth of at least \$9.0 million.
- As of December 31, 2005, Senstar was in compliance with these ratios and terms.

As of December 31, 2005, we had approximately \$12.0 million available under our credit lines. In addition, our subsidiaries had approximately \$3.8 million available under their credit lines.

In connection with the related loans listed immediately above, Bank Leumi USA placed a \$3.0 million fixed charge on our deposits with that bank.

C. Research and Development, Patents and Licenses.

Government Grants

We participate in programs sponsored by the Israeli Government for the support of research and development activities. In the years ended December 31, 2003, 2004 and 2005, we obtained \$139,000, \$228,000 and \$8,000, respectively, of royalty-bearing grants from the OCS for certain of our research and development projects. We are obligated to pay royalties to the OCS amounting to 3%-4.5% of revenues derived from sales of the products funded with these grants, up to 100% of the grants received, linked to the U.S. dollar. All grants received after January 1, 1999 will also bear interest at the rate of LIBOR. The obligation to pay these royalties is contingent on actual sales of the products, and in the absence of such sales no payment is required.

Royalties paid to the OCS amounted to \$80,000, \$61,000 and \$83,000 in the years ended December 31, 2003, 2004 and 2005, respectively.

As of December 31, 2005, we had a contingent obligation to pay royalties of approximately \$1.8 million to the OCS upon the successful sale of products developed using such research and development programs sponsored by the OCS.

The Israeli Government, through the Fund for the Encouragement of Marketing Activities, awarded us grants for overseas marketing expenses. We are obligated to pay royalties to this fund at the rate of 3% of the increase in export sales, up to the amount of the grants we received. To date, we have received \$253,000 in grants from the Fund and, during the years ended December 31, 2003, 2004 and 2005, we did not pay any royalties. As of December 31, 2005, we had a remaining contingent obligation to the Fund of \$82,000.

Investment Tax Credit

Senstar is eligible for investment tax credits on its research and development activities and on certain current and capital expenditures. During the years ended December 31, 2003, 2004 and 2005, Senstar recognized \$216,000, \$177,000 and \$153,000, respectively, of investment tax credits as a reduction of research and development expenses. Senstar has available investment tax credits of approximately \$249,000 to reduce future federal Canadian income taxes payable. These credits will expire at various dates from 2014 through 2015. See also Item 4.B. "Information on the Company—Business Overview—Research and Development; Royalties."

D. Trend Information.

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

E. Off-Balance Sheet Arrangements.

At December 31, 2005, we have guaranteed the advance payments and the performance of our work to certain of our customers (usually government entities). Such guarantees are required by contract for our performance during the installation and operational period of projects throughout Israel and the rest of the world. The guarantees for installation typically expire soon after certain milestones are met and guarantees for operations typically expire proportionally over the contract period. The maximum potential amount of future payments we could be required to make under our guarantees at December 31, 2005 and March 31, 2006 were \$8.7 million and \$8.0 million, respectively. We have not recorded any liability for such amounts, as we expect that our performance will be acceptable and to date, no performance bank guarantees have been exercised against us; however, on July 11, 2006 a customer made demand for the payment under a bank performance guarantee in the amount of \$1.4 million, for which we have recorded a provision in our financial statements for the year ended December 31, 2005. On our motion, the District Court in Haifa, Israel has issued a temporary injunction against the payment of such guarantee pending a hearing in August 2006. Although we obtained the temporary injunction, according to our legal counsel, our chances to ultimately prevent the forfeiture of the guarantee remain unclear. In view of the above and due to the uncertainty in preventing the forfeiture of the performance bank guarantee, we included a provision in the amount of \$1.4 million in respect of this guarantee in our financial statements.



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, 2004 and 2005, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2005. 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% of total consolidated assets as of December 31, 2005, and whose revenues constitute approximately 4.6% of total consolidated revenues for the year ended December 31, 2005. The financial statements of this company were audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to amounts included for this subsidiary, is based solely on the reports 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 reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports 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, 2004 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
February 22, 2006 (except Note 17 dated July 13, 2006)

Kost Forer Gabbay and Kasierer
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2004	2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 11,964	\$ 10,099
Short-term bank deposits	-	17,053
Trade receivables (net of allowance for doubtful accounts of \$ 320 and \$ 306 at December 31, 2004 and 2005, respectively)	*) 15,102	24,012
Unbilled accounts receivable	*) 5,595	8,596
Other accounts receivable and prepaid expenses	3,858	4,455
Deferred income taxes	488	1,187
Inventories (Note 3)	12,702	11,110
<u>Total current assets</u>	49,709	76,512
LONG-TERM INVESTMENTS AND RECEIVABLES:		
Long-term trade receivables	344	290
Long-term bank deposits	2,994	1,800
Structured notes	3,000	-
Severance pay fund	2,142	2,070
<u>Total long-term investments and receivables</u>	8,480	4,160
PROPERTY AND EQUIPMENT, NET (Note 4)	14,659	15,587
DEFERRED INCOME TAXES	186	828
OTHER INTANGIBLE ASSETS, NET (Note 5)	656	569
GOODWILL	4,286	4,186
<u>Total assets</u>	\$ 77,976	\$ 101,842

*) Reclassified.

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)

	December 31,	
	2004	2005
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit (Note 6)	\$ 15,618	\$ 18,068
Current maturities of long-term debt (Note 8)	1,849	3,647
Trade payables	3,189	6,360
Customer advances	-	3,990
Other accounts payable and accrued expenses (Note 7)	6,669	8,914
Unrealized losses on hedging forward contracts	781	79
	<u>28,106</u>	<u>41,058</u>
LONG-TERM LIABILITIES:		
Unrealized losses on hedging forward contracts	650	50
Long-term bank debt (Note 8)	3,500	1,653
Accrued severance pay	2,172	2,131
	<u>6,322</u>	<u>3,834</u>
COMMITMENTS AND CONTINGENT LIABILITIES (Note 9)		
SHAREHOLDERS' EQUITY (Note 10):		
Share capital -		
Ordinary shares of NIS 1 par value -		
Authorized: 19,748,000 shares at December 31, 2004 and 2005;		
Issued and outstanding: 8,672,448 and 10,372,448 shares at		
December 31, 2004 and 2005, respectively	2,825	3,220
Additional paid-in capital	32,526	47,509
Deferred stock compensation	(477)	(38)
Accumulated other comprehensive income	1,639	2,435
Retained earnings	7,035	3,824
	<u>43,548</u>	<u>56,950</u>
Total liabilities and shareholders' equity	<u>\$ 77,976</u>	<u>\$ 101,842</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)

	Year ended December 31,		
	*) 2003	*) 2004	2005
Revenues	\$ 58,655	\$ 60,468	\$ 61,282
Cost of revenues	32,847	33,226	39,154
Gross profit	25,808	27,242	22,128
Operating expenses:			
Research and development, net (Note 15a)	4,773	4,683	5,265
Selling and marketing, net	11,427	12,519	13,180
General and administrative	5,305	5,771	5,961
Award granted by principal shareholders	-	1,200	-
<u>Total operating expenses</u>	<u>21,505</u>	<u>24,173</u>	<u>24,406</u>
Operating income (loss)	4,303	3,069	(2,278)
Financial expenses, net (Note 15b)	1,003	762	800
Income (loss) before income taxes	3,300	2,307	(3,078)
Income taxes (tax benefit) (Note 12)	910	1,133	(23)
Income (loss) from continuing operations	2,390	1,174	(3,055)
Gain (loss) from discontinued operations, net (Note 16)	14	(121)	(156)
Net income (loss)	<u>\$ 2,404</u>	<u>\$ 1,053</u>	<u>\$ (3,211)</u>
Basic net earnings (loss) per share from continuing operations	\$ 0.30	\$ 0.13	\$ (0.31)
Basic net loss per share from discontinued operations	-	(0.01)	(0.01)
Basic net earnings (loss) per share (Note 11)	<u>\$ 0.30</u>	<u>\$ 0.12</u>	<u>\$ (0.32)</u>
Diluted net earnings (loss) per share from continuing operations	\$ 0.30	\$ 0.13	\$ (0.31)
Diluted net loss per share from discontinued operations	-	(0.01)	(0.01)
Diluted net earnings (loss) per share (Note 11)	<u>\$ 0.30</u>	<u>\$ 0.12</u>	<u>\$ (0.32)</u>

*) Reclassified.

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)	Retained earnings	Total comprehensive income	Total shareholders' equity
Balance as of January 1, 2003	7,666,370	\$ 2,600	\$ 21,791	\$ (3)	\$ (1,006)	\$ 11,649		\$ 35,031
Declared dividend	-	-	-	-	-	(401)		(401)
Exercise of stock options	137,446	30	432	-	-	-		462
Amortization of deferred stock compensation	231,963	-	-	3	-	-		3
Stock dividend	-	53	1,875	-	-	(1,928)		-
Comprehensive income:								
Net income	-	-	-	-	-	2,404	\$ 2,404	2,404
Unrealized losses on forward contracts, net	-	-	-	-	(807)	-	(807)	(807)
Foreign currency translation adjustments	-	-	-	-	2,292	-	2,292	2,292
Total comprehensive income							<u>\$ 3,889</u>	
Balance as of December 31, 2003	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 compensation related to officers' options grant	-	-	-	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 compensation related to officers' options grant	-	-	-	439	-	-		439
Deferred taxes on stock options	-	-	190	-	-	-		190
Comprehensive income:								
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 income							<u>\$ (2,415)</u>	
Balance as of December 31, 2005	<u>10,372,448</u>	<u>\$ 3,220</u>	<u>\$ 47,509</u>	<u>\$ (38)</u>	<u>\$ 2,435</u>	<u>\$ 3,824</u>		<u>\$ 56,950</u>
Accumulated unrealized earnings on forward contracts, net					\$ 5			
Accumulated foreign currency translation adjustments					2,430			
Accumulated other comprehensive income as of December 31, 2005					<u>\$ 2,435</u>			

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

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2003	2004	2005
<u>Cash flows from operating activities:</u>			
Net income (loss)	\$ 2,404	\$ 1,053	\$ (3,211)
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Loss (gain) from discontinued operations	(14)	121	156
Depreciation and amortization	1,378	1,966	1,964
Gain on sale of property and equipment	(9)	(18)	(10)
Decrease (increase) in accrued interest on short-term and long-term bank deposits	(199)	657	(322)
Amortization of deferred stock compensation	3	184	439
Decrease (increase) in trade receivables, net	*) (2,977)	*) 3,956	(8,998)
Decrease in receivables from related parties	28	-	-
Decrease (increase) in unbilled accounts receivable	*) 1,533	*) (4,130)	(2,819)
Decrease (increase) in other accounts receivable and prepaid expenses	(836)	16	(599)
Decrease (increase) in deferred income taxes	(88)	178	(1,020)
Decrease (increase) in inventories	(2,581)	(552)	1,676
Decrease (increase) in long-term trade receivables	1,210	(44)	54
Increase (decrease) in trade payables	49	(1,953)	3,096
Increase in other accounts payable and accrued expenses	1,727	880	2,194
Increase in customer advances	-	-	3,990
Accrued severance pay, net	77	(2)	31
Award granted by principal shareholders	-	1,200	-
Realized losses (gains) on hedging forward contract	-	476	(441)
Net cash provided by (used in) continuing operations	1,705	3,988	(3,820)
Net cash provided by (used in) discontinued operations	19	(310)	(319)
Net cash provided by (used in) operating activities	1,724	3,678	(4,139)
<u>Cash flows from investing activities:</u>			
Purchase of short-term deposits	-	-	(16,731)
Purchase of long-term bank deposits	-	(3,000)	-
Proceeds from sale of long-term deposits	-	-	1,194
Purchase of structured notes	(3,000)	-	-
Redemption of structured notes	-	-	3,000
Proceeds from sale of short-term bank deposits	3,505	8,400	-
Proceeds from sale of property and equipment	33	59	71
Purchase of property and equipment	(3,194)	(4,858)	(2,736)
Purchase of know-how and patents	(48)	(89)	(46)
Acquisition of the business activity of Dominion Wireless Inc. (a)	(902)	-	-
Net cash provided by (used in) investing activities	(3,606)	512	(15,248)

*) Reclassified.

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

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2003	2004	2005
<u>Cash flows from financing activities:</u>			
Short-term bank credit, net	3,098	2,895	2,402
Proceeds from long-term bank loans	43	-	1,800
Principal payment of long-term bank loans	(103)	(365)	(1,849)
Proceeds from exercise of employee stock options	462	967	-
Proceeds from issuance of shares, net	-	-	14,916
Dividend paid	-	(401)	-
	<u>3,500</u>	<u>3,096</u>	<u>17,269</u>
Net cash provided by financing activities			
Effect of exchange rate changes on cash and cash equivalents	252	289	253
Increase (decrease) in cash and cash equivalents	1,870	7,575	(1,865)
Cash and cash equivalents at the beginning of the year	2,519	4,389	11,964
	<u>\$ 4,389</u>	<u>\$ 11,964</u>	<u>\$ 10,099</u>
<u>Supplemental disclosures of cash flows activities:</u>			
Cash paid during the year for:			
Interest	\$ 1,099	\$ 1,093	\$ 828
Taxes	\$ 1,544	\$ 1,164	\$ 887
<u>Non-cash activities:</u>			
Declared dividend	\$ 401	\$ -	\$ -
 (a) <u>Acquisition of the business activity of Dominion Wireless Inc.:</u>			
Net fair value of the assets acquired at the acquisition date was as follows:			
Inventories	\$ 376		
Property and equipment	90		
Technology	436		
	<u>\$ 902</u>		

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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 and Israel.

As for major customer data, see Note 14b.

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

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

The Asset Purchase Agreement with DW, stipulated for additional payments to be made conditioned upon the achievement of operating income milestones during the periods ending on December 31, 2003, 2004 and 2005. Since such goals were not met, no additional payments were due.

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

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

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

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

*) Reclassified.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL (Cont.)

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

1. DW's inventories and property and equipment are presented at current replacement cost.
2. The value assigned to technology was determined using the Income Approach on the basis of the present value of cash flows attributable to the intellectual property over its expected future life. Technology is amortized on a straight-line basis over a period of 8 years.

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

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

	Year ended December 31, 2003
Revenues	\$ 59,227 *)
Net income	\$ 1,910
Basic net earnings per share	\$ 0.24
Diluted net earnings per share	\$ 0.24

*) Reclassified.

- c. 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".

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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:

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

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

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

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

c. Principles of consolidation:

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

d. Cash equivalents:

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

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

A bank deposit with maturities of more than one year is included in long-term bank deposits, and presented at cost. The deposit is in U.S. dollars, bears interest of 4.75% and matures in 2010.

- f. Structured notes:

During 2003, the Company purchased structured notes ("the Notes") at par value totaling \$ 3,000 to be settled in 2013. Under the terms of the Notes, the Notes bear interest of 10% for the first year. Thereafter, interest is determined based on six months LIBOR rates using the following formula: 10% minus two times six months LIBOR rate. The Notes are callable immediately after accumulating 12% interest payments.

The Company accounts for its investment in structured notes in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and FASB Emerging Issues Task Force Issue ("EITF") No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes". Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Structured notes securities are classified as held-to-maturity since management believes the Company has the intent and ability to hold these securities to maturity and are stated at amortized cost. As of December 31, 2004, the investments in the Notes approximate their fair market value. During 2005, the notes were fully repaid.

- g. Inventories:

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

Cost is determined as follows:

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

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

During 2003, 2004 and 2005, the Group recorded inventory write-offs in the amount of \$ 601, \$ 224 and \$ 507, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- h. Long-term trade receivables:

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

- i. Property and equipment:

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

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

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

- 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 2003, 2004 and 2005, no impairment losses have been identified.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

l. Goodwill:

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

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. Goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital for each of the reportable units. During 2003, 2004 and 2005, no impairment losses have been identified.

Differences between the balance of goodwill as of December 31, 2004 and 2005 derive from functional currency translation adjustments. The entire goodwill balance relates to the Perimeter segment.

m. Revenue recognition:

The Group generates its revenues mainly from (1) installation of comprehensive security systems for which revenues are generated from long-term fixed price contracts; (2) sales of security products; and (3) services and maintenance, which are performed either on 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 over one year. Such revenues are recognized in accordance with Statement of Position ("SOP") No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," using contract accounting on a percentage of completion method, in accordance with the "Input Method". The amounts of revenues recognized are based on the total fees under the agreements and the percentage to completion achieved.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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. Estimates of total project requirements are based on prior experience of installing and integrating security systems, a history of no collection issues, delivery and acceptance of similar services and a history of no cancellation problems, which are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract.

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

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

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.

Fees are payable upon completion of agreed upon milestones and subject to customer acceptance. Amounts recognized in advance of contractual billing, mainly as a result of using the "Input Method", are recorded as unbilled accounts receivable. The period between most instances of advanced recognition of revenues and the customers' billing generally range 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 SAB No. 104, "Revenue Recognition in Financial Statements", when delivery has occurred, persuasive evidence of an agreement exists, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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.

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 EITF No. 01-08, "Determining Whether an Arrangement Contains a Lease" and SFAS No. 13, "Accounting for Leases", the service contract does not meet the definition of a lease and as such the subsidiary recognizes monthly service fees over the term of the agreement.

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

n. Accounting for stock-based compensation:

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The fair value for options granted in 2004 and 2005 is amortized over their vesting period and estimated at the grant date using the Black and Scholes option pricing model with the following weighted-average assumptions:

	2004	2005
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

Pro forma information under SFAS No. 123:

	Year ended December 31,		
	2003	2004	2005
Net income (loss) as reported:	\$ 2,404	\$ 1,053	\$ (3,211)
Add: stock-based compensation expenses determined under the intrinsic value based method included in the reported net income	3	184	439
Deduct: stock-based compensation expenses determined under fair value based method for all awards	(111)	(198)	(1,493)
Pro forma net income	\$ 2,296	\$ 1,039	\$ (4,265)
Basic net earnings (loss) per share, as reported	\$ 0.30	\$ 0.12	\$ (0.32)
Diluted net earnings (loss) per share, as reported	\$ 0.30	\$ 0.12	\$ (0.32)
Pro forma basic net earnings (loss) per share	\$ 0.29	\$ 0.12	\$ (0.43)
Pro forma diluted net earnings (loss) per share	\$ 0.29	\$ 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

p. Warranty costs:

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

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 \$ 128, \$ 228 and \$ 8 in 2003, 2004 and 2005, respectively.

r. Net earnings (loss) per share:

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

s. Concentrations of credit risk:

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 and Europe. The Group performs ongoing credit evaluations of its customers and to date have not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Group has determined to be doubtful of collection and in accordance with an aging key. In certain circumstances, the Group may require letters of credit, other collateral or additional guarantees.

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

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, 2003, 2004 and 2005, amounted to approximately \$ 313, \$ 306 and \$ 362, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

v. Fair value of financial instruments:

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

- (i) The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables, unbilled accounts receivable, short-term bank credit and trade payables approximate their fair value due to the short-term maturity of such instruments.
- (ii) The carrying amount of the Group's long-term trade receivables, long-term bank deposits and structured notes approximate their fair value. The fair value was estimated using discounted cash flows analyses, based on the Group's investment rates for similar type of investment arrangements.
- (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, 2004, the fair value of the Company's long-term borrowing was \$ 5,318, compared to the carrying amount of \$ 5,349. 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.
- (iv) The fair value of foreign currency contracts (used for hedge purposes) is estimated by obtaining current quotes from brokerage firms.

w. Advertising expenses:

Advertising costs are expensed as incurred. Advertising expenses for the years ended December 31, 2003, 2004 and 2005, were \$ 422, \$ 495 and \$ 420, 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 2003, 2004 and 2005 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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.

During 2005, the Company recognized no hedge ineffectiveness for the Euro contract cash flows hedge as the Company concluded that the changes in the cash flows attributable to the changes in the exchange rates are completely offset by the forward contract.

The Company determined 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, the forward loss was recorded in financial expenses in 2005.

As of December 31, 2005, the Company expects to reclassify \$ 6 of net income on derivative instruments from other comprehensive income to earnings during the next 12 months due to actual sales and related payments.

y. Reclassification:

An amount of \$ 1,870 in billed accounts receivable was reclassified from unbilled accounts to trade receivables to conform to current year presentation. The reclassification had no effect on previously reported net income, shareholders' equity or cash flows.

See also Note 16a.

z. Impact of recently issued accounting standards:

On December 16, 2004, the FASB issued SFAS No. 123(R) (revised 2004), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123(R)"). Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS No. 123. However, SFAS 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The Company adopted SFAS 123(R) on January 1, 2006.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

SFAS 123(R) permits companies to adopt its requirements using one of the following two methods:

1. The "modified prospective" method, in which compensation cost is recognized commencing with the effective date (i) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested at the effective date.
2. The "modified retrospective" method, which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123, for purposes of pro forma disclosures all prior periods presented.

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25, the intrinsic value method. The impact of the adoption of SFAS 123(R) cannot be predicted at this time, as it depends on levels of share-based payments for future grant. However, had the Company adopted SFAS 123(R) in prior periods, the impact of that Standard would have approximated the impact of SFAS 123, as described in the disclosure of the pro forma information above.

In March 2005, the SEC Staff issued Staff Accounting Bulletin No. 107 (SAB 107) to give guidance on implementation of SFAS 123(R).

NOTE 3:- INVENTORIES

	December 31,	
	2004	2005
Raw materials	\$ 6,806	\$ 4,902
Work in progress	2,320	1,855
Finished products	3,576	4,353
	\$ 12,702	\$ 11,110

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 4:- PROPERTY AND EQUIPMENT

a. Composition:

	December 31,	
	2004	2005
Cost:		
Land and buildings	\$ 8,790	\$ 8,949
Machinery and equipment	4,411	5,401
Machinery and equipment leased to customers under operating leases	4,952	6,796
Motor vehicles	1,341	1,297
Promotional display	4,236	4,115
Office furniture and equipment	2,924	3,190
Leasehold improvements	784	780
	<u>27,438</u>	<u>30,528</u>
Accumulated depreciation:		
Buildings	2,404	2,698
Machinery and equipment	2,958	3,846
Machinery and equipment leased to customers under operating leases	845	1,342
Motor vehicles	833	941
Promotional display	3,322	3,433
Office furniture and equipment	2,356	2,554
Leasehold improvements	61	127
	<u>12,779</u>	<u>14,941</u>
Depreciated cost	<u>\$ 14,659</u>	<u>\$ 15,587</u>

b. Depreciation expenses amounted to \$ 1,241, \$ 1,822 and \$ 1,823 for the years ended December 31, 2003, 2004 and 2005, respectively.

c. As for charges, see Note 9g.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5:- OTHER INTANGIBLE ASSETS, NET

a. Composition:

	December 31,	
	2004	2005
Cost:		
Know-how	\$ 502	\$ 502
Patents	2,639	2,787
Technology	436	436
	<hr/>	<hr/>
	3,577	3,725
	<hr/>	<hr/>
Accumulated amortization:		
Know-how	396	446
Patents	2,443	2,575
Technology	82	135
	<hr/>	<hr/>
	2,921	3,156
	<hr/>	<hr/>
Amortized cost	<u>\$ 656</u>	<u>\$ 569</u>

b. Amortization expenses related to intangible assets amounted to \$ 137, \$ 144 and \$ 141 for the years ended December 31, 2003, 2004 and 2005, respectively.

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

<u>December 31,</u>	
2006	\$ 111
2007	102
2008	93
2009	86
2010	<hr/>
	177
	<hr/>
	<u>\$ 569</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 6:- SHORT-TERM BANK CREDIT

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

	Interest rate		December 31,	
	2004	2005	2004	2005
	%			
In or linked to U.S. dollars (1)	4.08	4.14	\$ 8,600	\$ 15,100
In or linked to NIS (1)	5.47	5.00	5,556	1,742
In or linked to Canadian dollars (2)	4.75	-	1,462	-
In or linked to PLN (1)	-	5.92	-	1,226
			<u>\$ 15,618</u>	<u>\$ 18,068</u>
Weighted average interest rates at the end of the year	4.64	4.62		
Total authorized credit lines approximate			<u>\$ 33,245</u>	<u>\$ 48,895</u>
Unutilized credit lines approximate			<u>\$ 6,352</u>	<u>\$ 15,781</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, 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. One of the banks has agreed to waive such requirement for 2005 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. Although the Company has not received a formal waiver from the other bank to date, management believes that such waiver will be obtained within the next few weeks. As of December 31, 2005, the balance due to the abovementioned bank, amounts to approximately \$ 2,370 in short-term bank credit.

- (2) The loan to a subsidiary is collateralized by a general security agreement. The subsidiary has undertaken to maintain general covenants and the following financial ratios, with respect to the subsidiary's financial statements, and terms in respect of its used credit lines: (i) a quick ratio of not less than 1.25, (ii) a ratio of total liabilities to tangible net worth of not greater than 0.75 and (iii) tangible net worth of at least \$ 9,000.

As of December 31, 2005, the subsidiary has no commitments to the bank.

- b. As for charges, see Note 9g.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 7:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2004	2005
Employees and payroll accruals	\$ 1,380	\$ 1,596
Provision in respect of demand for bank performance guarantee (1)	-	1,436
Accrued expenses	3,911	4,599
Deferred revenues	81	284
Government authorities	308	84
Income tax payable	3	249
Others	986	666
	\$ 6,669	\$ 8,914

(1) See also Note 17.

NOTE 8:- LONG-TERM BANK DEBT

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

	Linkage terms	Interest rate		December 31,	
		2004	2005	2004	2005
		%			
Bank loan	U.S. \$	3.10	3.10	\$ 2,500	\$ 2,500
Bank promissory note	U.S. \$	-	5.45	-	820
Bank promissory note	U.S. \$	-	5.45	-	980
Bank promissory note (1)	U.S. \$	3.05	5.175	500	500
Bank promissory note (1)	U.S. \$	3.50	5.625	500	500
				3,500	5,300
Mortgage payable	U.S. \$	8.25	-	1,849	-
				5,349	5,300
Less - current maturities				1,849	3,647
				\$ 3,500	\$ 1,653
Weighted average interest rates at the end of the year		4.91	4.33		

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 8:- LONG-TERM BANK DEBT (Cont.)

- (1) As for financial ratios and terms in respect of long-term loans, the two \$ 500 promissory notes both have covenants that require the Group to maintain \$ 1 thousand 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, 2005, management believes that the Group was in compliance with these ratios and terms.

- b. As of December 31, 2005, the aggregate annual maturities of the long-term loans are as follows:

2006	\$ 3,647
2007	155
2008	163
2009	173
2010	<u>1,162</u>
	<u>\$ 5,300</u>

- c. As for charges, see Note 9g.

NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES

- a. Royalty commitments to the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade ("OCS"):

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

Royalties paid amounted to \$ 80, \$ 61 and \$ 83 for the years ended December 31, 2003, 2004 and 2005, respectively. As of December 31, 2005, the Company had remaining contingent obligations to pay royalties in the amount of approximately \$ 1,792.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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

- 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, 2003, 2004 and 2005. As of December 31, 2005, 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, 2005, royalty commitments under the agreement amounted to \$ 17.

- d. Lease commitments:

The Group rents its facilities and some of its motor vehicles under various operating lease agreements, which expire on various dates, the latest of which is in 2009.

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

2006	\$	404
2007		243
2008		137
2009		<u>37</u>
	\$	<u><u>821</u></u>

Total rent expenses for the years ended December 31, 2003, 2004 and 2005, were approximately \$ 368, \$ 671 and \$ 593, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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

e. Guarantees:

As of December 31, 2005, the Group obtained bank performance guarantees and advance payment guarantees and bid bond guarantees from several banks mainly in Israel in the amount of \$ 8,670. As for a customer's demand for the payment under a bank performance guarantee, see Note 17.

f. Legal proceedings:

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. The Company's legal counsel believes that the Company has valid defenses against the aforementioned claims and, therefore, no provision was recorded in the financial statements.

For arbitration procedures against Company's customer, see Note 17.

g. Charges:

As collateral for all of the Group liabilities to banks:

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 10:- SHAREHOLDERS' EQUITY

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

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

- b. 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, 2005, there were 299,676 options available for future grant.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

A summary of the Company's stock options activities in 2003, 2004 and 2005, is as follows:

	Year ended December 31,					
	2003		2004		2005	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	358,234	\$ 4.23	223,216	\$4.61	105,000	\$7.66
Granted	-	\$-	100,000	\$7.66	238,000	\$8.65
Adjustment as a result of stock dividend	10,256	\$-	7,652	\$-	-	\$-
Exercised	(137,446)	\$3.55	(225,338)	\$4.61	-	-
Forfeited	(7,828)	\$-	(530)	\$-	-	\$-
Outstanding at the end of the year	<u>223,216</u>	<u>\$4.61</u>	<u>105,000</u>	<u>\$7.66</u>	<u>343,000</u>	<u>\$8.35</u>
Exercisable options at the end of the year	<u>223,216</u>	<u>\$4.61</u>	<u>-</u>	<u>\$-</u>	<u>231,200</u>	<u>\$8.56</u>

The options outstanding as of December 31, 2005 have been separated into ranges of exercise price as follows:

Options outstanding as of December 31, 2005	Exercise price	Weighted average remaining contractual life (in months)	Options exercisable as of December 31, 2005
105,000	\$ 7.66	1	-
233,000	\$ 8.56	-	231,200
<u>5,000</u>	<u>\$ 13</u>	<u>24</u>	<u>-</u>
<u>343,000</u>	<u>\$ 8.35</u>		<u>231,200</u>

Where the Company has recorded deferred stock compensation for options issued with an exercise price below the fair market value of the Ordinary shares, the deferred stock compensation has been amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expenses of approximately \$ 3, \$ 184 and \$ 439 were recognized during the years ended December 31, 2003, 2004 and 2005, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

d. Dividends:

1. Dividends, if any, will be declared and paid in U.S. dollars. Dividends paid to shareholders in Israel will be converted into NIS on the basis of the exchange rate prevailing at the date of payment. The Company has determined that it will not distribute dividends out of tax-exempt profits.
2. The Company's Board of Directors 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 dividend.
3. At the Annual General Meeting of Shareholders held on July 29, 2004, the shareholders approved the payment of an interim cash dividend in the amount of \$ 0.05 per Ordinary share of NIS 1 par value each, which was declared by the Board of Directors in December 2003.

NOTE 11:- BASIC AND DILUTED NET EARNINGS PER SHARE

	Year ended December 31,		
	2003	2004	2005
Numerator:			
Income (loss) from continuing operations	\$ 2,390	\$ 1,174	\$ (3,055)
Gain (loss) on discontinued operations	14	(121)	(156)
Net income (loss)	<u>\$ 2,404</u>	<u>\$ 1,053</u>	<u>\$ (3,211)</u>
Denominator:			
Denominator for basic net earnings per share - weighted-average number of shares outstanding	7,947,778	8,581,348	9,883,407
Effect of diluting securities: Employee stock options and warrants to underwriters	<u>80,848</u>	<u>55,031</u>	<u>16,926</u>
Denominator for diluted net earnings per share - adjusted weighted average shares and assumed exercises	<u>8,028,626</u>	<u>8,636,379</u>	<u>9,900,333</u>
Basic net earnings (loss) per share from continuing operations	\$ 0.30	\$ 0.13	\$ (0.31)
Basic net loss per share from discontinued operations	<u>-</u>	<u>(0.01)</u>	<u>(0.01)</u>
Basic net earnings (loss) per share	<u>\$ 0.30</u>	<u>\$ 0.12</u>	<u>\$ (0.32)</u>
Diluted net earnings (loss) per share form continuing operations	\$ 0.30	\$ 0.13	\$ (0.31)
Diluted net loss per share from discontinued operations	<u>-</u>	<u>(0.01)</u>	<u>(0.01)</u>
Diluted net earnings (loss) per share	<u>\$ 0.30</u>	<u>\$ 0.12</u>	<u>\$ (0.32)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME

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

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

1. In 1992, a program of the Company was granted the status of an "Approved Enterprise". The Company has elected to enjoy the "alternative benefits" track - waiver of grants in return for tax exemption - and, accordingly, the Company's income from this program was tax-exempt for a period of four years, and was subject to a reduced tax rate of 15%-25% for a period ranging between three to six years (depending on the percentage of foreign ownership of the Company). The period of benefits under this program began in 1994 and terminated in 2003.
2. On March 18, 1997, a program of the Company was granted the status of an "Approved Enterprise". The Company elected to enjoy the "alternative benefits" track - waiver of grants in return for tax exemption and accordingly, the Company's income from this program was tax-exempt for a period of four years, and is subject to a reduced tax rate of 15%-25% for a period ranging between three to six years (depending on the percentage of foreign ownership of the Company). The period of benefits under this program began in 1998 and will terminate in 2007.
3. On August 13, 2002, a program of the Company was granted the status of an "Approved Enterprise". The Company elected to enjoy the "alternative benefits" track - waiver of grants in return for tax exemption - and, accordingly, the Company's income from this program is tax-exempt for a period of two years, and is subject to a reduced tax rate of 15%-25% for a period of five to eight years (depending upon the percentage of foreign ownership of the Company). The benefit period for this program began in 2003 and will terminate in 2012.

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the Law, regulations published there under and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2005, management believes that the Company is in compliance with all of the aforementioned conditions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME (Cont.)

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.

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.

Income from sources other than "Approved Enterprise", during the benefit period will be subject to tax at regular rate of 34% in 2005 (see d. 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 34%), 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME (Cont.)

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%).

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

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

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

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

- d. Tax rates:

1. On 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%. The amendment had no material impact on the Company's financial statements.

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

- e. Investment tax credit:

One of the Company's subsidiaries is eligible for investment tax credits on its research and development activities and on certain current and capital expenditures. During fiscal year 2005, the subsidiary recognized \$ 153 of investment tax credits as a reduction of research and development expenses. In total, the subsidiary has investment tax credits available to reduce future federal income taxes payable, amounting to \$ 249, which will expire at various dates from 2014 through 2015.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME (Cont.)

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

	Year ended December 31,		
	2003	2004	2005
Income (loss) before taxes as reported in the statements of income	\$ 3,300	\$ 2,307	\$ (3,078)
Tax rate	36%	35%	34%
Theoretical tax expense (tax benefit)	\$ 1,188	\$ 807	\$ (1,047)
Increase (decrease) in taxes:			
Non-deductible items, net	17	(400)	25
Deferred taxes on losses for which valuation allowance was provided	298	1,163	579
Tax exemption applicable to "Approved Enterprises" and exempted income	(440)	(302)	347
Taxes in respect of prior years	(107)	(23)	52
Other	(46)	(112)	21
Taxes on income (tax benefit) in the statements of income	\$ 910	\$ 1,133	\$ (23)
Per share amounts (basic and diluted) of the tax benefit resulting from "Approved Enterprises"	\$ 0.06	\$ 0.03	\$ (0.04)
g. Taxes on income included in the statements of income:			
Current taxes:			
Domestic	\$ 395	\$ 460	\$ -
Foreign	534	518	620
Deferred income taxes (tax benefit):			
Domestic	-	(70)	(642)
Foreign	88	248	(53)
Taxes in respect of prior years:			
Domestic	(107)	-	-
Foreign	-	(23)	52
Taxes on income (tax benefit) from continuing operations	910	1,133	(23)
Taxes on income (tax benefit) from discontinued operations	3	(32)	(37)
Total taxes on income	\$ 913	\$ 1,101	\$ 14

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME (Cont.)

- h. Deferred income taxes:

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

	December 31,	
	2004	2005
Operating loss carryforward	\$ 2,992	\$ 3,923
Reserves and tax allowances	(26)	963
	2,966	4,886
Total deferred assets before valuation allowance		
Valuation allowance	(2,292)	(2,871)
	\$ 674	\$ 2,015
Net deferred tax assets		
Domestic	\$ 288	\$ 1,553
Foreign	386	462
	\$ 674	\$ 2,015

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

	Year ended December 31,		
	2003	2004	2005
Domestic	\$ 2,200	\$ 2,290	\$ (2,998)
Foreign	1,100	17	(80)
	\$ 3,300	\$ 2,307	\$ (3,078)

- j. Net operating losses carryforward:

The Company has estimated total available carryforward tax losses of \$ 2,377 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 \$ 8,331 and \$ 944, respectively, to offset against future taxable income for 16 to 20 years, and an indefinite period, respectively. As of December 31, 2005, 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

NOTE 13:- BALANCES AND TRANSACTIONS WITH RELATED PARTIES

a. Balances with related parties:

	December 31,	
	2004	2005
Balances with related parties	\$ 35	\$ 290

b. Sales to related parties:

	Year ended December 31,		
	2003	2004	2005
Sales to related parties (1)	\$ 196	\$ 386	\$ 671

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

NOTE 14:- 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 is executing turnkey projects based on the Company's security management system and acting as an integrator.
3. Video monitoring services - The Group supplies video monitoring services through Smart Interactive Systems, Inc., a subsidiary established in the U.S. in June 2001.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- 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,														
	2003					2004					2005				
	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total
Revenues	\$ 51,077	\$ 6,720	\$ 403	\$ 455	\$ 58,655	\$ 46,342	\$ 11,375	\$ 2,060	\$ 691	\$ 60,468	\$ 40,143	\$ 17,970	\$ 2,897	\$ 272	\$ 61,282
Depreciation and amortization	\$ 1,056	\$ 20	\$ 292	\$ 10	\$ 1,378	\$ 1,252	\$ 11	\$ 698	\$ 5	\$ 1,966	\$ 1,228	\$ 19	\$ 713	\$ 4	\$ 1,964
Operating income (loss), before financial expenses and taxes on income	\$ 5,803	\$ 936	\$ (1,870)	\$ (566)	\$ 4,303	\$ 4,978	\$ 1,430	\$ (2,262)	\$ (1,077)	\$ 3,069	\$ 4,334	\$ (5,290)	\$ (1,375)	\$ 53	\$ (2,278)
Financial expenses, net					(1,003)					(762)					(800)
Taxes on income					910					1,133					23
Gain (loss) on discontinued operations, net					14					(121)					(156)
Net income					\$ 2,404					\$ 1,053					\$ (3,211)
	December 31,														
	2003					2004					2005				
	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Video monitoring	Other	Total
Total long-lived assets	\$ 13,476	\$ 88	\$ 2,787	\$ 12	\$ 16,363	\$ 13,576	\$ 192	\$ 5,814	\$ 19	\$ 19,601	\$ 13,042	\$ 194	\$ 7,087	\$ 19	\$ 20,342

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- SEGMENT INFORMATION (Cont.)

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

	Year ended December 31,		
	2003	2004	2005
Customer A	27.5%	*) -	23.9%
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:

	Year ended December 31,		
	2003	2004	2005
1. Revenues:			
Israel	\$ 19,797	\$ 9,617	\$ 19,309
Romania	5,151	9,521	6,244
Europe (excluding Romania)	5,465	9,150	3,691
USA	13,292	17,871	13,185
Canada	6,338	4,068	8,759
Others	8,612	10,241	10,094
	\$ 58,655	\$ 60,468	\$ 61,282
2. Long-lived assets:			
Israel	\$ 3,626	\$ 3,211	\$ 2,930
Europe	980	1,069	921
USA	8,655	11,518	12,714
Canada	2,998	3,649	3,656
Others	104	154	121
	\$ 16,363	\$ 19,601	\$ 20,342

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:- SELECTED STATEMENTS OF INCOME DATA

- a. Research and development expenses, net:

	Year ended December 31,		
	2003	2004	2005
Expenses	\$ 5,128	\$ 5,088	\$ 5,427
Less - royalty-bearing grants and investment tax credit	355	405	162
	\$ 4,773	\$ 4,683	\$ 5,265

- b. Financial income (expenses):

Financial expenses:			
Interest on long-term debt	\$ (298)	\$ (289)	\$ (622)
Interest on short-term bank credit	(808)	(849)	(630)
Forward contracts loss	-	-	(110)
Foreign exchange losses	(692)	(161)	(314)
	(1,798)	(1,299)	(1,676)
Financial income:			
Interest on short-term and long-term bank deposits and structured notes	672	496	707
Foreign exchange gains	123	41	169
	795	537	876
	\$ (1,003)	\$ (762)	\$ (800)

NOTE 16:- 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 income and cash flows as discontinued operations, accordingly, the comparative figures were reclassified for all periods presented.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16:- DISCONTINUED OPERATIONS (Cont.)

- b. The following are the results of discontinued operations for the years ended December 31, 2003, 2004 and 2005:

	Year ended December 31,		
	2003	2004	2005
Revenues	\$ 706	\$ 506	\$ 427
Cost of revenues	531	499	470
Gross profit (loss)	175	7	(43)
Operating expenses:			
Sales and marketing, net	158	160	149
Operating income (loss)	17	(153)	(192)
Taxes on income (tax benefit)	3	(32)	(36)
Net income (loss)	\$ 14	\$ (121)	\$ (156)

NOTE 17:- SUBSEQUENT EVENT

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. 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 \$ 3,181 related to an advance payment that was secured by a bank advance payment guarantee on June 20, 2006.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 17:- SUBSEQUENT EVENT (Cont.)

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 has not yet filed its response. Based on the opinion of the Company's legal counsel, the Company believes that there is a good likelihood that the arbitration will result in a favorable decision for the Company.

Due to 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. Although the Company obtained the temporary injunction, according to its legal counsel, the Company's chances to ultimately prevent the forfeiture of the guarantee remain unclear. In view of the above, and due to the uncertainty in preventing the forfeiture of the guarantee, the Company included a provision in the amount of \$ 1,436 in respect of this guarantee in its financial statements.
