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MAGAL SECURITY SYSTEMS LTD

Form 20-F

July 17, 2006

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(B) OR (G) OF THE SECURITIES  
EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE  
ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934

DATE OF EVENT REQUIRING THIS SHELL COMPANY REPORT .....

COMMISSION FILE NUMBER: 0-21388

MAGAL SECURITY SYSTEMS LTD.

(Exact name of Registrant as specified in its charter  
and translation of Registrant's name into English)

ISRAEL

(Jurisdiction of incorporation or organization)

P.O. BOX 70, INDUSTRIAL ZONE, YEHUD 56100, ISRAEL

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:  
NONE

Securities registered or to be registered pursuant to Section 12(g) of the Act:

ORDINARY SHARES, NIS 1.0 PAR VALUE PER SHARE

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d)  
of the Act: NONE

Indicate the number of outstanding shares of each of the issuer's classes of  
capital or common stock as of the close of the period covered by the annual  
report:

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ORDINARY SHARES, PAR VALUE NIS 1.0 PER SHARE ..... 10,372,448 (as of December 31, 2005) Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

This Annual Report on Form 20-F is incorporated by reference into the Registrant's Registration Statements on Form F-3, File Nos. 333-9050 and 333-123265, as amended.

INTRODUCTION

Magal Security Systems Ltd. develops, manufactures, markets and sells complex computerized security systems, including a line of perimeter security systems, a hardware and software "all in one" security solution which integrates closed circuit television, or CCTV, related applications such as outdoor and indoor video motion detection systems, security management and control systems, personal emergency location systems, a pipeline security system, and provides video monitoring services. Our predecessor commenced operations in 1969 as a department specializing in perimeter security systems within the electronics division of Israel Aircraft Industries Ltd., or IAI. Effective April 1984, we purchased from IAI substantially all of the assets, and assumed substantially all of the related liabilities, of that department. In March 1993, we completed an initial public offering of 1,380,000 ordinary shares, in February 1997, we completed a public offering of an additional 2,085,000 ordinary shares and in

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April 2005, we completed a public offering of an additional 1,700,000 ordinary shares. Our ordinary shares are traded on the NASDAQ National Market and on the Tel Aviv Stock Exchange under the symbol MAGS.

Except for the historical information contained in this annual report, the statements contained in this annual report are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in Item 3.D. "Key Information-Risk Factors" and elsewhere in this annual report.

Statements which use the terms "believe," "do not believe," "expect," "plan," "intend," "estimate," "anticipate" and similar expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the U.S., we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

We have trademark rights in the United States and other national jurisdictions arising out of our trademark registrations, applications, and/or use of the following trademarks and service marks: SENSTAR-STELLAR logo, the S logos, SENSTAR-STELLAR, SENSTAR-STELLAR (and design) SENSTAR, STELLAR, STELLAR SYSTEMS, STELLAR SYSTEMS (and design), PANTHER, GUIDAR, REPELS, SENNET, PERIMITRAX, INTELLI-FLEX, INTELLI-FIELD, X-FIELD, OMNITRAX, STARLED, STARNET, FRONTLINE, E-FIELD, H-FIELD, E-FLEX, ARMOURFLEX, SIMPL, CROSSFIRE, ECHOCHECK, FLASH, FLARE, and all other marks used to identify particular products and services associated with our businesses.

Any other trademarks and trade names appearing in this annual report are owned by their respective holders.

Our address on the Internet is [www.magal-ssl.com](http://www.magal-ssl.com). The information on our website is not incorporated by reference into this annual report.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with U.S. generally accepted accounting principles, or U.S. GAAP. All references in this annual report to "dollars" or "\$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels. The representative exchange rate between the NIS and the dollar as published by the Bank of Israel on July 11, 2006 was NIS 4.387 per \$1.00.

As used in this annual report, the terms "we," "us" and "our" mean Magal Security Systems Ltd. and its subsidiaries, unless otherwise indicated.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description of its terms.



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### PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED CONSOLIDATED FINANCIAL DATA.

We have derived the following selected consolidated financial data as of December 31, 2004 and 2005 and for each of the years ended December 31, 2003, 2004 and 2005 from our consolidated financial statements set forth elsewhere in this annual report that have been prepared in accordance with U.S. GAAP. We have derived the following selected consolidated financial data as of December 31, 2001, 2002 and 2003 and for each of the years ended December 31, 2001 and 2002 from our audited consolidated financial statements not included in this annual report. You should read the following selected consolidated financial data together with the section of this annual report entitled "Operating and Financial Review and Prospects" and our consolidated financial statements and notes thereto included elsewhere in this annual report.

	YEAR ENDED DECEMBER 31		
	2001 (*)	2002 (*)	2003 (*)
	(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)		
<b>CONSOLIDATED STATEMENT OF INCOME DATA:</b>			
Revenues	\$40,416	\$ 42,376	\$ 58,655
Cost of revenues	21,081	23,458	32,847
Gross profit	19,335	18,918	25,808
Operating expenses:			
Research and development, net	3,054	3,128	4,773
Selling and marketing, net	7,790	8,511	11,427

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General and administrative	4,949	4,938	5,305
Award granted by principal shareholders	-	-	-
	-----	-----	-----
Total operating expenses	15,793	16,577	21,505
	-----	-----	-----
Operating income (loss)	3,542	2,341	4,303
Financial income (expenses), net	40	199	(1,003)
	-----	-----	-----
Income (loss) before income taxes	3,582	2,540	3,300
Income taxes (tax benefit)	446	646	910
	-----	-----	-----
Income (loss) from continuing operations .	3,136	1,894	2,390
Gain (loss) from discontinued operations, net	31	(6)	14
	-----	-----	-----
Net income (loss)	3,167	1,888	2,404
	=====	=====	=====
Basic net earnings (loss) per share from continuing operations	\$ 0.41	\$ 0.24	\$ 0.30
Basic net loss per share from discontinued operations	-	-	-
	-----	-----	-----
Basic net earnings (loss) per share	\$ 0.41	\$ 0.24	\$ 0.30
	=====	=====	=====
Diluted net earnings (loss) per share from continuing operations	\$ 0.40	\$ 0.23	\$ 0.30
Diluted net loss per share from discontinued operations	-	-	-
	-----	-----	-----
Diluted net earnings (loss) per share	\$ 0.40	\$ 0.23	\$ 0.30
	=====	=====	=====
Weighted average number of ordinary shares used in computing basic net earnings per share	7,738	7,866	7,948
Weighted average number of ordinary shares used in computing diluted net earnings per share	7,925	8,069	8,029
Cash dividend per share	\$ 0.13	\$ -	\$ 0.05
	=====	=====	=====

(\*) Reclassified.

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Our Board of Directors declared share dividend distributions of 3.0%, 3.0% and 5.0% in May 2002, May 2003 and July 2004, respectively. All per share data in the above table has been adjusted to reflect the share dividends.

On July 28, 2005, we decided to eliminate our indoor security sensors operations. Accordingly, the operating results and cash flows attributed to the indoor security sensors operations were presented in our statements of income and cash flows as discontinued operations, and the comparative figures were reclassified for all periods presented.

	AS OF DECEMBER 31,		
	2001	2002	2003
	-----	-----	-----
	(IN THOUSANDS)		
CONSOLIDATED BALANCE SHEET DATA:			
Cash and cash equivalents	\$ 2,738	\$ 2,519	\$ 4,389
Short and long-term bank deposits and structured notes	11,849	12,357	12,051

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Working capital	18,391	15,688	21,401
Total assets	53,347	59,741	71,443
Short-term bank credit (including current maturities of long-term loans)	6,264	10,357	16,438
Long-term bank loans	5,038	4,698	1,873
Total shareholders' equity	32,700	35,031	38,984

### B. CAPITALIZATION AND INDEBTEDNESS.

Not applicable

### C. REASONS FOR THE OFFER AND USE OF PROCEEDS.

Not applicable.

### D. RISK FACTORS.

Our business, results of operations and financial condition could be seriously harmed due to any of the following risks, among others. If we do not successfully address the risks to which we are subject, our business, results of operations and financial condition may be materially and adversely affected and our share price may decline.

#### RISKS RELATED TO OUR BUSINESS

WE DEPEND ON LARGE ORDERS FROM A RELATIVELY SMALL NUMBER OF CUSTOMERS FOR A SUBSTANTIAL PORTION OF OUR REVENUES. AS A RESULT, OUR REVENUES AND OPERATING RESULTS MAY VARY FROM QUARTER TO QUARTER.

We receive large orders from a relatively small number of customers and our revenues and operating results are subject to substantial periodic variations. Individual orders from customers can represent a substantial portion of our revenues in any one period and significant orders by a customer during one period may not be followed by further orders from the same customer in subsequent periods. As a result, our revenues and operating results for a specific quarter may not be indicative of our future performance and quarter-to-quarter comparisons of our operating results may not be meaningful, making it difficult for investors to evaluate our future prospects based on the results of any quarter.

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In addition, we have a limited order backlog, which makes revenues in any quarter substantially dependent upon orders we deliver in that quarter.

OUR REVENUES DEPEND ON GOVERNMENT PROCUREMENT PROCEDURES AND PRACTICES. A SUBSTANTIAL DECREASE IN OUR CUSTOMERS' BUDGETS WOULD ADVERSELY AFFECT OUR RESULTS OF OPERATIONS.

Our products are primarily sold to governmental agencies, governmental authorities and government-owned companies, many of which have complex and time-consuming procurement procedures. A substantial period of time often elapses from the time we begin marketing a product until we actually sell that product to a particular customer. In addition, our sales to governmental agencies, authorities and companies are directly affected by these customers' budgetary constraints and the priority given in their budgets to the procurement of our products. A decrease in governmental funding for our customers' budgets would adversely affect our results of operations.

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THE LOSS OF ONE OR MORE OF OUR KEY CUSTOMERS, IN PARTICULAR THE ISRAELI MINISTRY OF DEFENSE, WOULD RESULT IN A LOSS OF A SIGNIFICANT AMOUNT OF OUR REVENUES.

A relatively few customers account for a large percentage of our revenues. For the years ended December 31, 2003, 2004 and 2005, revenues generated from sales to the Israeli Ministry of Defense, or MOD, accounted for 27.5%, 7.8% and 23.9%, respectively, of our revenues. The loss of the MOD as a customer without replacement by a customer or customers of similar volume would have a material adverse effect on our financial results.

WE HAVE INITIATED AN ARBITRATION PROCEEDING AGAINST A CUSTOMER IN EASTERN EUROPE TO RECOVER FUNDS PAYABLE TO US UNDER THE TERMS OF A TURNKEY PROJECT. IN THE EVENT WE ARE UNSUCCESSFUL IN THIS ARBITRATION, OUR FINANCIAL RESULTS WILL BE ADVERSELY IMPACTED.

In May 2005 we entered into an agreement to supply comprehensive security solutions for a sensitive site in Eastern Europe. As part of the agreement, we received an advance payment, secured by a bank advanced payment guarantee that was to be reduced proportionally as execution of the project progressed. In addition, we issued the customer a performance bank guarantee. We commenced the project and delivered some of the equipment and other deliverables to the customer in 2005. In April 2006, the customer informed us that it was canceling the agreement due to errors in the design documents submitted by us. In addition, the customer did not make payments required under the agreement. Based on its cancellation of the agreement, the customer collected \$3.2 million under the bank advanced payment guarantee on June 20, 2006.

We believe that there is no factual or legal ground for the cancellation of the agreement or the demand for payment under the bank performance guarantee, and accordingly, we believe that the agreement is still valid. On April 28, 2006, we commenced arbitration proceedings against the customer. In these proceedings we asked the arbitrators to find that the agreement is valid and to enforce the payments due to us pursuant to the agreement. The customer has not yet filed its response. Based on the opinion of our legal counsel, we believe that there is a good likelihood that the arbitration will result in a favorable determination. We intend to vigorously pursue our claim. However, we may not be successful in the arbitration, which may result in a significant negative impact on our financial results.

On July 11, 2006 the customer made a demand for additional payment under a bank performance guarantee for \$1.4 million. Upon our motion, the District Court in Haifa, Israel 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 for the year ended December 31, 2005.

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IN THE FUTURE, THE LEVEL OF OUR CONTRACTS MAY BE REDUCED DUE TO CHANGES IN GOVERNMENTAL PRIORITIES AND AUDITS.

Governmental purchases of our systems, products and services may decline in the future as the governmental purchasing agencies may terminate, reduce or modify contracts or subcontracts if:



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- o Their requirements or budgetary constraints change;
- o they cancel multi-year contracts and related orders if funds become unavailable;
- o they shift spending priorities into other areas or for other products; and
- o they adjust contract costs and fees on the basis of audits.

Any such event may have a material adverse affect on us.

IF WE DO NOT RECEIVE MOD APPROVALS NECESSARY FOR US TO EXPORT THE PRODUCTS WE PRODUCE IN ISRAEL, OUR REVENUES MAY DECREASE.

Under Israeli law, the export of products that we manufacture in Israel and the export of certain of our know-how are subject to approval by the MOD. We must obtain permits from the MOD to initiate sales proposals with regard to these exports, as well as for actual export transactions. We may not be able to receive all the required permits for which we may apply in the future. If we do not receive the required permits for which we apply, our revenues may decrease.

OUR WHOLLY-OWNED SUBSIDIARY, SMART INTERACTIVE SYSTEMS, INC., MAY NEVER ACHIEVE A PROFIT. IF SMART CONTINUES TO INCUR LOSSES, OUR FUTURE RESULTS OF OPERATIONS WILL BE ADVERSELY AFFECTED.

In 2001, we established Smart Interactive Systems, Inc., or Smart, to meet the growing demand for real-time video monitoring services for use in industrial sites, commercial businesses and VIP residences. We have invested \$15.1 million in Smart through December 31, 2005. Its operations to date have not been profitable, and it has an accumulated deficit of \$6.7 million as of December 31, 2005. Smart's success will depend upon its ability to penetrate the market for these services. If Smart is unable to market its services or if its services fail to penetrate the market, we may lose our investment in this company and our future results of operations will be adversely affected.

THE MARKET FOR OUR PRODUCTS IS CHARACTERIZED BY CHANGING TECHNOLOGY, REQUIREMENTS, STANDARDS AND PRODUCTS, AND WE MAY BE ADVERSELY AFFECTED IF WE DO NOT RESPOND PROMPTLY AND EFFECTIVELY TO THESE CHANGES.

The market for our products is characterized by evolving technologies, changing industry standards, changing regulatory environments, frequent new product introductions and rapid changes in customer requirements. The introduction of products embodying new technologies and the emergence of new industry standards and practices can render existing products obsolete and unmarketable. Our future success will depend on our ability to enhance our existing products and to develop and introduce, on a timely and cost-effective basis, new products and product features that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of our customers.

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In the future:

- o we may not be successful in developing and marketing new products or product features that respond to technological change or evolving industry standards;

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- o we may experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products and features; or
- o our new products and product features may not adequately meet the requirements of the marketplace and achieve market acceptance.

If we are unable to respond promptly and effectively to changing technology, we will be unable to compete effectively in the future.

### WE FACE RISKS ASSOCIATED WITH DOING BUSINESS IN INTERNATIONAL MARKETS.

A large portion of our sales is to markets outside of Israel (68.5% in 2005 and 84.1% in 2004), and a key component of our strategy is to continue to expand in such markets, the most significant of which currently are North America, Europe, and Asia. Our international sales efforts are affected by costs associated with the shipping of our products and risks inherent in doing business in international markets, including:

- o unexpected changes in regulatory requirements;
- o currency fluctuations;
- o export restrictions, tariffs and other trade barriers;
- o unexpected difficulties in staffing and managing foreign operations;
- o longer payment cycles;
- o difficulties in collecting accounts receivable;
- o political instability; and
- o seasonal reductions in business activities.

One or more of such factors may have a material adverse effect on us.

WE ARE ENGAGED IN A HIGHLY COMPETITIVE BUSINESS. IF WE ARE UNABLE TO COMPETE EFFECTIVELY, OUR REVENUES AND INCOME WILL BE MATERIALLY AND ADVERSELY AFFECTED.

The business in which we are engaged is highly competitive. Some of our competitors and potential competitors have greater research and development, financial and personnel resources, including governmental support, or more extensive business experience than we do. If we are unable to compete effectively in the market for our products, our revenues and income will be materially and adversely affected.

### WE MAY BE ADVERSELY AFFECTED BY LONG SALES CYCLES.

We have in the past and expect in the future to experience long time periods between initial sales contacts and the execution of formal contracts for our products and completion of product installations. The cycle from first contact to revenue generation in our business involves, among other things, selling the concept of our technology and products, developing and implementing a pilot program to demonstrate the capabilities and accuracy of our products, negotiating prices and other contract terms, and, finally, installing and implementing our products on a full-scale basis. This cycle entails a

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substantial period of time, sometimes as much as one or more years, and the lack of revenues during this cycle and the expenses involved in bringing new sales to the point of revenue generation may put a substantial strain on our resources.

WE MAY NOT BE ABLE TO IMPLEMENT OUR GROWTH STRATEGY.

As part of our growth strategy, we seek to acquire or invest in complementary, including competitive, businesses, products and technologies. We currently have no commitments or agreements with respect to any acquisitions or investments and we may not be able to consummate any acquisition or investment. Even if we do acquire or invest in these businesses, products or technology, the process of integrating acquired assets into our operations may result in unforeseen operating difficulties and expenditures and may absorb significant management attention that would otherwise be available for the ongoing development of our business.

In addition, we have limited experience in making acquisitions and managing growth. We may not be able to realize the anticipated benefits of any acquisition. Moreover, future acquisitions by us could result in potentially dilutive issuances of our equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to identifiable intangible assets, any of which could materially adversely affect our operating results and financial position. Acquisitions also involve other risks, including risks inherent in entering markets in which we have no or limited prior experience and the potential loss of key employees and the risk that we may experience difficulty or delays in obtaining necessary permits.

WE MAY NOT BE SUCCESSFUL IN MARKETING AND DEVELOPING MARKETS FOR OUR NEW PRODUCTS.

As part of our growth strategy, we developed three new products, DreamBox, Fortis and PipeGuard. We intend to continue to invest substantial funds in the marketing and sales of these products. Our marketing and sale efforts may not be successful, in which case our growth strategy will be harmed.

WE MAY NOT BE ABLE TO PROTECT OUR PROPRIETARY TECHNOLOGY AND UNAUTHORIZED USE OF OUR PROPRIETARY TECHNOLOGY BY THIRD PARTIES MAY IMPAIR OUR ABILITY TO COMPETE EFFECTIVELY.

Our success and ability to compete depend in large part upon protecting our proprietary technology. We have approximately 45 patents and have patent applications pending. We also rely on a combination of trade secret and copyright law and confidentiality, non-disclosure and assignment-of-inventions agreements to protect our proprietary technology. It is our policy to protect our proprietary rights in our products and operations through contractual obligations, including confidentiality and non-disclosure agreements with certain employees, distributors and agents, suppliers and subcontractors. These measures may not be adequate to protect our technology from third-party infringement, and our competitors may independently develop technologies that are substantially equivalent or superior to ours. Additionally, our products may be sold in foreign countries that provide less protection to intellectual property than that provided under U.S. or Israeli laws.

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WE COULD BECOME SUBJECT TO LITIGATION REGARDING INTELLECTUAL PROPERTY RIGHTS, WHICH COULD SERIOUSLY HARM OUR BUSINESS.

Third parties may in the future assert against us infringement claims or

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claims asserting that we have violated a patent or infringed upon a copyright, trademark or other proprietary right belonging to them.

In addition, we purchase components for our turnkey products from independent suppliers. Certain of these components contain proprietary intellectual property of these independent suppliers. Third parties may in the future assert claims against our suppliers that such suppliers have violated a patent or infringed upon a copyright, trademark or other proprietary right belonging to them. If such infringement by our suppliers or us were found to exist, a party could seek an injunction preventing the use of their intellectual property. In addition, if an infringement by us were found to exist, we may attempt to acquire a license or right to use such technology or intellectual property. Any infringement claim, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

WE DEPEND ON LIMITED SOURCES FOR COMPONENTS, AND IF WE ARE UNABLE TO OBTAIN THESE COMPONENTS WHEN NEEDED, WE WILL EXPERIENCE DELAYS IN MANUFACTURING OUR PRODUCTS AND OUR FINANCIAL RESULTS MAY BE ADVERSELY AFFECTED.

We acquire most of the components utilized in our products, including, but not limited to, our turnkey products and certain services from a limited number of suppliers and subcontractors. We may not be able to obtain such items from these suppliers and subcontractors on satisfactory terms in the future. Temporary disruptions of our manufacturing operations would result if we were required to obtain materials from alternative sources, which may have an adverse effect on our financial results.

UNDETECTED DEFECTS IN OUR PRODUCTS MAY INCREASE OUR COSTS AND IMPAIR THE MARKET ACCEPTANCE OF OUR PRODUCTS.

The development, enhancement and implementation of our complex systems entail substantial risks of product defects or failures. Despite testing by us and our customers, errors may be found in existing or new products, resulting in delay or loss of revenues, warranty expense, loss of market share or failure to achieve market acceptance, or otherwise adversely affecting our business, financial condition and results of operations. Moreover, the complexities involved in implementing our systems entail additional risks of performance failures. We may encounter substantial delays or other difficulties due to such complexities. Any such occurrence could have a material adverse effect upon our business, financial condition and results of operations. In addition, the potential harm to our reputation that may result from product defects or implementation errors could be damaging to us.

WE DEPEND ON OUR SENIOR MANAGEMENT AND KEY PERSONNEL, PARTICULARLY JACOB EVEN-EZRA, OUR CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AND IZHAR DEKEL, OUR PRESIDENT, THE LOSS OF WHOM WOULD NEGATIVELY AFFECT OUR BUSINESS.

Our future success depends in large part on the continued services of our senior management and key personnel. In particular, we depend on the services of Jacob Even-Ezra, our chairman and chief executive officer, and Izhar Dekel, our president. We carry key person life insurance for Jacob Even-Ezra and for Izhar Dekel. Any loss of the services of Jacob Even-Ezra, Izhar Dekel, other members of senior management or other key personnel would negatively affect our business.

OUR FAILURE TO RETAIN AND ATTRACT PERSONNEL COULD HARM OUR BUSINESS, OPERATIONS AND PRODUCT DEVELOPMENT EFFORTS.

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Our products require sophisticated research and development, marketing and sales and technical customer support. Our success depends on our ability to attract, train and retain qualified research and development, marketing and sales and technical customer support personnel. Competition for personnel in all of these areas is intense and we may not be able to hire sufficient personnel to achieve our goals or support the anticipated growth in our business. If we fail to attract and retain qualified personnel, our business, operations and product development efforts would suffer.

THE IMPLEMENTATION OF SFAS NO. 123(R), WHICH WILL REQUIRE US TO RECORD COMPENSATION EXPENSE IN CONNECTION WITH EQUITY SHARE-BASED COMPENSATION AS OF THE FIRST QUARTER OF 2006, MAY REDUCE OUR PROFITABILITY.

On December 16, 2004, the Financial Accounting Standards Board, or FASB, issued Statement No. 123 (revised 2004), Share-Based Payment, or SFAS No. 123(R), which is a revision of SFAS No. 123. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized on the basis of their fair values while SFAS No. 123(R) requires, as of the first quarter of 2006, all share-based payments to employees to be recognized on the basis of their fair values. SFAS No. 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 adoption of SFAS No. 123(R) may have a significant effect on our results of operations in the future; however, the impact of its adoption cannot be predicted at this time. In addition, such adoption could limit our ability to use stock options as an incentive and retention tool, which could, in turn, negatively impact our ability to recruit employees and retain existing employees. Had we adopted SFAS 123(R) in 2005, the impact of that standard would have decreased our net income by approximately \$1.05 million, as described in the disclosure of pro forma net income and earnings per share in our consolidated financial statements.

COMPLIANCE WITH CHANGING REGULATION OF CORPORATE GOVERNANCE AND PUBLIC DISCLOSURE MAY RESULT IN ADDITIONAL EXPENSES.

As a result of changing laws, regulations and standards relating to accounting, corporate governance and public disclosure, the costs of being a public company in general have increased in recent years. The Sarbanes-Oxley Act of 2002 requires changes in some of our corporate governance and securities disclosure or compliance practices. We expect that the on-going implementation of these regulations will further increase our legal compliance costs and will make some activities more time consuming. We are presently evaluating and monitoring regulatory developments and cannot estimate the magnitude of additional costs we may incur as a result of such developments. In order to implement Section 404 of the Sarbanes-Oxley Act of 2002, which governs internal controls and procedures for financial reporting, we will need to expend significant management time and financial resources to comply with the applicable requirements. This and other proposed legislation may increase the fees of our professional advisors and our insurance premiums.

RISKS RELATING TO OUR ORDINARY SHARES

VOLATILITY OF THE MARKET PRICE OF OUR ORDINARY SHARES COULD ADVERSELY AFFECT OUR SHAREHOLDERS AND US.

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The market price of our ordinary shares has been, and is likely to be, highly volatile and could be subject to wide fluctuations in response to numerous factors, including the following:

- o political, economic and other developments in the State of Israel;
- o terrorist attacks and other acts of war, and any response to them;
- o actual or anticipated variations in our quarterly operating results or those of our competitors;
- o announcements by us or our competitors of technological innovations or new and enhanced products;
- o developments or disputes concerning proprietary rights;
- o introduction and adoption of new industry standards;
- o changes in financial estimates by securities analysts;
- o market conditions or trends in our industry;
- o changes in the market valuations of our competitors;
- o announcements by us or our competitors of significant acquisitions;
- o entry into strategic partnerships or joint ventures by us or our competitors; and
- o additions or departures of key personnel.

In addition, the stock market in general, and the market for Israeli companies and home defense companies in particular, has been highly volatile. Many of these factors are beyond our control and may materially adversely affect the market price of our ordinary shares, regardless of our performance.

### RISKS RELATING TO OUR LOCATION IN ISRAEL

#### CONDUCTING BUSINESS IN ISRAEL ENTAILS SPECIAL RISKS.

We are incorporated under Israeli law and our principal offices and manufacturing and research and development facilities are located in the State of Israel. Accordingly, we are directly influenced by the political, economic and military conditions affecting Israel. Specifically, we could be adversely affected by any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, and a significant downturn in the economic or financial condition of Israel.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. These developments have adversely affected the regional peace process, placed the Israeli economy under significant stress, and have negatively influenced Israel's relationship with several Arab countries. In August 2005, Israel evacuated all Israeli settlements in the Gaza Strip and four settlements in the West Bank. In January 2006, Hamas won the elections in the Palestinian Authority and as a result the diplomatic relations between Israel and the

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Palestinian Authority have worsened. The implications of these developments cannot at this time be foreseen. Any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price.

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POLITICAL TRADE RELATIONS COULD LIMIT OUR ABILITY TO SELL OR BUY INTERNATIONALLY.

We could be affected adversely by the interruption or reduction of trade between Israel and its trading partners. Some countries, companies and organizations continue to participate in a boycott of Israeli firms and others doing business with Israel or with Israeli companies. To date, these measures have not had a material adverse affect on our business. In the future, restrictive laws, policies or practices towards Israel or Israeli businesses may have an adverse impact on our business.

OUR RESULTS OF OPERATIONS MAY BE NEGATIVELY AFFECTED BY THE OBLIGATION OF OUR PERSONNEL TO PERFORM MILITARY SERVICE.

Many of our executive officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces, or IDF, and are subject to being called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

THE ECONOMIC CONDITIONS IN ISRAEL HAVE NOT BEEN STABLE IN RECENT YEARS.

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel deteriorate.

WE MAY BE ADVERSELY AFFECTED BY A CHANGE IN THE EXCHANGE RATE OF THE NEW ISRAELI SHEKEL AGAINST THE DOLLAR.

Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results. In 2001, 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.

WE CURRENTLY BENEFIT FROM GOVERNMENT PROGRAMS AND TAX BENEFITS THAT MAY BE DISCONTINUED OR REDUCED.

We currently receive grants and tax benefits under Israeli government programs, we must continue to meet specified conditions, including, but not limited to, making specified investments from our equity in fixed assets and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products or transfer particular technology outside of Israel. If we fail to comply with these conditions in the future, the benefits we receive could be canceled and we could be required to refund any payments previously received under these programs, including any accrued interest, or pay increased taxes or royalties. The Israeli government has reduced the benefits available under these programs in recent years and these programs and benefits may be discontinued or curtailed in the future. If the Israeli government ends these programs and benefits, our business, financial condition, results of operations and net income could be materially adversely affected.

THE TAX BENEFITS THAT WE CURRENTLY RECEIVE FROM OUR APPROVED ENTERPRISE PROGRAMS REQUIRE US TO SATISFY SPECIFIED CONDITIONS. IF WE FAIL TO SATISFY THESE CONDITIONS, WE MAY BE REQUIRED TO PAY ADDITIONAL TAXES AND WOULD LIKELY BE DENIED THESE BENEFITS IN THE FUTURE.

The Investment Center of the Ministry of Industry, Trade and Labor of the State of Israel has granted approved enterprise status to certain of our manufacturing facilities. Starting from when we begin to generate net income from these approved enterprise programs, any portion of our income derived from these approved enterprise programs will be exempt from tax for a period of two years and will be subject to a reduced tax for an additional five to eight years, depending on the percentage of our share capital held by non-Israeli residents. The benefits available to our approved enterprise programs are dependent upon the fulfillment of conditions stipulated in applicable law and in each program's certificate of approval. If we fail to comply with these conditions, in whole or in part, we may be required to pay additional taxes and interest for the period in which we benefited from the tax exemption or reduced tax rates and would likely be denied these benefits in the future.

PROVISIONS OF ISRAELI LAW MAY DELAY, PREVENT OR MAKE DIFFICULT AN ACQUISITION OF US, WHICH COULD PREVENT A CHANGE OF CONTROL AND THEREFORE DEPRESS THE PRICE OF OUR SHARES.

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

YOUR RIGHTS AND RESPONSIBILITIES AS A SHAREHOLDER WILL BE GOVERNED BY ISRAELI LAW AND DIFFER IN SOME RESPECTS FROM THE RIGHTS AND RESPONSIBILITIES OF SHAREHOLDERS UNDER U.S. LAW.

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in



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typical U.S. corporations. In particular, shareholder of an Israeli company has a duty to act in good faith in exercising his or her rights and fulfilling his or her obligations toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a controlling shareholder of an Israeli company or a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or who has the power to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

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IT MAY BE DIFFICULT TO ENFORCE A NON-ISRAELI JUDGMENT AGAINST US, OUR OFFICERS AND DIRECTORS.

All of our executive officers and directors are nonresidents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult for an investor, or any other person or entity, to enforce against us or any of those persons in an Israeli court a U.S. court judgment based on the civil liability provisions of the U.S. federal securities laws. It may also be difficult to effect service of process on these persons in the United States. Additionally, it may be difficult for an investor, or any other person or entity, to enforce civil liabilities under U.S. federal securities laws in original actions filed in Israel.

AS A FOREIGN PRIVATE ISSUER WHOSE SHARES ARE LISTED ON THE NASDAQ National MARKET, WE MAY FOLLOW CERTAIN HOME COUNTRY CORPORATE GOVERNANCE PRACTICES INSTEAD OF CERTAIN NASDAQ REQUIREMENTS.

As a foreign private issuer whose shares are listed on the NASDAQ National Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules, including the composition of our Board of Directors, director nomination procedure, compensation of officers, distribution of annual reports to shareholders, and quorum at shareholders' meetings. In addition, we may follow Israeli law instead of the NASDAQ Marketplace Rules that require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of our company, certain transactions other than a public offering involving issuances of a 20% or more interest in our company and certain acquisitions of the stock or assets of another company.

#### ITEM 4. INFORMATION ON THE COMPANY

##### A. HISTORY AND DEVELOPMENT OF THE COMPANY.

We were incorporated under the laws of the State of Israel on March 27, 1984 under the name Magal Security Systems Ltd. We are a public limited liability company under the Israeli Companies Law, 5739-1999 and operate under this law and associated legislation. Our principal executive offices and primary

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manufacturing and research and development facilities are located near Tel Aviv, Israel, in the Yehud Industrial Zone. Our mailing address is P.O. Box 70, Industrial Zone, Yehud 56100, Israel and our telephone number is 972-3-539-1444. Our agent for service of process in the U.S. is Magal Senstar Inc., 43184 Osgood Road, Fremont, CA, 94539. Our address on the Internet is www.magal-ssl.com. The information on our website is not incorporated by reference into this annual report.

We develop, manufacture, market and sell complex computerized security systems, including a line of perimeter security systems, a hardware and software "all in one" security solution which integrates CCTV, related applications such as outdoor and indoor video motion detection systems, security management and control systems, personal emergency location systems and a pipeline security system. We also provide video monitoring services through our Smart subsidiary.

For a discussion of our capital expenditures and divestitures, see Item 5.B. "Operating and Financial Review and Prospects-Liquidity and Capital Resources."

### B. BUSINESS OVERVIEW.

#### GENERAL

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

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- o a line of perimeter security systems, which automatically detect and locate intruders, identify the nature of intrusions and provide emergency notification;
- o 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
- o video monitoring services.

#### BUSINESS AND MARKETING STRATEGY

Our primary objective is to become a leading provider of security systems worldwide. To achieve this objective, we have implemented a business strategy incorporating the following key elements:

**REFINE AND BROADEN PRODUCT LINE.** We have identified the security needs of our customers and intend to enhance our current products and develop new products to meet those needs. We intend to continue to focus on developing new products, expanding the capabilities of existing products and making custom enhancements for specific projects. Since the beginning of 2004, we have launched three new products, the DreamBox, Fortis and PipeGuard, that significantly broaden the spectrum of security solutions we offer and substantially expand our potential security markets.

**ENTER NEW MARKETS AND STRENGTHEN PRESENCE IN EXISTING MARKETS.** In 2006 we

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intend to continue to penetrate new geographic markets by various means, including the establishment of alliances with local distributors. We also intend to increase our marketing efforts in our existing markets and to acquire or invest in complementary, including competitive, businesses, products and technologies.

**LEVERAGE EXISTING CUSTOMER BASE; CROSS-MARKET PRODUCTS.** We believe that we have the capability to offer certain of our customers a comprehensive security package. As part of our product development process, we seek to maintain close relationships with our customers to identify market needs and to define appropriate product specifications. We intend to expand the depth and breadth of our existing customer relationships while initiating similar new relationships. We believe that the three products we launched in 2004 will substantially broaden our potential markets.

**OFFER COMPREHENSIVE TURNKEY SOLUTIONS.** By broadening our product range to include both indoor and outdoor security systems and by developing our security management and control systems and Dreambox "all in one" CCTV security solution, we now offer comprehensive turnkey security solutions that provide a comprehensive security implementation process. This process entails:

- o in-depth threat analysis;
- o determination of the appropriate hardware and software solutions;
- o training sessions for systems operators; and
- o upon customer approval, integration of the required systems into our security management and control systems.

We believe that the market for turnkey security solutions presents a significant opportunity. We are emphasizing our ability to offer turnkey solutions in keeping with our objective of becoming a leading provider of comprehensive security solutions.

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### PRODUCTS AND SERVICES

#### PERIMETER SECURITY SYSTEMS

Perimeter security systems enable customers to monitor, limit and control access by unauthorized personnel to specific regions or areas. High-end perimeter systems are sophisticated in nature and are used by correctional facilities, military installations, power companies and other high-security installations. We believe that we are a leading provider of security systems and maintenance in this industry.

Our line of perimeter security systems consists of the following:

- o taut wire perimeter intrusion detection systems;
- o vibration detection systems; and
- o field disturbance sensors.

Our line of perimeter security systems utilizes sophisticated sensor devices to detect and locate intruders and identify the nature of intrusions. Our perimeter security systems have been installed along thousands of kilometers

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of borders and facility boundaries throughout the world, including more than 600 correctional institutions in the U.S. and correctional institutions in several other countries. In addition, we have installed several hundred miles of high security electronic perimeter systems along Israel's borders.

**TAUT WIRE PERIMETER INTRUSION DETECTION SYSTEMS.** Our taut wire systems consist of wire strung at high tension between anchor posts. Sensor posts are located at the middle between anchor posts. These sensor posts contain one or more devices that detect changes in the tension being exerted on and by the taut wires. Any force applied against these wires, or released from them, as by cutting, unless within the parameters designed into the sensors themselves or programmed into the central control units, automatically triggers an alarm. We use taut wire perimeter systems as both an integral component of intruder detection systems and as a physical barrier to infiltration.

Our sealed sensors are not affected by radio frequency interference, climatic or atmospheric conditions, or electrical transients from power lines or passing vehicles. The sensors self-adjust to, or remain unaffected by, extreme temperature variations, minor soil movements and other similar environmental changes that might trigger false alarms in less sophisticated systems. Our taut wire perimeter systems are designed to discriminate automatically between fence tension changes typically caused by small animals or violent weather and forces more typically exerted by a human intruder.

Our taut wire perimeter systems offer customers a wide range of installation options. Sensor posts can be as far as 200 feet apart, with relatively inexpensive ordinary fence anchor posts between them. These systems may stand alone, be mounted on a variety of fence posts or added to an existing wall or other structure, or mounted on short posts, with or without outriggers.

Taut wire perimeter systems have been approved by various Israeli and U.S. security and military authorities. We have installed several hundred kilometers of these perimeter systems along Israel's borders to assist in preventing unauthorized entry and infiltration. Our taut wire perimeter systems are sold for approximately \$50-\$100 per meter.

**VIBRATION DETECTION SYSTEMS.** We offer two types of vibration detection systems. While less sensitive than taut wire installations, the adaptability of these systems to a wide range of pre-existing barrier structures makes these products viable alternatives for cost-conscious customers. Our vibration detection devices are most effective when installed on common metal fabric perimeter systems, such as chain link or welded mesh. In our BARRICADE 500 system, pairs of electro-mechanical sensors are attached to fence panels three meters apart on any of several common types of fence structures. Once attached to the fence, each sensor detects vibrations in the underlying structures. The sensor system's built-in electro-mechanical filtering combines with system input from a weather sensor to minimize the rate of false alarms from wind, hail or other sources of nuisance vibrations.

Intelli-FLEX, Intelli-FIBER and fence protection systems, or FPS, microprocessor-based triboelectric and Electret cable fence sensors are vibration sensitive transducers. These systems detect any attempt to cut, climb or penetrate the fence and have microphonic properties. The microphonic feature permits audio to be used for low-cost alarm assessment, providing users with an additional tool for determining the nature of an attempted intrusion. Our vibration detection systems are sold for between \$11-\$26 per meter.

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FIELD DISTURBANCE SENSORS. We offer two types of field disturbance sensors. The Intelli-Field volumetric electronic field disturbance sensor can be installed outdoors on perimeter systems, buildings or as free-standing units. The Perimitrax buried volumetric field disturbance sensor can be buried in most types of soil and paved areas and uses "leaky coax" technology to detect attempted perimeter penetrations. Both systems detect intrusions before the intruder touches the sensor. The Intelli-Field system costs approximately \$80-\$190 per meter and the Perimitrax system is sold for approximately \$65-\$170 per meter.

We have installed high-security taut wire electronic perimeter systems over several hundred kilometers of Israel's borders and have sold a number of our high-security perimeter systems to protect other locations in Israel, including Ben-Gurion International Airport, facilities of IAI and the Israel Electric Company, the Israeli parliament, or the Knesset, industrial plants, prisons and military bases. Outside Israel, our high-security perimeter systems have been purchased to protect various sites, including military installations, refineries, conventional and nuclear power stations, oil tank farms, industrial facilities, storage areas and warehouses, royal palaces and presidential residences in various European countries, North America, South America and the Far East.

Currently, airport security activities concentrate almost exclusively on screening passengers and luggage within the airport terminal in connection with passenger check-in. We are aware of only a few airports in the world which currently have high-security perimeter protection systems to prevent infiltrators from reaching the airport's grounds from outside. Most of these airports utilize a system manufactured by us. In marketing our high-security perimeter systems, we target authorities responsible for airport security. To date, we have sold and installed a limited amount of perimeter systems at certain airports in Israel, Europe, the U.S. and the Far East. We are continuing to negotiate with authorities in several other countries to install our perimeter systems around airports. However, we cannot assure you that any revenues will result from these negotiations.

Our high-security perimeter systems offer prison authorities the opportunity to address an escape attempt in real-time, rather than at the next roll-call, which may be several hours after the escape. Our high-security perimeter systems have already been installed in prisons in Australia, Europe, Israel, North America and the Far East.

Ten models of our perimeter intrusion detection sensors have been approved by the U.S. Department of the Air Force for use in the \$498 million Force Protection Integrated Base Defense Security System, or IBDSS, program. The IBDSS program includes intrusion detection systems designed to prevent unauthorized entry or access to large, medium and small military facilities. The IBDSS program to protect classified facilities was initiated in October 2003 and is scheduled for completion in September 2008. Our products have been approved by the U.S. Department of the Air Force for use in the various tested applications and configurations, and they will be supplied to the U.S. Department of the Air Force through the major U.S. integrators.

The IDF has tested our perimeter security products along with those of several of our competitors and our system and two competitor's systems were the only systems to be approved for participation in the MOD's bid for perimeter security systems.

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### DREAMBOX

The DreamBox is a state-of-the-art embedded hardware and software product which integrates a number of CCTV related applications into one box. The system is designed to be economical, as well as compact to save space, by avoiding the use of a complicated cable installation and integration.

DreamBox contains twelve different applications, including a digital video and audio recording, video and audio matrix switcher, outdoor and indoor video motion detection system, or VMD, security management system, or SMS, and a transmission system.

The DreamBox, is sold at a substantially lower price than the cost of the other product applications if sold separately, a factor which positions DreamBox as the leading security solution for all strategic facilities. Its target markets include governmental, institutional and other sensitive facilities, such as airports, train stations, seaports, prisons, casinos and hospitals, all of which require the use of high quality CCTV applications.

By developing this product, we entered a new area of activity. We refer to the DreamBox's target market as an 'add-on' market for us, and believe that this product is substantially broadening our target markets. As an example, we entered the field of digital video recording, which is only one of many DreamBox applications.

### SECURITY MANAGEMENT AND CONTROL SYSTEMS

The deployment of multiple security systems creates the need for a system that can manage and control these systems through a single database. In response to this need, we offer MagNet and Fortis, security management and control systems that integrate 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 support 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.

Since its introduction, we have sold our security management system and provided turnkey projects to several customers, including large international companies and international airports.

At the end of 2002 we won a bid to protect the Otopeni International Airport in Bucharest, Romania. The contract totals approximately \$16 million. This turnkey project includes different types of security systems as well as video and data communication systems that will be integrated by MagNet. In March 2004, we signed an extension of the contract for \$3.8 million and in August 2004, we signed another extension of the contract for \$3.3 million. This contract, including the extensions, is expected to be completed by December 2006.

### SECURITY MANAGEMENT SYSTEM

MagNet, our security management system, integrates the management, control and display of various security systems into a single, real-time database. MagNet, which is based on computer communications and controlled by a unique server developed by us, converts real-time data received from field units, analyzes that data and transmits operational commands accordingly. It also generates alarms to indicate problems with any connected security system and provides explanations as to the causes of the alarms. MagNet displays video pictures of the alarm source, using an advanced video matrix with a user-friendly interface. The operational commands transmitted by MagNet are

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routed back to the field units or to operator workstations which then convert these commands to visual information and allow the system operator to respond and influence the system's operation.

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MagNet integrates various detection technologies, including infrared and microwave, and enables multiple operators to simultaneously control the system. It can serve and manage multiple security systems, sensors, detectors and controllers, and is unaffected by the distance between the various system components under its control. MagNet can integrate and control both outdoor security systems and indoor security systems, and its open architecture enables operation with systems manufactured by other manufacturers as well as those manufactured by us. Data can be entered into the MagNet system from anywhere in the world through the Internet, provided appropriate authorization exists. In addition, MagNet's TCP/IP protocol and Ethernet boards, using the Windows NT operating system, allow the system to use a wide range of communications media, such as telephone lines, fiber optics and wireless communication. MagNet operates with, and can provide solutions for, various types of security configurations, as well as adaptations for additional and new security systems.

### INTEGRATED COMMAND AND CONTROL SYSTEM

Fortis, our fully integrated command and control system, supports real-time decision making and wide-area command and control. Fortis reduces the period of time from intruder detection to intruder engagement to a minimum. Fortis was 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.

The system creates a unified and interactive intelligence picture - drawing data from all sensors, while displaying the movement of security personnel in the field and adding other relevant information, such as video from various sources, auxiliary services and weather conditions. This combined picture, which is continuously updated, is sent by the central command to all security personnel in the command chain, and serves as a unified basis for operational planning and allocation of tasks. Using advanced technology, Fortis provides the security officer with a graphical command tool, which updates the location details and video view of the alerting area, while simultaneously enabling a constant watch over security personnel movements, thus optimizing the operational response.

Fortis's target markets include governmental, institutional and large sensitive facilities, such as borders, airports, hospitals, power plants and water sources, as well as large manufacturing facilities requiring real-time control and protection.

### PIPELINE SECURITY SYSTEMS

As of end of 2005, there were an estimated three million miles of unprotected oil and gas pipelines worldwide. Although the need for securing these pipelines has been strongly recognized by the oil and gas industry for years, and in spite of increasing threats since the events of 9/11 and current instability in Iraq and elsewhere in the Middle East, there was no effective solution for securing buried pipes against damage caused by terror, sabotage, theft or other third party threats. We have identified the demand and have implemented a technology aimed at meeting this challenge. PipeGuard, our pipeline security system, provides a solution for securing buried assets and infrastructure, including oil and gas pipelines and buried communication lines

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such as fiber optic cables.

PipeGuard utilizes an innovative and unique technology to guard buried pipelines, regardless of pipeline length, with the ability to detect potential attack and alert authorities before potential harm or damage occurs. Its target market includes oil and gas companies, owners and operators of pipelines or communication cables and governmental agencies dealing with security and environment.

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PipeGuard combines well proven sensors, geophones, with advanced edge of technology recognition algorithm capabilities based on the analysis of seismic signals, thus effectively filtering out false alarms. Using state of the art communications, only predefined signals are transmitted to the control station.

PipeGuard is suitable for all pipes or cables, from existing and operational pipelines, to new pipelines under construction. The system can easily be integrated into a full turnkey security solution, including perimeter protection, ground or air patrol and others. By answering the challenge of securing pipelines, we offer a total security solution for the oil and gas industry - from the oil field to the refineries.

### PERSONAL EMERGENCY LOCATION SYSTEMS

Our products deliver high reliability personal portable duress alarm systems to protect personnel in correctional facilities. These products identify individuals in distress and can pinpoint the location of the distress signal with an indoor-to-outdoor and floor-to-floor accuracy unmatched by any other product.

Flash Personal Emergency Alarm Systems, or Flash, and Flare Personal Emergency Locating Systems, or Flare, use radio frequency technology to provide a one touch emergency system that is so small it can be worn on a belt. The systems, sold mainly to correctional facilities, consist of transmitters that send distress signals to receivers mounted throughout the building. Receivers relay the signal to a central location indicating someone requires assistance and their location in the building. The systems employ automated testing procedures that help to reduce maintenance costs. The hardware and software was developed and researched in the U.S. and competes against infrared and ultrasonic technologies.

Our personal alarm system, or PAS, uses an ultrasonic based emergency notification and communication system. The system, sold mainly to correctional facilities, allows individuals moving throughout a facility to quickly indicate their exact location in a crisis situation through a transmitter that is carried by them.

### VIDEO MONITORING SERVICES

The rapid consolidation of some of the largest companies in the electronic security services industry combined with their overall emphasis on residential security has led to fewer providers of high quality, innovative commercial electronic security services. We believe that the potential market for commercial real-time video monitoring security services is large and that within a few years most of the security systems used at industrial and commercial sites will adopt video monitoring systems as the preferred method of surveillance and protection. Consequently, in 2001, we established Smart to provide commercial real-time video monitoring security services.



Smart provides remote video verification services and remote video surveillance services. Smart verification systems are activated by an event, such as an illegal entry or tampering with property. Within seconds of an event being triggered by an intrusion, Smart systems automatically store the video images which are then sent to a central control room. The use of audio response to an event allows the control room operator to effectively stop a developing incident by broadcasting a warning message directed at the intruder. In addition, the control room operator can replay video images captured before and after the event to verify a criminal intrusion. Smart operators are then able to respond to the intrusion quickly and effectively by summoning police assistance or an entity's appropriate internal security response team. Smart central monitoring station is able to provide instantaneous security responses across the U.S.

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#### MARKETING, SALES AND DISTRIBUTION

We market products primarily to government agencies, government authorities and government-owned companies. However, the activities of certain of these government bodies are increasingly being privatized in jurisdictions throughout the world. We believe that our reputation as a vendor of high-security products in one of the world's most security-conscious countries often provides us and our sales representatives with direct access to senior government and corporate officials in charge of security matters elsewhere. In addition we have begun to invest resources in the distribution of perimeter intrusion detection systems to private corporations. We attempt to initiate contact with potential customers at trade shows, where we demonstrate our products and distribute promotional materials. After initial discussions, we generally seek to provide potential customers with products on a trial basis or in a small-scale installation. We believe that this affords prospective purchasers an opportunity to assess our products over a sustained period of time under realistic conditions. We have sales offices located in the United Kingdom, Germany, Mexico, the United States, China, Romania and Poland.

#### PERIMETER INTRUSION DETECTION SYSTEMS

We generally sell our perimeter intrusion detection systems to exclusive distributors for various geographic territories or for specific projects. These exclusive distributors then resell these products at prices negotiated with their respective customers. In some cases, however, we pay commissions on these third-party sales either to the distributor or to the sales representatives responsible for facilitating the transaction. In addition to marketing activities, some of our distributors also provide installation and maintenance services for our products. We currently have over 50 distributors who resell these systems. We occasionally use agents to find suitable distributors and pay finders' fees to these agents for their services.

For the last two years we have distributed our taut wire detection systems in the U.S. through our subsidiary Magal Senstar Inc., or MSI, and an unaffiliated third party who was granted a non-exclusive right to distribute such systems in the U.S. and in Canada.

#### SECURITY MANAGEMENT AND CONTROL SYSTEMS DREAMBOX AND TURNKEY PROJECTS.

Our marketing efforts for our Security Management and Control Systems, DreamBox and turnkey projects consists of direct contacts with potential customers. We offer the MagNet, Fortis and DreamBox products primarily as part

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of comprehensive turnkey project solutions or, at the customer's preference, as stand-alone products. We distribute our systems in the U.S. and Canada through our U.S. and Canadian subsidiaries, MSI and Senstar Stellar Corporation, or Senstar, respectively.

### PIPELINE SECURITY SYSTEMS

The target markets for our pipeline security systems include oil and gas companies, owners and operators of pipelines or communication cables and governmental agencies engaged with security and environment issues.

### PERSONAL EMERGENCY LOCATION SYSTEMS

We market our personal emergency location systems directly to potential customers, mainly correctional facilities in North America.

### VIDEO MONITORING SERVICES

Smart offers its services mainly to industrial sites, commercial businesses, educational facilities and VIP residences. Smart sells its services through its direct sales force.

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The following table shows the breakdown of our consolidated revenues for the calendar years 2003, 2004 and 2005 by operating segment:

	Year Ended December 31,		
	2003 (*)	2004 (*)	2005
	-----	-----	-----
	(In thousands)		
Perimeter products	\$51,077	\$46,342	\$40,143
Projects	6,720	11,375	17,970
Video monitoring	403	2,060	2,897
Other	455	691	272
	-----	-----	-----
Total	\$58,655	\$60,468	\$61,282
	=====	=====	=====

(\*) Reclassified

### CUSTOMERS

The following table shows the geographical breakdown of our consolidated revenues for the calendar years 2003, 2004 and 2005:

	Year Ended December 31,		
	2003 (*)	2004 (*)	2005
	-----	-----	-----
	(In thousands)		
Israel	\$19,797	\$ 9,617	\$19,309
U.S.	13,292	17,871	13,185
Canada	6,338	4,068	8,759
Romania	5,151	9,521	6,244
Europe (excluding Romania)	5,465	9,150	3,691

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Others	8,612	10,241	10,094
	-----	-----	-----
Total	\$58,655	\$60,468	\$61,282
	=====	=====	=====

(\*) Reclassified

For the years ended December 31, 2003, 2004 and 2005, revenues generated from sales to the MOD and the IDF, accounted for 27.5%, 7.8% and 23.9%, respectively, of our revenues. 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 generating similar revenues 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.

### SUPPORT AND MAINTENANCE

Our systems are installed by us or by the customer after appropriate training, depending on the size of the specific project and the location of the customer's facilities, as well as on the customer's prior experience with our systems. We generally provide our customers with training on the use and maintenance of our systems. This training is conducted either on-site or at our facilities. In addition, some of our local perimeter security systems customers have signed maintenance contracts with us. For systems installed outside of Israel, maintenance is provided by an independent third party, by distributors or by the end user. We also provide services, maintenance and support on an "as needed" basis.

We require distributors of our high-security perimeter systems to purchase a demonstration kit that includes full-scale models of our perimeter products, and to send technical personnel to Israel to participate in courses given by us that focus on the marketing, installation and servicing of our products.

Similarly, with regard to our subsidiaries' products, customer personnel are trained in product installation and maintenance either at the subsidiaries' facilities or at the customer's facility. Installation supervision and assistance are sometimes purchased along with the equipment. The life expectancy of a high-security perimeter system is approximately ten years. Consequently, many miles of perimeter systems need to be replaced each year.

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During 2005, we derived less than 5.0% of our total revenues from maintenance and services. We generally provide a warranty on most of our products for defects for which we receive notice within 12-24 months of the delivery date of the product.

### RESEARCH AND DEVELOPMENT; ROYALTIES

We place considerable emphasis on research and development to improve our existing products and technology and to develop new products and technology. We believe that our future success will depend upon our ability to enhance our existing products and technology and to introduce on a timely basis new commercially viable products and technology addressing the needs of our customers. We intend to continue to devote a significant portion of our personnel and financial resources to research and development. As part of our product development process, we seek to maintain close relationships with our

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customers to identify market needs and to define appropriate product specifications. Our development activities are a direct result of the input and guidance we receive from our marketing personnel during our annual meetings with such personnel. In addition, the heads of research and development for each of our development centers discussed below meet annually to identify market needs for new products.

Our research and development expenses during 2003, 2004 and 2005 were approximately \$5.1 million, \$5.1 million and \$5.4 million, respectively, of which royalty bearing grants from the Office of the Chief Scientist of the Israel Ministry of Industry, Trade and Labor, or the OCS, and investment tax credits, constituted approximately 6.9%, 8.0% and 3.0% of such expenses. In addition to our own research and development activities, we also acquire know-how from external sources. We cannot assure you that any of our research and development projects will yield profitable results.

We have the following three development centers, each of which develops various products and technologies based on its area of expertise:

- o in Israel, we develop a wide range of products including our taut wire, mechanical vibration, video and high-end SMS systems and PipeGuard;
- o in California, MSI develops our microphonic fence sensors as well as our microwave detection, personal alarm and small/medium and control systems; and
- o in Canada, Senstar develops our leaky coax radar, triboelectric and fiber-optic fence sensors, electrostatic volumetric detection and medium to high-end control systems and personal emergency location systems.

### OFFICE OF THE CHIEF SCIENTIST OF THE ISRAEL MINISTRY OF INDUSTRY, TRADE AND LABOR

We have historically sought co-financing of our development projects from the OCS. 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 an amount equal to 100% of the grants received, linked to the U.S. dollar. All grants received after January 1, 1999 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. We paid royalties amounting to \$80,000, \$61,000 and \$83,000 in the years ended December 31, 2003, 2004 and 2005, respectively. As of December 31, 2005, our aggregate contingent obligation to the OCS amounted to \$1.8 million.

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The terms of these grants require that the manufacture of products developed with these grants be performed in Israel and prohibit transferring technology developed with grants without the prior consent of the Research Committee of the OCS. We cannot assure you that, if requested, the OCS will grant such consent. Each application to the OCS is reviewed separately, so we cannot assure you that the Israeli Government will continue to support our research and development.

### THE FUND FOR THE ENCOURAGEMENT OF MARKETING ACTIVITIES

The Israeli Government, through the Fund for the Encouragement of Marketing

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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, and in the years ended December 31, 2003, 2004 and 2005, we have not paid any royalties. As of December 31, 2005, our aggregate contingent obligation amounted to \$82,000.

### BACKLOG

As of May 31, 2006, our backlog amounted to approximately \$20.0 million of which approximately \$12.5 million is expected to be delivered by the end of 2006, \$3.0 million is expected to be delivered by the end of 2007 and \$4.5 million is expected to be delivered thereafter.

### MANUFACTURING AND SUPPLY

Our manufacturing operations consist of designing and developing our products, fabricating and assembling components and finished products, quality control and final testing. Substantially all of our manufacturing operations are currently performed at our plant in Yehud, Israel. See "Property, Plants and Equipment" below.

We acquire most of the components utilized in our products, including, but not limited to, our turnkey products, and certain services from a limited number of suppliers and subcontractors. We cannot assure you that we will continue to be able to obtain such items from these suppliers on satisfactory terms. Alternative sources of supply are available, and therefore, we are not dependent upon these suppliers and subcontractors. We also maintain an inventory of systems and spare parts in order to enable us to overcome potential temporary supply shortages until an alternate source of supply is available. Nevertheless, temporary disruptions of our manufacturing operations would result if we were required to obtain materials from alternative sources, which may have an adverse effect on our financial results.

Senstar's manufacturing operations are located at its facility in Carp, Ontario, Canada and consist of design and development, assembly, final testing and quality control. Senstar uses local subcontractors for making and mounting its printed circuit board assemblies.

MSI's manufacturing operations are located at its facility in Fremont, California and consist of development and design, assembly, quality control and final testing. MSI uses local subcontractors for making and mounting its printed circuit board assemblies.

### COMPETITION

The principal factors affecting competition in the market for security systems are a system's high probability for detection and low probability of false and nuisance alarms. We believe that a manufacturer's reputation for reliable equipment is a major competitive advantage, and that such a reputation will usually be based on the performance of the manufacturer's installed systems. Additional competitive factors include quality of customer support, maintenance and price. We believe that we are competitive with respect to these factors and that we have a good reputation in the markets in which we compete.

Several companies, including Elbit Systems Ltd., Elfar Ltd., Rav-Tec Ltd., Trans Ltd. and Gal-Dor Ltd. in Israel, and Detektion Security Systems Inc.,

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Herras, Pilkington PLC, Del Norte Security, Geoquip Ltd. and Siemens AG outside of Israel, produce high-security detection systems.

There are a number of companies that have developed video motion detection systems, including Geutebruck GmbH, Adpro, Siemens AG and Bosch.

We believe that our principal competitors for Dreambox systems are Nice Systems Ltd., Verint Systems Inc. and DVTel Inc.

We believe that our principal competitors for security management and control systems and turnkey project offerings include, among others, Honeywell Inc., Lockheed Martin Corporation, Raytheon Company, Siemens AG, Dornier, Elbit Systems Ltd. and Rafael.

We believe that our principal competitor for the Pipeguard system is an Australian company, Future Fibre Technologies Pty. Ltd.

We believe that our principal competitors for personal emergency location systems are Actall Corp. and Visonic Networks.

We believe that our principal competitors for video monitoring services are Westec Security, Inc. and InterSTAR Systems, Inc.

Some of our competitors and potential competitors have greater research, development, financial and personnel resources, including governmental support, or more extensive business experience than we do. We cannot assure you that we will be able to maintain the quality of our products relative to those of our competitors or continue to develop and market new products effectively.

### INTELLECTUAL PROPERTY RIGHTS

We have approximately 45 patents issued and patent applications pending in the U.S. and in several other countries and have obtained licenses to use proprietary technologies developed by third parties. We cannot assure you:

- o that patents will be issued from any pending applications, or that the claims allowed under any patents will be sufficiently broad to protect our technology;
- o that any patents issued or licensed to us will not be challenged, invalidated or circumvented; or
- o as to the degree or adequacy of protection any patents or patent applications may or will afford.

In addition, we claim proprietary rights in various technologies, know-how, trade secrets and trademarks relating to our principal products and operations. We cannot assure you as to the degree of protection these claims may or will afford. It is our policy to protect our proprietary rights in our products and operations through contractual obligations, including confidentiality and non-disclosure agreements with certain employees and distributors. We cannot assure you as to the degree of protection these contractual measures may or will afford. Although we are not aware that we are infringing upon the intellectual property rights of others, we cannot assure you that an infringement claim will not be asserted against us in the future. We believe that our success is less dependent on the legal protection that our patents and other proprietary rights may or will afford than on the knowledge, ability, experience and technological expertise of our employees. We cannot provide any assurance that we will be able to protect our proprietary technology. The unauthorized use of our proprietary technology by third parties may impair our ability to compete effectively. We could become subject to litigation regarding intellectual property rights, which could seriously harm our business.

We have trademark rights associated with our use of Flash and Intelli-FLEX, and rights obtained by trademark registration for Flare, Perimitrax, Panther, Intelli-FIELD, Senstar, Senstar-Stellar and the Senstar-Stellar logo.

#### GOVERNMENT REGULATION OF CERTAIN EXPORTS

Under Israeli law, the export of products that we manufacture in Israel and/or certain know-how is subject to approval by the MOD. We must obtain permits from the MOD to initiate sales proposals with regard to such exports, as well as for actual export transactions. We cannot assure you that we will receive all the required permits for which we may apply in the future.

#### C. ORGANIZATIONAL STRUCTURE.

The table below lists our subsidiaries. We, or one of our subsidiaries, own 100% of the outstanding capital stock of the subsidiary.

Effective as of April 1, 2005, Perimeter Products Inc., one of our wholly owned U.S. subsidiaries merged into another of our U.S. wholly owned subsidiaries, Senstar Stellar Inc. Following the merger, Senstar Stellar Inc.'s name was changed to Magal Senstar Inc., or MSI.

NAME OF SUBSIDIARY -----	COUNTRY OF INCORPORATION -----
Senstar-Stellar Corporation	Canada
Magal Senstar Inc.	United States (Delaware)
Senstar GmbH	Germany
Kobb Inc.	United States (Delaware)
Magal B.V.	The Netherlands
Senstar-Stellar Latin America S.A. de C.V.	Mexico
Senstar-Stellar Limited	United Kingdom
Smart Interactive Systems, Inc.	United States (Delaware)
E.S.E. Ltd.	Israel
Magal Security Sisteme S.R.L	Romania
Magal Security Systems Poland	Poland

#### D. PROPERTY, PLANTS AND EQUIPMENT.

Our two-story 2,533 square meter plant is located on a 4,352 square meter parcel in the Yehud Industrial Zone. We purchased the rights to the land in August 1988 from a third party, which had purchased them primarily from the Israel Land Authority. In accordance with Israeli law, this parcel of land is still registered in the name of the Israel Land Authority. We will be entitled to have title to the property recorded in our name when Israeli authorities subdivide the property into parcels. This procedure is a statutory requirement

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for transferring land ownership in Israel. The products that we manufacture at this facility include our taut-wire intrusion detection systems, our vibration detection systems, our video-motion detection systems, MagNet, Fortis, DreamBox, PipeGuard, and other perimeter systems.

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Senstar owns a 33,000 square foot facility in Carp, Ontario, Canada. Approximately 7,000 square feet are devoted to administrative, marketing and management functions and approximately 8,000 square feet are used for engineering, system integration and customer service. Senstar uses the remaining 18,000 square feet for production operations, including cable manufacturing, assembly, testing, warehousing, shipping and receiving. In December 2004, Senstar bought an additional 182,516 square feet of vacant land adjacent to this property for future expansion. Senstar also leases 358,560 square feet of land near this facility, for \$2,500 per year. This area is used as an outdoor sensor test and demonstration site for its products. The products that Senstar manufactures at this facility include the Perimitrax/Panther 2000 buried cable intrusion detection systems, the Intelli-Field electro static detection system, the Intelli-FLEX microphonic fence detection system, Flash and Flare, and various perimeter monitoring and control systems.

MSI owns a 20,000 square foot facility in Fremont, California. The products that MSI manufactures at this facility include Intelli-Wave, various sensors, the PAS personal alarm system and the MX control and monitoring center.

In connection with two of our credit lines, a fixed charge was placed on our plant in Israel by each of Bank Leumi Israel and Union Bank of Israel, each of which ranks pari-passu with the other.

We believe that our facilities are suitable and adequate for our operations as currently conducted and as foreseen. In the event we require additional facilities, we believe that we will be able to obtain such facilities at commercially reasonable rates.

#### ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

#### ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

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 FACTORS."

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:

- o a line of perimeter security systems, which automatically detect and locate intruders, identify the nature of intrusions and provide



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emergency notification;

- o 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
- o video monitoring services.

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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

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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:

- o continuing the growth of revenues and profitability of our perimeter security system line of products;
- o enhancing the introduction and recognition of our new products into the markets;
- o penetrating into new markets and strengthening our presence in existing markets;

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- o succeeding in selling our comprehensive turnkey solutions; and
- o achieving operating profitability from our Smart subsidiary.

### DISCUSSION OF CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and the use of different assumptions would likely result in materially different results of operations.

Critical accounting policies are those that are both most important to the portrayal of our financial position and results of operations, and require management's most difficult, subjective or complex judgments. Although not all of our significant accounting policies require management to make difficult, subjective or complex judgments or estimates, the following policies and estimates are those that we deem most critical:

#### REVENUE RECOGNITION

We generate our 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 on a time-and-materials basis.

Revenues from installation of comprehensive security systems are generated from fixed price contracts according to which the time between the signing of the contract and the final customer acceptance is over a period generally exceeding one year. Such revenues are recognized using contract accounting on a percentage of completion method. The amounts of revenues recognized are based on the total fees under the agreements and the percentage to completion achieved in accordance with the "Input Method."

Project costs include material purchased to produce the system, related labor and overhead expenses and subcontractor's costs. We measured the

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percentage to completion 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 our prior experience in installing and integrating security systems, our collection experience, delivery and acceptance of similar services, which are reviewed and updated regularly by us. 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. Until 2006, we never experienced a material cancellation for one of our projects.

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 our results of operations when they are reasonably determinable by us, on a cumulative catch-up basis.

We believe that the use of the percentage of completion method is appropriate as we have the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, the contracts we execute 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 the event of terminations for convenience. In all cases we expect to perform our contractual obligations and our customers are expected to satisfy their obligations under the contract.

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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. At December 31, 2005 we recorded \$8.6 million of such unbilled receivables.

We sell 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 when delivery has occurred, persuasive evidence of an agreement exists, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

Services and maintenance are performed under either fixed-price basis or time-and-materials basis contracts. Under fixed-price contracts, we agree to perform certain work for a fixed price. Under time-and-materials contracts, we are reimbursed for labor hours at negotiated hourly billing rates and for materials. Related revenues are recognized 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 collectability is reasonably assured.

One of our subsidiaries provides security video monitoring services. The majority of its executed 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.

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Under the contracts, service is not dependent on specific equipment. Our subsidiary's obligation is related to the provision of monitoring services. The service contracts do not meet the definition of a lease, and as such, the subsidiary recognizes the monthly service fees over the terms of the contracts.

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

### INVENTORIES

Inventories are stated at the lower of cost or market value. We periodically evaluate 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:

- o Raw materials, parts and supplies - using the "first-in, first-out" method.
- o Work-in-progress - represents the cost of production in progress.
- o Finished products - on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

During 2003, 2004 and 2005, we recorded inventory write-offs in the amounts of \$601,000, \$224,000 and \$507,000, respectively.

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### INCOME TAXES

We account for income taxes in accordance with Statement of Financial Accounting Standard No. 109 "Accounting for Income Taxes." This statement prescribes the use of the liability method whereby deferred tax asset 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. We provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and we must establish a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. Increases in the valuation allowance result in additional expense to be reflected within the tax provision in the consolidated statement of income. At December 31, 2005, we had a deferred tax asset of \$2.0 million. We have total estimated available carryforward tax losses of \$2.4 million to offset against future taxable income. Our subsidiaries in the United States and the United Kingdom have estimated total available carry-forward tax losses of \$8.3 million and \$944,000, respectively, that may be offset against

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future taxable profit for 16-20 years and an indefinite period, respectively. As of December 31, 2005, we recorded a full valuation allowance of our subsidiaries' 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.

### GOODWILL

Goodwill represents the excess of the costs over the net fair value of the assets of the businesses acquired. Goodwill acquired in a business combination on or after July 1, 2001 may not be amortized and we ceased to amortize goodwill acquired in prior periods beginning January 2002.

We test goodwill impairment on acquisition and at least annually thereafter or between annual tests in certain circumstances, we write down goodwill when impaired, rather than amortizing it 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 flow.

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 were identified.

As of December 31, 2005, our goodwill amounted to \$4.2 million which principally relates to our perimeter security systems segment.

### IMPAIRMENT OF LONG LIVED ASSETS

Our long-lived assets and certain identifiable intangibles are reviewed for impairment 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 of assets to the future undiscounted cash flows expected to be generated by the group of assets. 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 group of assets exceeds their fair value. During 2003, 2004 and 2005, no impairment losses were identified.

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### FINANCIAL STATEMENTS IN U.S. DOLLARS

A significant portion of our revenues is generated in dollars. Financing and investing activities including credit, loans, equity transactions and cash investments are executed in dollars. We believe that the dollar is the primary currency of the economic environment in which we operate. Thus, our functional and reporting currency is the dollar. The dollar was also determined to be the functional currency of our U.S.- based subsidiaries.

Monetary accounts maintained in currencies other than the dollar are remeasured into dollars. 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.

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The financial statements of all our foreign subsidiaries, excluding our U.S. subsidiaries, whose functional currency is their local currency, 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 period. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

Accordingly, we had accumulated foreign currency translation income of approximately \$2.3 million and \$2.4 million that was included as part of "accumulated other comprehensive income" within our balance sheets at December 31, 2004 and 2005, respectively. During 2003, 2004 and 2005, foreign currency translation income of \$2.3 million, \$1.1 million and \$87,000, respectively, were included under "accumulated other comprehensive income." Had we determined that the functional currency of our subsidiaries (not including our U.S. subsidiaries) was the dollar, these gains would have increased our income for each of the years presented.

### CONCENTRATIONS OF CREDIT RISK

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

Of our cash and cash equivalents and short-term and long-term bank deposits at December 31, 2005, \$26.8 million is invested in major Israeli and U.S. banks, approximately \$2.2 million is invested in other banks, mainly with Deutsche Bank, RBC Royal Bank and BBVA Bancomer. Cash and cash equivalents in the United States may be in excess of insured limits and are not insured in other jurisdictions. We believe that the financial institutions that hold our investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The short term and long term trade receivables and the unbilled accounts receivable of our company and our subsidiaries are derived from sales to large and solid organizations located mainly in Israel, the United States, Canada and Europe. We perform ongoing credit evaluations of our customers and to date have not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that we have determined to be doubtful of collection and by a general reserve. In certain circumstances, we may require letters of credit, other collateral or additional guarantees. As of December 31, 2005, the allowance for doubtful accounts amounted to \$306,000.

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### DERIVATIVE INSTRUMENTS

We recognize our derivative instruments as either assets or liabilities in our 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, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

We designate our derivative instruments as cash flow hedges (i.e., hedging

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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.

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, 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.

During the year ended December 31, 2005, we recognized a net loss of \$368,000 related to the effective portion of our hedging instruments and a net gain of \$442,000 related to the portion of the hedging instrument excluded from the assessment of hedge ineffectiveness.

During the year ended December 31, 2004, we recognized a net loss of \$932,000 related to the effective portion of our hedging instruments and a net loss of \$19,000 related to the portion of the hedging instrument excluded from the assessment of hedge ineffectiveness.

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.

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### FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used by us and our subsidiaries in estimating the fair value of our financial instruments:

- o 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.
- o The carrying amount of our long-term trade receivables, long-term bank

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deposits and structured notes approximate their fair value. The fair value was estimated using discounted cash flows analyses, based on our investment rates for similar types of investment arrangements.

- o The carrying amounts of our long-term bank 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 our long-term borrowings was \$5.3 million, compared to the carrying amount of \$5.4 million. As of December 31, 2005, the fair value of our long-term borrowings was \$5.3 million, compared to the carrying amount of \$5.3 million.
- o The fair value of foreign currency contracts (used for hedge purposes) is estimated by obtaining current quotes from investment bankers.

### RECENT ACCOUNTING PRONOUNCEMENTS IN THE UNITED STATES

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. We adopted SFAS 123(R) on January 1, 2006.

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

- o 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.
- o 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, we currently account 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 we adopted SFAS 123(R) in 2005, the impact of that standard would have decreased our net income by approximately \$1.05 million, as described in the disclosure of pro forma net income and earnings per share in our consolidated financial statements.

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



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

\* 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

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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.

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**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(R), 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.

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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.

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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(R), 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

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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.

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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" and Note 17 to our consolidated financial statements).

	JUN. 30, 2005		SEPT. 30, 2005	
	As previously reported	As adjusted	As previously reported	As adjusted
<b>CONSOLIDATED STATEMENT OF INCOME DATA:</b>				
Revenues	\$ 17,138	\$ 13,238	\$ 17,721	\$ 17,721
Cost of revenues	9,705	8,865	10,239	10,239
Gross profit	7,433	4,373	7,482	7,482
Operating expenses:				
Research and development, net	1,276	1,276	1,337	1,337
Selling and marketing, net	3,882	3,340	3,775	3,775
General and administrative	1,438	1,438	1,367	1,367
Award granted by principal shareholders	-	-	-	-
Total operating expenses	6,596	6,054	6,479	6,479
Operating income (loss)	837	(1,681)	1,003	1,003
Financial income (expenses), net	(37)	(37)	(119)	(119)
Income (loss) before income taxes	800	(1,718)	884	884
Income taxes (tax benefit)	294	(170)	260	260
Income (loss) from continuing operations	506	(1,548)	624	624

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Loss from discontinued operations, net	(24)	(24)	(21)
	-----	-----	-----
Net income	482	(1,572)	603
	=====	=====	=====

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	2004*		
	MAR. 31,	JUN. 30,	SEPT. 30,
	-----	-----	-----
CONSOLIDATED STATEMENT OF INCOME DATA:			
Revenues	\$ 14,082	\$ 14,374	\$ 15,152
Cost of revenues	7,779	7,879	8,346
	-----	-----	-----
Gross profit	6,303	6,495	6,806
	-----	-----	-----
Operating expenses:			
Research and development, net	1,131	1,161	1,193
Selling and marketing, net	2,587	3,043	2,974
General and administrative	1,301	1,417	1,415
Award granted by principal shareholders	-	1,200	-
	-----	-----	-----
Total operating expenses	5,019	6,821	5,582
	-----	-----	-----
Operating income (loss)	1,284	(326)	1,224
Financial income (expenses), net	(93)	(258)	(223)
	-----	-----	-----
Income (loss) before income taxes	1,191	(584)	1,001
Income taxes (tax benefit)	451	140	310
	-----	-----	-----
Income (loss) from continuing operations	740	(724)	691
Loss from discontinued operations, net	(53)	(14)	(27)
	-----	-----	-----
Net income	687	(738)	664
	=====	=====	=====
CONSOLIDATED STATEMENT OF INCOME DATA, EXPRESSED AS A PERCENTAGE OF REVENUES:			
Revenues	100.0%	100.0%	100.0%
Cost of revenues	55.2	54.8	55.1
	-----	-----	-----
Gross profit	44.8	45.2	44.9
	-----	-----	-----
Operating expenses:			
Research and development, net	8.0	8.1	7.9
Selling and marketing, net	18.4	21.2	19.6
General and administrative	9.2	9.9	9.3
Award granted by principal shareholders	-	8.3	-
	-----	-----	-----
Total operating expenses	35.6	47.5	36.8
	-----	-----	-----
Operating income (loss)	9.1	(2.3)	8.1
Financial income (expenses), net	(0.7)	(1.8)	(1.5)
	-----	-----	-----

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Income (loss) before income taxes	8.5	(4.1)	6.6
Income taxes (tax benefit)	3.2	1.0	2.0
	-----	-----	-----
Income (loss) from continuing operations	5.3	(5.0)	4.6
Loss from discontinued operations, net	(0.4)	(0.1)	(0.2)
	-----	-----	-----
Net income (loss)	4.9%	(5.1)%	4.4%
	=====	=====	=====

(\*) 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:

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

See also Item 3.D. "Key Information-Risk Factors." 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.

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### 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.

The following table presents information about the rate of devaluation of the NIS against the dollar:

Year ended	Israeli inflation	NIS devaluation	Israeli inflation
December 31,	rate %	rate %	adjusted for devaluation
-----	-----	-----	-----
			%

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2001	1.4	9.3	(7.9)
2002	6.5	7.3	(0.8)
2003	(1.9)	(7.6)	5.7
2004	1.2	(1.6)	2.8
2005	2.4	6.8	(4.4)

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

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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.



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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
	(in thousands)	
Net cash provided by (used in) continuing operations	\$ 1,705	\$ 3,988
Net cash provided by (used in) discontinued operations	19	(310)
	-----	-----
Net cash provided by (used in) operating activities	1,724	3,678
Net cash provided by (used in) investing activities	(3,606)	512
Net cash provided by financing activities	3,500	3,096
Effect of exchange rate changes on cash and cash equivalents	252	289
	-----	-----
Increase (decrease) in cash and cash equivalents	1,870	7,575
Cash and cash equivalents at the beginning of the year	2,519	4,389
	-----	-----
Cash and cash equivalents at the end of the year	\$ 4,389	\$ 11,964
	-----	-----

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

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other.

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

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

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- o Minimal annual consolidated net income in the amount of \$1 million; and
- o 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:

- o A quick ratio of not less than 1.25;
- o A ratio of total liabilities to tangible net worth of not greater than 0.75; and
- o Tangible net worth of at least \$9.0 million.
- o 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.

As of December 31, 2005, our outstanding balance under our credit lines consisted of:

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- o Short-term NIS-denominated loans of approximately \$1.7 million, bearing an average interest at a rate of 5%;
- o Short-term dollar-denominated loans of approximately \$15.1 million, bearing an average interest at a rate of 4.1%;
- o Short-term Polish Zloty-denominated loan of approximately \$1.2 million, bearing an average interest at a rate of 5.9%;
- o Several bank performance and advance payment guarantees totaling approximately \$8.6 million, at an annual cost of 0.5%-1.0%; and
- o Forward contracts of approximately \$1.1 million.

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As of December 31, 2005, our subsidiaries had outstanding, in the aggregate, \$5.3 million in long-term loans as follows:

- o \$2.5 million, bearing interest at a fixed annual rate of 3.1%. The interest on the outstanding balance under this loan is due monthly. This loan is due in one installment in April 2006;
- o \$500,000, bearing interest at an annual rate of 5.6% and collateralized by the assets of our US subsidiary, Magal Senstar Inc., or MSI. This loan is due in one installment in April 2006;
- o \$500,000, bearing interest at an annual rate of 5.2% and collateralized by MSI's assets. This loan is due in one installment in April 2006;
- o \$820,000 to MSI, bearing interest at a fixed rate of 5.5%. The loan is due in 20 quarterly installments of \$47,200, commencing February 2006. We have guaranteed the full amount of this loan; and
- o \$980,000 to MSI, bearing interest at a fixed rate of 5.5%. The loan is due in one installment in November 2010. We have guaranteed the full amount of this loan.

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.

The two \$500,000 promissory notes issued to Bank Leumi USA both have covenants that require us to maintain \$1.0 million in deposits at all times, otherwise the interest rate on the notes become the bank's rate plus 0.3% until the minimum deposit is maintained.

As of December 31, 2005, Senstar GmbH obtained bank performance guarantees in the amount of \$130,000.

As of December 31, 2005, Senstar issued a letter of credit in the amount of \$96,000 in connection with the purchase of supplies.

### 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,

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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.

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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.

For additional discussion of the information required by this item see "Operating and Financial Review and Prospects-Operating Results" and "Operating and Financial Review and Prospects-Liquidity and Financial Resources" above.

### 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

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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.

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### F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS.

The following table summarizes our minimum contractual obligations and commercial commitments as of December 31, 2005 and the effect we expect them to have on our liquidity and cash flow in future periods.

Contractual Obligations	Payments due by Period		
	Total	less than 1 year	1-2 Years
	-----	-----	-----
Long-term debt obligations	\$5,300,000	\$3,647,000	\$318,000
Capital (finance) lease obligations	-	-	-
Operating lease obligations	821,000	404,000	380,000
Purchase obligations	300,000	-	300,000
Other long-term liabilities reflected on the company's balance sheet under U.S. GAAP	-	-	-
	-----	-----	-----
Total	\$6,421,000	\$4,051,000	\$998,000
	=====	=====	=====

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### ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

#### A. DIRECTORS AND SENIOR MANAGEMENT.

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

NAME	AGE	POSITION
Jacob Even-Ezra	75	Chairman of the Board and Chief Executive Officer
Izhar Dekel	54	President and Director
Chaim Porat	70	Vice President - Far East and Australia Marketing

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Yehezkel Farber	65	Vice President - Operations
Zvi Dank	56	Vice President - Research and Development
Raya Asher	38	Vice President - Finance, Chief Financial Officer and Secretary
Asaf Even-Ezra	40	Vice President - Israel and West European Marketing
Dany Pizen	54	Vice President - East European and CIS Marketing
Ofer Katz	57	Vice President - Aviation Security
Raffi Netzer	43	Vice President - Africa and Latin America Marketing
Nathan Kirsh	74	Director
Jacob Nuss	58	Director
Jacob Perry	62	Director
Zeev Livne	61	Director
Shaul Kobrinsky	54	Outside Director
Anat Winner	47	Outside Director

Messrs. Even-Ezra, Dekel, Kirsh, Nuss, Perry and Livne will serve as directors until our 2006 Annual General Meeting of Shareholders. Mr. Kobrinsky and Mrs. Winner will serve as outside directors pursuant to the provisions of the Israeli Companies Law for three-year terms until our 2008 annual general meeting of shareholders, following which their service may be renewed for only one additional three-year term.

Jacob Even-Ezra and Asaf Even-Ezra are father and son. Izhar Dekel is Jacob Even-Ezra's son-in-law and Asaf Even-Ezra's brother-in-law. Other than these relationships, there are no other family relationships among our directors and senior executives.

JACOB EVEN-EZRA has served as our chairman of the board and chief executive officer since 1984, and from 1987 until 1990 he also served as our president. He is currently a member of the Executive Council and the Management Committee of Tel-Aviv University. From 1985 to 1988, Mr. Even-Ezra was also chairman of the Israel Export Institute. Mr. Even-Ezra holds a B.Sc. in Electrical Engineering from Israel Institute of Technology, or the Technion.

IZHAR DEKEL has served as our president since 1990 and as a director since 1993. Mr. Dekel served as our finance manager from 1984 to 1990. Mr. Dekel holds an M.B.A. and a B.A. in Economics and International Relations from the Hebrew University of Jerusalem.

CHAIM PORAT has served as our vice president - Far East and Australian marketing since 1988. Prior to joining us, Mr. Porat served as the head of the security division of Beta Engineering Ltd. Mr. Porat holds a B.Sc. in Electrical Engineering from the Technion.

YEHEZKEL FARBER has been our vice president - operations since 1986. Previously Mr. Farber served as the manager of the customer systems department of IAI.

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ZVI DANK has served as our vice president - research and development since 1984. Before joining us, Mr. Dank worked as an electronic engineer in the electronics division of IAI. Mr. Dank holds a B.Sc. in Electrical Engineering from the Technion.

RAYA ASHER has served as our vice president - finance, chief financial officer and secretary since 1998. Prior to joining us, Ms. Asher served as a senior audit manager with Kost Levary and Forer, Certified Public Accountants in Israel, the predecessor of our auditors, Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global. Ms. Asher holds an M.B.A. in Business and a

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B.A. in Accounting and Economics from Tel Aviv University.

ASAF EVEN-EZRA joined us in 1995 and has served as our vice president - Israel and West European marketing since 1998. Mr. Even-Ezra also heads our video motion detection division. Mr. Even Ezra holds an M.B.A. and a B.A. in Business from the New York Institute of Technology.

DANY PIZEN has served as our vice president - East European and CIS marketing since 1995. Before joining us, Mr. Pizen served as vice president of business development of Eldor Electronics Ltd., before which he served for 20 years in the IDF and retired as a Lieutenant Colonel. Mr. Pizan holds a B.A. in Social Science from Bar Ilan University.

OFER KATZ has served as our vice president - aviation security since 1995. Prior to that and since 1984 he served in our software and computer development department as manager of our production line and in operations and special projects.

RAFI NEZER has served as our vice president - Africa and Latin America marketing since 2004. Before joining us and since 1999, Mr. Nezer acted as director of marketing for Rada Electronic Industries Ltd. Mr. Nezer holds an M.B.A. in Business Administration from INSEAD and an L.L.B. from the Tel Aviv University.

NATHAN KIRSH has served as a director since 1984. Mr. Kirsh is an independent investor. Mr. Kirsh serves as one of the trustees of the Eurona Foundation, the beneficial owner of 81.5% of the ordinary shares of our company that are held by Mira Mag Inc. Mr. Kirsh holds a B.A. in Commerce from the University of Witwatersrand, Johannesburg.

JACOB NUSS has served as a director since 1993. Mr. Nuss currently serves as the vice president - internal auditing of IAI, and served as IAI's deputy vice president - internal auditing from 1999 to 2003. From 1993 to 1999, Mr. Nuss served as the director of finance of IAI's electronics group. From 1991 to 1993, Mr. Nuss served as assistant to the chairman of the board of IAI. Mr. Nuss has served in various financial management capacities at IAI since 1975. Mr. Nuss holds an M.B.A. in Business from the Tel Aviv University and a B.A. in Economics and Business Management from Bar Ilan University. Mr. Nuss holds a certificate in internal auditing.

JACOB PERRY was appointed to serve as a director in December 2002. From 1995 to December 2002, Mr. Perry was President and CEO of Cellcom Israel Ltd., Israel's largest cellular phone operator. Mr. Perry served 29 years with the Israeli General Security Service, and served as its chief from 1988 until 1995. Mr. Perry has also served as an adviser to the Israeli Prime Minister on the subject of prisoners of war and missing persons. He was a board member of El-Al Israel Airlines and a member of the management of many public organizations. Mr. Perry is also a chairman of the board of directors of various companies, including Mizrahi Tefahot Bank B.M. and Lipman Electronic Engineering Ltd. Mr. Perry holds an A.M.P. from Harvard Business School and a B.A. in Oriental Studies and History of the Jewish People from Tel-Aviv University.

ZEEV LIVNE was appointed to serve as a director in July 2004. Mr. Livne has served as the chairman of Livne Strategic Consultants LTD. since 2001. Mr. Livne served 39 years with the IDF until 2001. During his long military career with the IDF, Mr. Livne served as the Defense Attache to the U.S. and Canada from 1997 to 2001, Military Secretary to the Prime Minister of Israel from 1996 to

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1997 and Ground Force Commander from 1994 to 1996. From 1992 to 1994 Mr. Livne established the IDF Home Front Command and served as its first Commander. Mr. Livne serves on the board of directors of "PAZKAR," a private Israeli company. Mr. Livne holds a B.A. in History from the Tel Aviv University, and an M.A. in Geography from the University of Haifa.

SHAUL KOBRINSKY was appointed to serve as an outside director in July 2004. Mr. Kobrinsky has served as the President and Chief Executive Officer of Urdan Industries Ltd., an investment and holding company since 1997. Since 2003 Mr. Kobrinsky has served as senior managing director of Alagem Capital Group (a Beverly Hills based investment group). From 1989 to 1997, Mr. Kobrinsky served as chief executive officer of Cargal Ltd., an Israeli company that manufactures corrugates. Previously, and since 1984, Mr. Kobrinsky served as deputy managing director of Clal Industries Ltd., a holding and investment company. Mr. Kobrinsky serves as an outside director of Scope Metal Trading Ltd. Mr. Kobrinsky holds a B.A. in Economics from Tel Aviv University.

ANAT WINNER was appointed to serve as an outside director in July 2004. Mrs. Winner has been a business advisor since 2003. Mrs. Winner served from October 2001 to July 2004 as Chief Executive Officer and Chief Financial Officer of Israel News Ltd. From 1999 to October 2001, Mrs. Winner served as Chief Financial Officer of DBS Satellite Services (1998) Ltd. (YES), an Israeli company that is engaged in setting up and operating DBS television systems. Previously, and since 1995, Mrs. Winner served as chief financial officer of Eurocom Cellular Communications Ltd., an Israeli company that is engaged in importing and marketing cellular phones. Mrs. Winner also serves as a director of Internet Gold-Golden Lines Ltd. Mrs. Winner holds a B.A. degree in Accounting and Economics from Haifa University and has been a certified public accountant for 15 years.

### B. COMPENSATION.

During the fiscal year ended December 31, 2005, we paid aggregate compensation to all of our officers and directors as a group (consisting then of 16 persons) of approximately \$1.4 million. In addition, we have provided automobiles to our executive officers at our expense. We have two key-man life insurance policies for Izhar Dekel. We are the beneficiary of one of these policies and certain of Mr. Dekel's family members are the beneficiaries of the other policy. We bear the cost of each of these insurance policies. We also have a key-man life insurance policy for Jacob Even-Ezra, of which we are the beneficiary.

Directors who are not officers of us or of any entity that beneficially owns 5% or more of our ordinary shares, as well as our outside directors, receive an annual fee of approximately \$5,600 and an additional fee of approximately \$300 for each board or committee meeting that they attend.

Under the Israeli Companies Law, the board of directors must approve all compensation arrangements for the chief executive officer of the company, and unless provided otherwise in the company's articles of association, all compensation arrangements for officers and employees (other than the company's directors) are subject to the chief executive officer's approval. Directors' compensation arrangements (other than outside directors) also require audit committee approval before board approval and shareholder approval. However, pursuant to amendments to the Companies Regulations (Relief from Related Party Transactions), 5760-2000, directors' compensation and employment arrangements do not require, in certain circumstances, shareholder approval. In addition, under these regulations, if the director or office holder is a controlling shareholder of the company, then the employment and compensation arrangements of such director or office holder do not require shareholder approval if such arrangements meet certain criteria.



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An outside director is entitled to compensation as provided in regulations promulgated under the Israeli Companies Law and is otherwise precluded from receiving any other compensation, directly or indirectly, in connection with such service.

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During 2005, we granted options for the purchase of total of 53,500 ordinary shares to certain of our directors and executive officers. During 2004, we granted options to purchase 94,500 ordinary shares to certain of our directors and executive officers. We have no service contracts with any of our directors to provide services as a director that provide for benefits upon termination of employment. However, we do have employment agreements with certain of our directors in connection with their service as employees.

### C. BOARD PRACTICES.

#### INTRODUCTION

According to the Israeli Companies Law and our Articles of Association, the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. Our executive officers are responsible for our day-to-day management. The executive officers have individual responsibilities established by our chief executive officer and board of directors. Executive officers are appointed by and serve at the discretion of the board of directors, subject to any applicable agreements.

#### ELECTION OF DIRECTORS AND OFFICERS

Our articles of association provide for a board of directors of not less than three and not more than eleven members as may be determined from time to time at our annual general meeting. Our Board of Directors is currently composed of eight directors.

Our directors, (except the outside directors as detailed below), are elected by our shareholders at our annual general meeting and hold office until the next annual general meeting. All the members of our board of directors, (except the outside directors as detailed below), may be reelected upon completion of their term of office. Our annual general meetings are held at least once every calendar year, but not more than fifteen months after the last preceding annual general meeting. In the intervals between our annual general meetings, the board of directors may appoint new directors to fill vacancies. All of our current directors, including the outside directors, were elected by our shareholders at our annual general meeting of shareholders of July 2005.

Under a recent amendment to the Israeli Companies Law, our board of directors is required to determine the minimum number of directors who must have "accounting and financial expertise," as such term is defined in regulations promulgated under the Israeli Companies Law. Our Board of Directors has determined that our Board of Directors will include at least one director who has "accounting and financial expertise," within the meaning of the regulations promulgated under the Israeli Companies Law. Our Board of Directors has further determined that Ms. Anat Winner has the requisite "accounting and financial expertise."

We do not follow the requirements of the NASDAQ Marketplace Rules with regard to the nomination process of directors, and instead, we follow Israeli law and practice, in accordance with which our directors are recommended by our

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board of directors for election by our shareholders. See below in this Item 6.C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Exemptions for Foreign Private Issuers."

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### DIRECTORS' SERVICE CONTRACTS

Two of our directors, Jacob Even-Ezra and Izhar Dekel, entered into substantially similar employment agreements with us, effective January 1993. These agreements contain certain non-competition and confidentiality provisions. In addition, each agreement establishes a base salary and a package of benefits with an aggregate value of approximately 20% of the base salary, as well as a possible bonus. In December 2005, our board of directors, subject to shareholders approval, extended the appointment of Mr. Even-Ezra as chairman of the board until January 2008 and as chief executive officer for such period until a new chief executive officer is appointed. Under the Israeli Companies Law, such dual positions require shareholders approval which must be renewed every three years. Our shareholders approved this dual position in July 2004. In December 2000, our board of directors extended the term of Mr. Dekel's employment until such time as it is terminated by us or by Mr. Dekel pursuant to the terms of the agreement. Under the Israeli Companies Law, the terms of employment of Mr. Dekel, who is also a member of our board of directors requires shareholders' approval. Our shareholders approved Mr. Dekel's terms of employment in July 2004. See also Item 6.B. "Directors, Senior Management and Employees-Compensation" above.

### OUTSIDE DIRECTORS

The Israeli Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint at least two outside directors. Outside directors must be Israeli residents who are qualified to be appointed as directors, unless the company's shares have been offered to the public outside of Israel or have been listed on a stock exchange outside of Israel. No person may be appointed as an outside director if, at the time of the appointment or during the two years that preceded the appointment, the person or the person's relative, partner, employer or an entity of which he is a controlling shareholder had an interest in the company, in a person who was a controlling shareholder of the company at the time of the appointment, or in an entity which was controlled by the company or its controlling shareholder at the time of the appointment or during the two years that preceded the appointment.

In addition, no person may serve as an outside director if the person's position or other activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director. If, at the time outside directors are to be appointed, all current members of the board of directors are of the same gender, then at least one outside director must be of the other gender.

According to a March 2005 amendment to the Israeli Companies Law, effective as of January 2006, at least one of the outside directors must be an "accounting and financial expert" and the other outside directors must be "professional experts," as such terms are defined by regulations promulgated under the Israeli Companies Law. This requirement does not apply to outside directors appointed prior to the March 2005 amendment, however a company can not renew the appointment of any such outside director for an additional term unless the outside director is (i) an accounting and financial expert or (ii) a professional expert and at the time the appointment is to be renewed, an outside

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director who is an accounting and financial expert serves on the board of directors.

The outside directors are elected by shareholders. The shareholders voting in favor of their election must include at least one-third of the shares of the non-controlling shareholders of the company who voted on the matter. This minority approval requirement need not be met if the total shareholdings of those non-controlling shareholders who vote against their election represent 1% or less of all of the voting rights in the company. Outside directors serve for a three-year term, which may be renewed for only one additional three-year term. Outside directors can be removed from office only by the same special percentage of shareholders that can elect them, or by a court, and then only if the outside directors cease to meet the statutory qualifications with respect to their appointment or if they violate their duty of loyalty to the company.

Any committee of the board of directors that is authorized to exercise powers vested in the board of directors must include at least one outside director and the audit committee must include all the outside directors. An outside director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

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### INDEPENDENT DIRECTORS

In general, under NASDAQ Stock Market Rules a majority of our Board of Directors must qualify as independent directors within the meaning of the NASDAQ Marketplace Rules and our audit committee must have at least three members and be comprised only of independent directors, each of whom satisfies the respective "independence" requirements of NASDAQ and the Securities and Exchange Commission. However, on June 27, 2006, we provided NASDAQ with a notice of non-compliance with respect to the requirement to maintain a majority of independent directors, as defined under NASDAQ Marketplace Rules. Instead, we follow Israeli law and practice which requires that we appoint at least two outside directors, within the meaning of the Israeli Companies Law, to our board of directors. (See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices.") In addition, in accordance with rules of the Securities and Exchange Commission, we have the mandated three independent directors, as defined by the Securities and Exchange Commission and NASDAQ rules, on our audit committee.

Our Board of Directors has determined that Ms. Winner and Mr. Kobrinsky qualify both as independent directors under the Securities and Exchange Commission and NASDAQ requirements and as outside directors under the Israeli Companies Law requirements. Our Board of Directors has further determined that Messrs. Nuss and Livne qualify as independent directors under the Securities and Exchange Commission and NASDAQ requirements.

### AUDIT COMMITTEE

Our audit committee, which was established in accordance with Section 114 of the Israeli Companies Law and Section 3(a)(58)(A) of the Securities Exchange Act of 1934, assists our board of directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent public accountants' qualifications and independence, the performance of our internal audit function

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and independent public accountants, finding any defects in the business management of our company for which purpose the audit committee may consult with our independent auditors and internal auditor, proposing to the board of directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our board of directors.

The responsibilities of the audit committee also include approving related-party transactions as required by law. Under Israeli law an audit committee may not approve an action or a transaction with a controlling shareholder, or with an office holder, unless at the time of approval two outside directors are serving as members of the audit committee and at least one of the outside directors was present at the meeting in which an approval was granted.

Our audit committee consists of three board members who satisfy the respective "independence" requirements of the Securities and Exchange Commission, NASDAQ and Israeli Law for audit committee members. Our audit committee is currently composed of Mrs. Anat Winner and Messrs. Shaul Kobrinsky and Jacob Nuss. Our Board of Directors has determined that Ms. Anat Winner qualifies as a financial expert. The audit committee meets at least once each quarter. Our audit committee charter is available on our website at [www.magal-ssl.com](http://www.magal-ssl.com).

### INTERNAL AUDITOR

Under the Israeli Companies Law, the board of directors must appoint an internal auditor proposed by the audit committee. The role of the internal auditor is to examine whether the company's actions comply with the law, integrity and orderly business procedure. Under the Israeli Companies Law, the internal auditor may not be an interested party, an office holder, or an affiliate, or a relative of an interested party, office holder or affiliate, nor may the internal auditor be the company's independent accountant or its representative. Mr. Daniel Spira, CPA (Isr.) is our internal auditor.

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### APPROVAL OF SPECIFIC RELATED-PARTY TRANSACTIONS

The Israeli Companies Law imposes a duty of care and a duty of loyalty on all office holders of a company, including directors and executive officers. The duty of care requires an office holder to act with the level of competence at which a reasonable office holder would employ under the same circumstances, including. An office holder's duty of care includes a duty to use reasonable means to obtain:

- o information on the appropriateness of a given action brought for his approval or performed by him by virtue of his position; and
- o all other important information pertaining to these actions.

The duty of loyalty requires an officer holder to act in good faith and in the company's interest. The duty of loyalty includes a duty to:

- o refrain from any conflict of interest between the performance of his duties in the company and his personal affairs;
- o refrain from any activity that is competitive with the company;

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- o refrain from exploiting any business opportunity of the company to receive a personal gain for himself or others; and
- o disclose to the company any information or documents relating to the company's affairs which the office holder has received by virtue of his position in the company.

Each person listed as a director or executive officer in the table under "Item 6.A. Directors, Senior Management and Employees -- Directors and Senior Management" above is an office holder. Under the Israeli Companies Law, all arrangements as to compensation of executive office holders who are not directors require approval of the chief executive officer, and the compensation of office holders who are directors must be approved by our audit committee, board of directors and shareholders.

The Israeli Companies Law requires that an office holder promptly disclose any personal interest that he may have and all related material information known to him in connection with any existing or proposed transaction by the company. If the transaction is an extraordinary transaction, that is, a transaction other than in the ordinary course of business, other than on market terms, or likely to have a material impact on the company's profitability, assets or liabilities, the office holder must also disclose any personal interest held by:

- o the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of these people; or
- o any corporation in which the office holder is a 5% or greater shareholder, director or general manager or in which he has the right to appoint at least one director or the general manager.

Under the Israeli Companies Law, once an office holder complies with the above disclosure requirement, the board of directors may approve a transaction between the company and an office holder, or a third party in which an office holder has a personal interest, unless the articles of association provide otherwise. A transaction that is adverse to the company's interest may not be approved.

In some cases, including in the case of an extraordinary transaction, such a transaction, action and arrangement must be approved by the audit committee and by the board of directors itself, and further shareholder approval is required to approve the terms of compensation of an office holder who is a director. An office holder who has a personal interest in a matter, which is considered at a meeting of the board of directors or the audit committee, may not be present during the board of directors or audit committee discussions and may not vote on this matter, unless the majority of the members of the board or the audit committee have a personal interest, as the case may be.

Under the Israeli Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder that holds 25% or more of the voting rights in a public company, provided no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, (including private offerings in which a controlling shareholder has a personal interest) and a transaction with a controlling shareholder or his relative

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regarding terms of service and employment, require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval for such transactions must include either at least one-third of the shareholders who have no personal interest in the transaction and are present and voting on the matter, in person, by proxy or by written ballot, at the meeting, or a majority of the voting power present and voting on the matter, provided that the shareholders who have no personal interest in the transaction who vote against the transaction do not represent more than one percent of the voting rights in the company. For a discussion of certain Israeli Companies Law regulations pertaining to tender offers by shareholders, see Item 10.B. "Additional Information-Memorandum and Articles of Association-Provisions Restricting a Change in Control of Our Company."

The Israeli Companies Law requires that every shareholder that participates, either in person or by proxy, in a vote regarding a transaction with a controlling member of the company indicate whether or not he or she has a personal interest in the vote in question, the failure of which results in the invalidation of that shareholder's vote. Regulations promulgated under the Israeli Companies Law provide that this requirement does not apply to a company whose shares are publicly traded outside of Israel if, pursuant to applicable foreign securities laws, the company is required to distribute a proxy statement.

However, under the Companies Regulations (Relief From Related Party Transactions), 5760-2000, promulgated pursuant to the Israeli Companies Law, each of the following transactions between a company and its controlling shareholder(s) does not require shareholder approval:

- o the extension of the term of an existing related-party transaction; provided that the original transaction was duly approved in accordance with the applicable provisions of the Israeli Companies Law or the Israeli Securities Law and regulations promulgated thereunder;
- o a transaction that has been approved by the audit committee and the board of directors as being solely for the benefit of the company;
- o a transaction between the company and its controlling shareholder(s) or an entity in which the controlling shareholder has a personal interest, provided that the audit committee and the board of directors approve the transaction and determine that the transaction is in accordance with the terms defined in a duly approved frame-work transaction. A frame-work transaction is a transaction that defines the general terms under which the company may, in the ordinary course of business, enter into transactions of a similar type;

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- o a transaction between the company and its controlling shareholder(s) or an entity in which the controlling shareholder has a personal interest, for the purpose of entering into a transaction with a third party or to submit a joint offer to conduct business with a third party, provided that the audit committee and the board of directors have approved the transaction and that the terms of the transaction in relation to the company are not materially different from those relating to the controlling shareholder(s) or an entity in which the controlling shareholder has a personal interest, taking into account their proportionate participation in the transaction; and
- o a transaction between companies that are controlled by the same

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controlling shareholder or between the company and an entity in which the controlling shareholder has a personal interest, provided that for each public company involved, the audit committee and the board of directors find that the transaction is in accordance with market terms, is in the ordinary course of business and does not harm the welfare of the company.

In addition, pursuant to amendment to these regulations, directors' compensation and employment arrangements do not require shareholder approval, provided certain criteria are met. Also, pursuant to this amendment, if the director or the office holder is a controlling shareholder of the company, then the employment and compensation arrangements of such director or office holder do not require shareholder approval, provided certain criteria are met.

The relief from having to obtain shareholder approval set forth above will not apply, and shareholder approval will be required, if one or more shareholders, holding at least 1% of the issued and outstanding share capital of the company or of the company's voting rights, object to the grant of such relief, provided that such objection is submitted to the company in writing not later than seven days from the date of the filing of a report regarding the adoption of such resolution by the company pursuant to the requirements of the Israeli Securities Law (which reporting requirements are not applicable to us as a "double foreign company").

Further, since our ordinary shares are listed on the Tel Aviv Stock Exchange, we are subject to additional provisions of the Israeli Companies Law, as amended. These provisions require that the board of directors and shareholders approve any private placement of securities by a public company that will:

- o increase the relative holdings of a shareholder that holds 5% or more of that company's outstanding share capital; or
- o cause any person to become, as a result of such issuance, a holder of more than 5% of such company's outstanding share capital.

However, in accordance with the Companies Regulations (Relief From Related Party Transactions), 5760-2000, shareholder approval is not required for a private placement in which less than 20% of the voting rights in the company, prior to such offer, are offered. For purposes of such exemption, the definition of a private placement includes:

- o private placements that are part of the same transaction or that are contingent or conditioned upon a previous private placement; and
- o all private placements effected by the issuer in the previous twelve-month period in which the same parties, or relatives or affiliates thereof, were involved, or the consideration thereof consists of rights to the same assets.

These private placement exemptions do not apply to private placements by a director or chief executive officer of the issuer or to a person or entity that will become, as a result of such private placement, a controlling shareholder of the issuer.

The Israeli Companies Law further provides that a shareholder shall refrain from oppressing other shareholders. In addition, any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder who, pursuant to the provisions of a company's articles of association, has the power to appoint or prevent the appointment of an office holder in the company, or has any other power over the company, is under a duty to act with fairness towards the company and can be

personally liable for a breach of such duty.

INDEMNIFICATION OF DIRECTORS AND OFFICERS AND LIMITATIONS OF LIABILITY

EXCULPATION OF OFFICE HOLDERS. Israeli law allows a company, if permitted by its articles of association, to exculpate an office holder in advance, in whole or in part, from liability for damages sustained by a breach of duty of care to the company, except with respect to a breach of his or her duty of care in the event of distributions.

OFFICE HOLDERS' INSURANCE. Israeli law provides that a company may, if permitted by its articles of association, enter into a contract to insure its office holders for liabilities incurred by the office holder with a respect to an act performed in his or her capacity as an office holder, as a result of: (i) the breach of his or her duty of care to the company or another person; (ii) a breach of his or her duty of loyalty to the company, provided that the office holder acted in good faith and had reasonable cause to assume that the act would not prejudice the company's interests; and (iii) a financial liability imposed upon the office in favor of another person.

INDEMNIFICATION OF OFFICE HOLDERS. Under Israeli law a company may, if permitted by its articles of association, indemnify an office holder for acts performed by the office holder in such capacity for (a) monetary liability imposed upon the office holder in favor of another person pursuant to a court judgment, including a settlement or an arbitration award approved by a court; (b) reasonable litigation expenses, including attorney's fees, actually incurred by the office holder as a result of an investigation or proceeding instituted against him by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against the office holder or the imposition of any financial liability in lieu of criminal proceedings, or concluded without the filing of an indictment against the office holder and a financial liability was imposed on him or her in lieu of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and (c) reasonable litigation expenses, including attorneys' fees, actually incurred by the office holder or imposed upon the office holder by a court: (i) in an action, suit or proceeding brought against the office holder by or on behalf of the company or another person, (ii) in connection with a criminal action in which the office holder was acquitted, or (iii) in connection with a criminal action in which the office holder was convicted of a crime that does not require proof of criminal intent.

Israeli law provides that a company's articles of association may permit the company to (a) indemnify an office holder retroactively, following a determination to this effect made by the company after the occurrence of the event in respect of which the office holder will be indemnified; and (b) undertake in advance to indemnify an office holder, except that with respect to a financial liability imposed on the office holder by any judgment, settlement or court-approved arbitration award, the undertaking must be limited to types of occurrences, which, in the opinion of the company's board of directors, are, at the time of the undertaking, foreseeable due to the company's activities and to an amount or standard that the board of directors has determined is reasonable under the circumstances.

LIMITATIONS ON EXCULPATION, INSURANCE AND INDEMNIFICATION. These provisions are specifically limited in their scope by Israeli law, which provides that a company may not indemnify an office holder, nor exculpate an office holder, nor enter into an insurance contract which would provide coverage for any monetary



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liability, incurred as a result of certain improper actions.

The term "office holder" of a company includes a director, general manager or chief executive officer, a vice president or any officer who reports directly to the general manager or chief executive officer of a company and any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title.

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Pursuant to the Israeli Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our audit committee and our board of directors and, if the office holder is a director, also by our shareholders.

Our shareholders approved our entering into an agreement to indemnify our office holders up to \$5 million, in advance. We currently maintain a directors and officers liability insurance policy with a per claim and aggregate coverage limit of \$5 million.

Our Articles of Association allow us to insure, indemnify and exempt our office holders, subject to the provisions of the Israeli Companies Law. We maintain a directors' and officers' liability insurance policy with a per claim and aggregate coverage limit of \$5 million, including legal costs incurred in Israel. In addition, our Audit Committee, Board of Directors and shareholders resolved to indemnify our office holders, pursuant to a standard indemnification agreement that provides for indemnification of an office holder in an amount up to \$5 million.

### NASDAQ EXEMPTIONS AND HOME COUNTRY PRACTICES

Under NASDAQ Marketplace Rule 4350, or Rule 4350, foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of Rule 4350, without the need to seek individual exemptions from NASDAQ. A foreign private issuer that elects to follow a home country practice instead of any of such provisions of Rule 4350, must submit to NASDAQ, in advance, a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws.

On July 7, 2005 and June 26, 2006, we provided NASDAQ with notices of non-compliance with Rule 4350. We informed NASDAQ that we do not comply with the following requirements of Rule 4350, and instead follow Israeli law and practice in respect of such requirements:

- o the requirement regarding the process of nominating directors. Instead, we follow Israeli law and practice in accordance with which our directors are recommended by our board of directors for election by our shareholders. See above in this Item 6.C. "Directors, Senior Management and Employees - Board Practices - Election of Directors."
- o the requirement regarding the compensation of our chief executive officer and all other executive officers. Instead, we follow Israeli law and practice in accordance with which our board of directors must approve all compensation arrangements for our chief executive officer and all compensation arrangements for officers are subject to the chief executive officer's approval. See above in this Item 6.C. "Directors, Senior Management and Employees - Compensation."

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- o the requirement that our independent directors have regularly scheduled meetings at which only independent directors are present. Under Israeli law independent directors are not required to hold executive sessions.
- o the requirement that we distribute to shareholders, and file with NASDAQ, copies of an annual report containing audited financial statements of our company and its subsidiaries within a reasonable period of time prior to our annual meeting of shareholders. Under Israeli law, as a company that is publicly traded both in Israel and outside of Israel, we are not required to distribute such annual reports to our shareholders. Our annual report on Form 20-F and audited financial statements are available on our website ([www.magal-ssl.com](http://www.magal-ssl.com), and we will send it to shareholders upon written request.

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- o the requirement to maintain a majority of independent directors, as defined under the NASDAQ Marketplace Rules. Instead, we follow Israeli law and practice which requires that we appoint at least two outside directors, within the meaning of the Israeli Companies Law, to our Board of Directors. In addition, we have the mandated three independent directors that meet the independent standards contained in the rules of the Securities and Exchange Commission and NASDAQ on our audit committee. See above in this Item 6C. "Directors, Senior Management and Employees - Board Practices - Independent and Outside Directors."

### D. EMPLOYEES.

As of December 31, 2005, we employed 309 full time employees, of whom 34 were employed in general management and administration, 47 in marketing, 20 in production management, 155 in production, installation and maintenance, and 53 in engineering and research and development. Of our 309 full time employees, 129 were employed in Israel, 56 were employed in the U.S., 89 were employed in Canada and 35 were employed in various other countries.

As of December 31, 2004, we employed 303 full-time employees, of whom 32 were employed in general management and administration, 55 in marketing, 19 in production management, 148 in production, installation and maintenance, and 49 in engineering and research and development. Of our 303 full-time employees, 120 were employed in Israel, 64 were employed in the U.S., 87 were employed in Canada and 32 were employed in various other countries.

As of December 31, 2003, we employed 288 full-time employees, of whom 24 were employed in general management and administration, 51 in marketing, 49 in production management, 114 in production, installation and maintenance, and 50 in engineering and research and development. Of our 288 full-time employees, 120 were employed in Israel, 61 were employed in the U.S., 79 were employed in Canada and 28 were employed in various other countries.

We are subject to various Israeli labor laws, collective bargaining agreements entered into from time to time between the Manufacturers Association and the Histadrut, as well as collective bargaining arrangements. These laws, agreements and arrangements cover a wide range of areas, including minimum employment standards, such as working hours, minimum wages, vacation, severance pay and pension plans, and special issues, such as equal pay for equal work,

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equal opportunity in employment and employment of youth and army veterans. Certain of our employees are parties to individual employment agreements. We generally provide our employees with benefits and working conditions beyond the required minimums. Each of our subsidiaries provides a benefits package and working conditions which are competitive with other firms in their area of operations.

Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without due cause. Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the U.S. Social Security Administration, which amounts also include payments for national health insurance.

### E. SHARE OWNERSHIP.

The following table sets forth certain information regarding the ownership of our ordinary shares by our directors and executive officers as of July 11, 2006.

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Name	Number of Ordinary Shares Owned(1)	Percentage of Outstanding Ordinary Shares(2)
Jacob Even-Ezra(3) (6) (7)	348,969	3.33%
Izhar Dekel(4) (7)	154,427	1.47%
Raffi Netzer	-	-
Chaim Porat	-	-
Yehezkel Farber	-	-
Zvi Dank	-	-
Raya Asher	-	-
Asaf Even-Ezra(6)	121,426	1.16%
Dany Pizen	-	-
Ofer Katz	-	-
Nathan Kirsh(5)	1,832,227	17.63%
Jacob Nuss	-	-
Zeev Livne	-	-
Jacob Perry	-	-
Shaul Kobrinsky	-	-
Anat Winner	-	-
All directors and executive officers as a group (16 persons)	2,608,775	24.77%

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\*Less than 1%

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible debenture notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 10,390,248 ordinary shares issued and

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outstanding as of July 11, 2006.

- (3) Includes 76,915 ordinary shares held by a trustee.
- (4) Include Mr. Dekel's beneficial ownership of 42,000 ordinary shares and 112,427 shares held by Mr. Dekel's wife, Ornit Dekel.
- (5) Includes Mr. Kirsh's beneficial ownership of 1,485,852 ordinary shares held by Mira Mag Inc. Mr. Kirsh is a trustee of the Eurona Foundation.
- (6) Jacob Even-Ezra and Asaf Even-Ezra are father and son.
- (7) Izhar Dekel is Jacob Even-Ezra's son-in-law and Asaf Even Ezra's brother-in-law.

As of July 11, 2006, the 16 directors and executive officers listed above, as a group, held options to purchase 142,800 of our ordinary shares at a weighted average exercise price of \$7.96 per share. Out of such options 94,500 options expire in January 2009 and 48,300 options expire in December 2010.

### STOCK OPTION PLAN

On October 27, 2003, our board of directors approved the 2003 Israeli Share Option Plan ("the 2003 Plan") which was approved by our shareholders in July 2004. The Board has elected to allot the options under Israel's capital gain tax treatment.

Under the 2003 Plan, stock options will be periodically granted to our employees, directors, officers and consultants, in accordance with the decision of our board of directors. Our board of directors has the authority to determine the number of options, if any, which will be granted to each of the recipients, 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. Subject to shareholder approval, the 2003 Plan will be effective for ten years and shall terminate in October 2013.

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Under the 2003 Plan, no option may be exercised before the second anniversary of the date on which it was granted, and each option expires on or before the fifth anniversary of the date on which it was granted. Pursuant to the plan, any options that are cancelled or not exercised within the option period will become available for future grants.

Pursuant to the provisions of the 2003 Plan, if we issue a stock dividend, the number of shares purchasable by any grantee upon the exercise of options that were granted prior to the issuance of the stock dividend will be correspondingly increased.

As of December 31, 2005, options to purchase 343,000 shares were outstanding and additional options to purchase 299,676 shares were available for grant.

Grants of stock options under the 2003 Plan are accounted for by us over the exercise periods thereof as a compensation expense with a corresponding credit to our contributed capital. Ordinary shares subject to options under the 2003 Plan are to be valued for this purpose at their market value at the time the options are granted.

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### ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

#### A. MAJOR SHAREHOLDERS

The following table sets forth certain information regarding the beneficial ownership of our ordinary shares as of July 11, 2006, by each person or entity known to own beneficially more than 5% of our outstanding ordinary shares based on the information provided to us by the holders or disclosed in public filings with the Securities and Exchange Commission. The voting rights of the shareholders listed below are not different from the voting rights of our other shareholders.

Name	Number of Ordinary Shares Beneficially Owned(1)	Percentage of Outstanding Ordinary Shares(2)
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Nathan Kirsh (3)	1,832,227	17.63%
Mira Mag Inc.(4)	1,485,852	14.30%
Clough Capital Partners L.P. (5)	663,069	6.38%
Diker Management LLC (6)	612,077	5.89%

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- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible debenture notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
  - (2) The percentages shown are based on 10,390,248 ordinary shares issued and outstanding as of July 11, 2006.
  - (3) Includes Mr. Kirsh's beneficial ownership of 1,485,852 ordinary shares held by Mira Mag Inc. (see footnote (4) below).
  - (4) Mira Mag Inc. is the holder of 1,485,852 ordinary shares. The beneficial owner of such shares is The Eurona Foundation. The Eurona Foundation is an entity controlled by Nathan Kirsh, the trustees of which are Prinz Michael von Liechtenstein, Altenbach 8, P.O. Box 339, FL-9490 Vaduz, Liechtenstein, and Nathan Kirsh, Spintex Village, Ezulwini, Swaziland.
  - (5) Based on information provided by Clough Capital Partners L.P. in a filing with the Securities and Exchange Commission, dated December 31, 2005.
  - (6) Based on information provided by Diker Management LLC in a filing with the Securities and Exchange Commission, dated November 18, 2005.

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In March and April 2004, Mira Mag Inc. sold an aggregate of 2,429,836, or 29.6%, of our ordinary shares in a series of open market transactions. In March and April 2004, Mr. Even-Ezra sold an aggregate of 210,666, or 2.6%, of our ordinary shares in a series of open market transactions.

On April 19, 2005, Mr. Kirsh, a trustee of the Eurona Foundation, Mira Mag Inc.'s controlling shareholder, and Mr. Jacob Even-Ezra participated in the offering of our ordinary shares and purchased 346,375 and 78,625 ordinary shares, respectively, at a purchase price of \$9.92 per ordinary share, the closing price of our ordinary shares at the date of the offering.

### MAJOR SHAREHOLDERS VOTING RIGHTS

Our major shareholders do not have different voting rights.

### RECORD HOLDERS

Based on a review of the information provided to us by our transfer agent, as of July 11, 2006, there were 61 holders of record of our ordinary shares, of which 49 record holders holding approximately 0.2% of our ordinary shares had registered addresses in the United States and 10 record holders holding approximately 16.4% of our ordinary shares had registered addresses in Israel. These numbers are not representative of the number of beneficial holders of our shares nor is it representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees, including CEDE & Co., the nominee for the Depository Company (the central depository for the U.S. brokerage community), which held approximately 76.0% of our outstanding ordinary shares as of said date.

### B. RELATED PARTY TRANSACTIONS.

In 2003 Mira Mag Inc., our then controlling shareholder, and Jacob Even-Ezra purchased IAI'S interest in our company.

On April 19, 2005 Mr. Kirsh, a trustee of the Eurona Foundation, Mira Mag Inc.'s controlling shareholder, and Mr. Even-Ezra participated in the offering of our ordinary shares and purchased 346,375 and 78,625 ordinary shares, respectively, at a purchase price of \$9.92 per ordinary share, the closing price of our ordinary shares at the date of the offering.

### REGISTRATION RIGHTS AGREEMENT

In furtherance of the approval obtained at the extraordinary general meeting of our shareholders held on November 20, 1995, we entered into a registration rights agreement, dated as of November 18, 1996, with Mira Mag, IAI and Jacob Even-Ezra. Pursuant to the registration rights agreement, upon the request of any of these principal shareholders, we are required to prepare and file, at our expense, with the Securities and Exchange Commission, a shelf registration statement for the ordinary shares held by them. In addition, we will indemnify them and any underwriter of such ordinary shares against certain civil liabilities under the Securities Act in connection with an offering of such ordinary shares. Pursuant to the registration rights agreement, in July 1998 we filed a registration statement on Form F-3, File No. 333-9050, for the ordinary shares held by Mira Mag.

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Our U.S. subsidiary, Smart, provides video monitoring services to companies controlled by Mr. Kirsh. The terms of the contracts under which we make sales to these companies were negotiated on an arms'-length basis and the terms of such contracts are no more favorable to these companies than those it could have obtained from an unaffiliated third party. Our sales to these companies during the years ended December 31, 2003, 2004 and 2005 were \$108,000, \$386,000 and \$671,000 respectively.

### EMPLOYMENT CONTRACTS

Jacob Even-Ezra and Izhar Dekel entered into substantially similar employment agreements with us, effective January 1993. These agreements contain certain non-competition and confidentiality provisions. In addition, each agreement establishes a base salary and a package of benefits with an aggregate value of approximately 20% of the base salary, as well as a possible bonus. In December 2005, our board of directors, subject to the approval of our shareholders, extended the appointment of Mr. Even-Ezra as chairman of the board until January 2008 and as chief financial officer for such period until a new CEO is appointed. Under the Israeli Companies Law, such dual positions require shareholders' approval which must be renewed every three years. Our shareholders approved this dual position in July 2004. In December 2000, our board of directors extended the term of Mr. Dekel's employment until such time as it is terminated by us or by Mr. Dekel pursuant to the terms of the agreement. Under the Israeli Companies Law, the terms of employment of Mr. Dekel, who is also a member of our board of directors requires shareholders' approval. Our shareholders approved Mr. Dekel's terms in July 2004. See also Item 6.B. "Directors, Senior Management and Employees-Compensation" above.

### C. INTERESTS OF EXPERTS AND COUNSEL.

Not applicable.

## ITEM 8. FINANCIAL INFORMATION

### A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION.

The Financial Statements required by this item are found at the end of this annual report, beginning on page F-1.

In 2005, the total amount of our revenues from our facilities located outside of Israel to customers outside of Israel was approximately \$34 million, or 55.7% of our total revenues. The total amount of our export revenues from our Israeli facilities to countries outside of Israel was approximately \$7.8 million, or 12.8% of our total revenues.

### LEGAL PROCEEDINGS

In April 2003, Rav-Tec Ltd. filed a civil action against us, the MOD and Mr. Giora Cohen in the District Court of Tel-Aviv. The plaintiff alleges that its failure in the field trials of the perimeter systems executed by the MOD during 1996-1997 resulted from intentional damage to its perimeter system and diversion of the results of certain intrusion tests made by Cohen who was then a soldier in the IDF. The plaintiff alleges that we were the employer of Cohen during 1995 and we still employed him as our agent during the field trials. The plaintiff requests the courts to annul the field trial and award it approximately \$714,000 in damages. We have denied all of the above allegations and claimed that the plaintiff's perimeter system failure was not the result of Cohen's actions. According to our legal counsel, we have good defenses against the aforementioned claims. The action has been forwarded to mediation.

In May 2005 we entered into an agreement to supply comprehensive security solutions for a sensitive site in Eastern Europe. As part of the agreement, we received an advance payment, secured by a bank advanced payment guarantee that was to be reduced proportionally as execution of the project progressed. In addition we issued the customer a performance bank guarantee. We commenced the project and delivered some of the equipment and other deliverables to the customer in 2005. In April 2006, the customer informed us that it was canceling the agreement due to errors in the design documents submitted by us. In addition, the customer did not make payments required under the agreement. Based on its cancellation of the agreement, the customer collected \$3.2 million under bank advance payment guarantee, on June 20, 2006.

We believe that there is no factual or legal ground for the cancellation of the agreement or the demand for payment under the bank performance guarantee. Accordingly, we believe that the agreement is still valid. On April 28, 2006, we commenced arbitration proceedings against the customer. In these proceedings we asked the arbitrators to find that the agreement is valid and to enforce the payments due to us pursuant to the agreement. The customer has not yet filed its response. Based on the opinion of our legal counsel, we believe that there is a good likelihood that the arbitration will result in a favorable determination. We intend to vigorously pursue our claim.

On July 11, 2006, the customer made a demand for additional payment under a bank performance guarantee for \$1.4 million. Upon our motion, the District Court in Haifa, Israel 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 addition, we are subject to legal proceedings arising in the normal course of business. Based on the advice of our legal counsel, management believes that these proceedings will not have a material adverse effect on our financial position or results of operations.

#### DIVIDEND POLICY

In each of 1999 and 2000, we paid a cash dividend to our shareholders of \$0.10 per ordinary share, representing approximately 32.0% of our net income before writing off the investment in our affiliate in each of 1998 and 1999. In 2001, we paid a cash dividend to our shareholders of \$0.13 per ordinary share, representing approximately 33.0% of our net income in 2000. In each of August 2002 and 2003, we paid a 3.0% stock dividend as a final dividend for the years ended December 31, 2001 and 2002, respectively.

On January 27, 2004 we paid a cash dividend to our shareholders of \$0.05 per ordinary share, representing approximately 17.0% of our net income in 2003. In August 2004, we paid a 5.0% stock dividend to our shareholders as a final dividend for 2003.

#### B. SIGNIFICANT CHANGES.

Except as otherwise disclosed in this annual report, there has been no material change in our financial position since December 31, 2005.

#### ITEM 9. THE OFFER AND LISTING

##### A. OFFER AND LISTING DETAILS.



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### ANNUAL STOCK INFORMATION

Our shares have traded on the NASDAQ National Market since our initial public offering in 1993 and on the Tel Aviv Stock Exchange since July 2001.

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The following table sets forth, for each of the years indicated, the range of high ask and low bid prices of our ordinary shares on the NASDAQ National Market and the Tel Aviv Stock Exchange:

	NASDAQ NATIONAL MARKET			TEL AVIV STOCK EXCH	
	HIGH	LOW		HIGH	
2001	15.20	2.87	NIS	64.00	NIS
2002	13.49	4.57		59.60	
2003	9.97	4.74		42.68	
2004	40.35	6.75		156.68	
2005	12.22	7.87		53.45	

### QUARTERLY STOCK INFORMATION

The following table sets forth, for each of the full financial quarters in the two most recent full financial years and any subsequent period, the range of high ask and low bid prices of our ordinary shares on the NASDAQ National Market and the Tel Aviv Stock Exchange:

	NASDAQ NATIONAL MARKET			TEL AVIV STOCK EXCH	
	HIGH	LOW		HIGH	
2004					
First Quarter	\$23.22	\$6.75	NIS	88.10	NI
Second Quarter	40.35	12.35		156.68	
Third Quarter	19.45	12.60		84.77	
Fourth Quarter	17.05	10.60		74.70	
2005					
First Quarter	\$12.22	\$9.50	NIS	53.45	NI
Second Quarter	11.37	7.89		49.35	
Third Quarter	11.21	7.87		50.13	
Fourth Quarter	10.96	8.40		49.56	
2006					
First Quarter	\$14.2	\$8.75	NIS	64.25	NI
Second Quarter	\$13.36	\$9.01		61.15	

### MONTHLY STOCK INFORMATION

The following table sets forth, for each of the most recent six months, the range of high ask and low bid prices of our ordinary shares on the NASDAQ National Market and the Tel Aviv Stock Exchange:

	NASDAQ NATIONAL MARKET			TEL AVIV STOCK EXCH	
	HIGH	LOW		HIGH	

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2006				
January	\$11.80	\$ 8.75	NIS 53.18	NIS
February	12.68	10.40	56.06	
March	14.20	12.05	64.25	
April	13.36	10.70	61.15	
May	11.49	9.31	49.91	
June	10.70	9.01	47.34	

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B. PLAN OF DISTRIBUTION.

Not applicable.

C. MARKETS.

Our ordinary shares have traded on the NASDAQ National Market under the symbol MAGS since our initial public offering in 1993. As of July 1, 2001, our ordinary shares are also traded on the Tel Aviv Stock Exchange under the symbol MAGS.

D. SELLING SHAREHOLDERS.

Not applicable.

E. DILUTION.

Not applicable.

F. EXPENSES OF THE ISSUE.

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL.

Not applicable.

B. MEMORANDUM AND ARTICLES OF ASSOCIATION.

We are registered with the Israeli Companies Registry and have been assigned company number 52-003892-8. Section 2 of our memorandum of association provides, among other things, that we were established for the purposes of acquiring from IAI a plant, known as the Magal Plant, engaged in the development, manufacture, sale and support of alarm devices and dealing in the development, manufacturing and support of security alarm devices and other similar products. In addition, the purpose of our company is to be eligible to perform and act in connection with any right or obligation of whatever kind or nature permissible under Israeli law.

BOARD OF DIRECTORS

The strategic management of our business (as distinguished from the daily management of the our business affairs) is vested in our board of directors, which may exercise all such powers and do all such acts as our company is authorized to exercise and do, and which are not required to be exercised by a

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resolution of the general meeting of our shareholders. The board of directors may, subject to the provisions of the Israeli Companies Law, delegate some of its powers to committees, each consisting of one or more directors, provided that at least one member of such committee is an outside director.

According to the Israeli Companies Law, we may stipulate in our articles of association that the general meeting of shareholders is authorized to assume the responsibilities of the board of directors. In the event the board of directors is unable to act or exercise its powers, the general meeting of shareholders is authorized to exercise the powers of the board of directors, although the articles of association do not stipulate so. Our board of directors has the power to assume the responsibilities of our chief executive officer if he is unable to act or exercise his powers or if he fails to fulfill the instructions of the board of directors with respect to a specific matter.

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Our articles of association do not impose any mandatory retirement or age-limit requirements on our directors and our directors are not required to own shares in our company in order to qualify to serve as directors.

For a discussion of the Israeli Companies Law regulations concerning a director's duty of care and duty of loyalty, see Item 6.C. "Directors, Senior Management and Employees-Board Practices-Approval of Specific Related-Party Transactions." For a discussion of the Israeli Companies Law regulations regarding indemnification of directors, see Item 6.C. "Directors, Senior Management and Employees-Board Practices-Indemnification of Directors and Officers and Limitations of Liability."

Directors' compensation arrangements (other than outside directors) require the approval of our audit committee before board and shareholder approval. However, pursuant to amendments to the Companies Regulations (Relief from Related Party Transactions), 5760-2000, directors' compensation and employment arrangements do not require shareholder approval if such arrangements are approved by both the audit committee and the board of directors, and meet certain criteria. In addition, if the director is a controlling shareholder of the company, then the employment and compensation arrangements of such director do not require shareholder approval; provided such arrangements meet certain specified criteria.

The relief from having to obtain shareholder approval set forth above will not apply, and shareholder approval will be required, if one or more shareholders, holding at least 1% of the issued and outstanding share capital of the company or of the company's voting rights, object to the grant of such relief, provided that such objection is submitted to the company in writing not later than seven days from the date of the filing of a report regarding the adoption of such resolution by the company pursuant to the requirements of the Israeli Securities Law (which reporting requirements are not applicable to us as a double foreign company).

The board of directors may from time to time, at its discretion, cause the company to borrow or secure the payment of any money for the purposes of the company, and may secure or provide for the repayment of such money in the manner as it deems fit.

### SHARE CAPITAL

Our share capital consists of NIS 19,748,000 divided into 19,748,000

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ordinary shares, par value NIS 1.00 each, all ranking PARI PASSU. All our ordinary shares have the same rights, preferences and restrictions, some of which are detailed below. At the general meeting of shareholders, our shareholders may, subject to certain provisions detailed below, create different classes of shares, each class bearing different rights, preferences and restrictions.

### DIVIDENDS

Holders of ordinary shares are entitled to participate in the payment of dividends in accordance with the amounts paid-up or credited as paid up on the nominal value of such ordinary shares at the time of payment (without taking into account any premium paid thereon). However, under article 13 of our articles of association no shareholder shall be entitled to receive any dividends until he shall have paid all calls then currently due and payable on each ordinary share held by such shareholder.

Declaration of a final dividend requires the approval by ordinary resolution of our shareholders at a general meeting of shareholders. Such resolution may reduce but not increase the dividend amount recommended by the board of directors. Dividends may be paid, in whole or in part, by way of distribution of dividends in kind.

Dividends may be paid only out of our distributable earnings, as defined in the Israeli Companies Law. Prior to any distribution of dividends, our board of directors has to determine that there is no reasonable concern that such distribution will prevent us from executing our existing and foreseeable obligations as they become due.

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### VOTING RIGHTS

Holders of ordinary shares are entitled to one vote for each share of record on all matters submitted to a vote of shareholders. Voting is done by a show of hands, unless a poll is demanded prior to a vote by a show of hands. Generally, resolutions are adopted at the general meeting of shareholders by an ordinary resolution, unless the Israeli Companies Law or the articles of association require an extraordinary resolution.

An ordinary resolution, such as a resolution approving the declaration of dividends or the appointment of auditors, requires approval by the holders of a simple majority of the shares represented at the meeting, in person or by proxy, and voting thereon. An extraordinary resolution requires approval by the holders of at least 75% of the shares represented at the meeting, in person or by proxy, and voting thereon.

The primary resolutions required to be adopted by an extraordinary resolution of the general meeting of shareholders are resolutions to:

- o amend the memorandum or the articles of association;
- o change the share capital, for example, increasing or canceling the authorized share capital or modifying the rights attached to shares; and
- o approve mergers, consolidations or winding up of our company.

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Our articles of association do not contain any provisions regarding a classified board of directors or cumulative voting for the election of directors.

### RIGHTS IN THE COMPANY'S PROFITS

Our shareholders have the right to share in our profits distributed as a dividend or any other permitted distributions.

### LIQUIDATION

Article 111 of our articles of association provides that upon any liquidation, dissolution or winding-up of our company, our remaining assets shall be distributed pro-rata to our ordinary shareholders.

### REDEMPTION

Under article 38 of our articles of association, we may issue redeemable stock and redeem the same.

### TRANSFER OF SHARES

The transfer of a fully paid-up ordinary share does not require the approval of our board of directors. However, according to article 17 of our articles of association, any transfer of an ordinary share requires an instrument of transfer in the form designated by the board of directors together with any other evidence of title as the board of directors may reasonably request.

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### SUBSTANTIAL LIMITATIONS ON SHAREHOLDERS

See Item 6.C. "Directors, Senior Management and Employees-Board Practices-Approval of Specific Related-Party Transactions."

### CAPITAL CALLS

Under our memorandum of association and the Israeli Companies Law, the liability of our shareholders is limited to the par value of the shares held by them.

### MODIFICATIONS OF SHARE RIGHTS

Shares which confer preferential or subordinate rights relating to, among other things, dividends, voting, and payment of capital may be created only by an extraordinary resolution of the general meeting of shareholders. The rights attached to a class of shares may be altered by an extraordinary resolution of the general meeting of shareholders, provided the holders of 75% of the issued shares of that class approve such change by the adoption of an extraordinary resolution at a separate meeting of such class, subject to the terms of such class. The provisions of the articles of association pertaining to general meetings of shareholders also apply to a separate meeting of a class of shareholders.

### GENERAL MEETINGS OF SHAREHOLDERS

An annual general meeting of shareholders is held at least once every

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calendar year, not later than 15 months after the last annual general meeting of shareholders, at such time and at such place as may be fixed by the board of directors. Any additional general meetings of shareholders are called "extraordinary general meetings." The board of directors may, in its discretion, convene an extraordinary general meeting and is obliged to do so upon receipt of a written request from the holders of at least 5% of our outstanding ordinary shares and/or of our voting rights.

The Israeli Companies Law provides that a company whose shares are traded on a stock exchange must give notice of a general meeting of shareholders to its shareholders of record at least twenty-one days prior to the meeting. A shareholder present, in person or by proxy, at the commencement of a general meeting of shareholders may not seek the cancellation of any proceedings or resolutions adopted at such general meeting of shareholders on account of any defect in the notice of such meeting relating to the time or the place thereof. Shareholders who are registered in our register of shareholders at the record date may vote at the general meeting of shareholders. The record date is set in the resolution to convene the general meeting of shareholders, provided, however, that such record date must be between four to twenty-one days or, in the event of a vote by ballots, between four to forty days prior the date the general meeting of shareholders is held.

The quorum required for a general meeting of shareholders consists of at least two record shareholders, present in person or by proxy, who hold, in the aggregate, at least one third of the voting power of our outstanding shares. A general meeting of shareholders will be adjourned for lack of a quorum after half an hour from the time appointed for such meeting to the same day in the following week at the same time and place or any other time and place as the board of directors designates in a notice to the shareholders. At such reconvened meeting, if a quorum is not present within half an hour from the time appointed for such meeting, two or more shareholders, present in person or by proxy, will constitute a quorum. The only business that may be considered at an adjourned general meeting of shareholders is the business that might have been lawfully considered at the general meeting of shareholders originally convened and the only resolutions that may be adopted are the resolutions that could have been adopted at the general meeting of shareholders originally convened.

### LIMITATIONS ON THE RIGHT TO OWN OUR SECURITIES

Neither our memorandum or articles of association nor the laws of the State of Israel restrict in any way the ownership or voting of our ordinary shares by non-residents, except that the laws of the State of Israel may restrict the ownership of ordinary shares by residents of countries that are in a state of war with Israel.

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### PROVISIONS RESTRICTING A CHANGE IN CONTROL OF OUR COMPANY

The Israeli Companies Law requires that mergers between Israeli companies be approved by the board of directors and general meeting of shareholders of both parties to the transaction. The approval of the board of directors of both companies is subject to such board of directors' confirmation that there is no reasonable doubt that after the merger the surviving company will be able to fulfill its obligations to its creditors. Each company must notify its creditors about the contemplated merger. Under the Israeli Companies Law, our articles of association are deemed to include a requirement that such merger be approved by an extraordinary resolution of our shareholders, as explained above. The

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approval of the merger by the general meetings of shareholders of each of the companies is also subject to additional approval requirements as specified in the Israeli Companies Law and regulations promulgated thereunder.

The Companies Law also provides that an acquisition of shares in a public company on the open market must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company. However, this rule does not apply if there already is another 25% or greater shareholder of the company. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold greater than a 45% interest in the company, unless there is another shareholder holding more than a 45% interest in the company. These requirements do not apply if, in general, the acquisition (1) was made in a private placement that received shareholder approval, (2) was from a 25% or greater shareholder of the company which resulted in the acquiror becoming a 25% or greater shareholder of the company, or (3) was from a shareholder holding more than a 45% interest in the company which resulted in the acquiror becoming a holder of more than a 45% interest in the company.

However, under the Companies Law, if as a result of any acquisition of shares the acquirer would hold more than 90% of the company's outstanding shares, the acquisition must be made by means of a tender offer for all of the outstanding shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to the acquirer. The Israeli Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquiror may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares. These rules do not apply if the acquisition is made by way of a private placement, provided such private placement is approved by the shareholders of the company. In addition, these rules do not apply to a company whose shares are publicly traded outside of Israel if applicable foreign securities laws restrict the acquisition of any level of control of the company or require the purchaser to make a tender offer to the public shareholders upon the acquisition of any level of control of the company.

### DISCLOSURE OF SHAREHOLDERS' OWNERSHIP

The Israeli Securities Law, 5728-1968 and regulations promulgated thereunder contain various provisions regarding the ownership threshold above which shareholders must disclose their share ownership. However, these provisions do not apply to companies, such as ours, whose shares are publicly traded in Israel as well as outside of Israel. As a result of the listing of our ordinary shares on the Tel Aviv Stock Exchange, we are required pursuant to the Israeli Securities Law and the regulations promulgated thereunder to deliver to the Israeli Share Registrar, the Israeli Securities Exchange Commission and the Tel Aviv Stock Exchange, all reports, documents, forms and information received by us from our shareholders regarding their shareholdings, provided that such information was published or required to be published under applicable foreign law.

### C. MATERIAL CONTRACTS.

We are not a party to any material contracts other than those entered into

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in the ordinary course of business.

### D. EXCHANGE CONTROLS.

Israeli law and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares. In May 1998, a new "general permit" was issued under the Israeli Currency Control Law, 1978, which removed most of the restrictions that previously existed under such law, and enabled Israeli citizens to freely invest outside of Israel and freely convert Israeli currency into non-Israeli currencies.

Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

### E. TAXATION.

The following is a discussion of Israeli and United States tax consequences material to us and to our shareholders. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

HOLDERS OF OUR ORDINARY SHARES SHOULD CONSULT THEIR OWN TAX ADVISORS AS TO THE UNITED STATES, ISRAELI OR OTHER TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF ORDINARY SHARES, INCLUDING, IN PARTICULAR, THE EFFECT OF ANY FOREIGN, STATE OR LOCAL TAXES.

### ISRAELI TAX CONSIDERATIONS

The following is a summary of the current tax structure applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of the material Israeli tax consequences to purchasers of our ordinary shares and Israeli government programs benefiting us. This summary does not discuss all the aspects of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law.

### GENERAL CORPORATE TAX STRUCTURE

Israeli companies are subject to income tax on their worldwide income. Pursuant to tax reform legislation that came into effect in 2003, the corporate tax rate is to undergo staged reductions to 25% by the year 2010. In order to implement these reductions, the corporate tax rate is scheduled to decline to 31% in 2006, 29% in 2007, 27% in 2008, and 26% in 2009.

However, the effective tax rate payable by a company that derives income from an approved enterprise, discussed further below, may be considerably less. See "-Tax Benefits under the Law for the Encouragement of Capital Investments, 1959."



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### LAW FOR THE ENCOURAGEMENT OF CAPITAL INVESTMENTS, 1959

#### GENERAL

The Law for the Encouragement of Capital Investments, 1959, commonly referred to as the Investment Law, provides that a proposed capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry, Trade and Labor of the State of Israel, commonly referred to as the Investment Center, be designated as an approved enterprise. Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, for example, the equipment to be purchased and utilized under the program. The tax benefits derived from any certificate of approval relate only to taxable income attributable to the specific approved enterprise. If a company has more than one approval or only a portion of its capital investments is approved, its effective tax rate is the result of a weighted average of the applicable rates.

Certain of our production facilities have been granted approved enterprise status pursuant to the Investment Law, which provides certain tax and financial benefits to investment programs that have been granted this status.

#### TAX BENEFITS

Taxable income of a company derived from an approved enterprise is generally subject to company tax at the maximum rate of 25%, rather than 31%, for the benefit period. This period is ordinarily seven years, or ten years if the company qualifies as a foreign investors' company as described below, commencing with the year in which the approved enterprise first generates taxable income. However, this period is limited to the earlier of twelve years from commencement of production or fourteen years from the date of approval.

A company that owns an approved enterprise may elect to receive an alternative package of benefits. Under the alternative package of benefits, a company's undistributed income derived from an approved enterprise will be exempt from company tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the approved enterprise within Israel, and the company will be eligible for a reduced tax rate for the remainder of the benefits period.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors' company. A foreign investors' company is a company more than 25% of whose share capital and combined share and loan capital is owned by non-Israeli residents. A company that qualifies as a foreign investors' company and has an approved enterprise program is eligible for tax benefits for a ten year benefit period. Income derived from the approved enterprise program will be exempt from tax for a period of two years and will be subject to a reduced tax rate for an additional eight years, provided that the company qualifies as a foreign investors' company. The tax rate for the additional eight-year period is 25%. However, if the level of foreign investment exceeds 49% but is less than 74%, then the tax rate for the additional eight-year period is 20%. If the level of foreign investment exceeds 74% but is less than 90%, then the tax rate for the additional eight-year period is 15%. If the level of foreign investment exceeds 90%, then the tax rate for the additional eight-year period is 10%. If the company does not qualify as a foreign investors' company, the period of the reduced tax rate will be five years.

A company that has elected the alternative package of benefits and that subsequently pays a dividend out of income derived from the approved enterprise

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during the tax exemption period will be subject to tax on the amount distributed at the rates mentioned above. The tax rate will be the rate that would have been applicable had the company not elected the alternative package of benefits. This rate is generally 10%-25%, depending on the percentage of the company's shares held by foreign shareholders. The dividend recipient is taxed at the reduced rate applicable to dividends from approved enterprises, which is 15% if the dividend is distributed during the tax benefit period and within 12 years after the period. The company must withhold this tax at the source.

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Subject to applicable provisions concerning income under the alternative package of benefits, all incomes are considered to be attributable to the entire enterprise and their effective tax rate is the result of a weighted average of the various applicable tax rates. Under the Investment Law, a company that has elected the alternative package of benefits is not obliged to distribute exempt retained profits, and may generally decide from which year's profits to declare dividends.

The benefits available to an approved enterprise program are dependent upon the fulfillment of conditions stipulated in applicable law and in the certificate of approval. If we fail to comply with these conditions with regard to our approved enterprises, the tax and other benefits we receive could be rescinded, in whole or in part, and we may be required to refund the amount of previously received benefits in addition to Israeli CPI linkage adjustments and interest costs. We believe that our approved enterprises currently substantially comply with all such conditions.

On April 1, 2005, an amendment to the Investments Law came into force. Pursuant to the amendment, a company's facility will be granted the status of "Approved Enterprise" only if it is proven to be an industrial facility (as defined in the Investments Law) that contributes to the economic independence of the Israeli economy and is a competitive facility that contributes to the Israeli gross domestic product. The amendment provides that the Israeli Tax Authority and not the Investment Center will be responsible for an Approved Enterprise under the alternative package of benefits, referred to as a Benefiting Facility. A company wishing to receive the tax benefits afforded to a Benefiting Facility is required to select the tax year from which the period of benefits under the Investment Law are to commence by simply notifying the Israeli Tax Authority within 12 months of the end of that year. In order to be recognized as owning a Benefiting Facility, a company is required to meet a number of conditions set forth in the amendment, including making a minimal investment in manufacturing assets for the Benefiting Facility and having completed a cooling-off period of no less than two to four years from the company's previous year of commencement of benefits under the Investments Law.

Pursuant to the amendment, a company with a Benefiting Facility is entitled, in each tax year, to accelerated depreciation for the manufacturing assets used by the Benefiting Facility and to certain tax benefits, provided that no more than 12 to 14 years have passed since the beginning of the year of commencement of benefits under the Investments Law. The tax benefits granted to a Benefiting Factory are determined according one of the following new tax routes:

(a) Similar to the currently available alternative route, exemption from corporate tax on undistributed income for a period of two to ten years, depending on the geographic location of the Benefiting Facility within Israel, and a reduced corporate tax rate of 10% to 25% for the remainder of the benefits

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period, depending on the level of foreign investment in each year. Benefits may be granted for a term of from seven to ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Benefiting Facility during the tax exemption period, such income will be subject to corporate tax at the applicable rate (10%-25%). The company is required to withhold tax at the source at a rate of 15% from any dividends distributed from income derived from the Benefiting Facility.

(b) A special tax route enabling companies owning facilities in certain geographical locations in Israel to pay corporate tax at the rate of 11.5% on income of the Benefiting Facility. The benefits period is ten years. Upon payment of dividends, the company is required to withhold tax at source at a rate of 15% for Israeli residents and at a rate of 4% for foreign residents.

(c) A special tax route that provides a full exemption from corporate tax and from tax with respect to dividends for companies with an annual income of at least NIS 13-20 billion that have invested a total of between NIS 600-900 million in facilities in certain geographical locations in Israel.

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Generally, a company that is Abundant in Foreign Investment (as defined in the Investments Law) is entitled to an extension of the benefits period by an additional five years, depending on the rate of its income that is derived in foreign currency.

The amendment changes the definition of "foreign investment" in the Investments Law so that instead of an investment of foreign currency in the company, the definition now requires a minimal investment of NIS 5 million by foreign investors. Furthermore, such definition now also includes the purchase of shares of a company from another shareholder; provided that the company's outstanding and paid-up share capital exceeds NIS 5 million. Such changes to the aforementioned definition will take effect retroactively from 2003.

The amendment will apply to approved enterprise programs in which the year of commencement of benefits under the Investments Law is 2004 or later, unless such programs received approval from the Investment Center on or prior to December 31, 2004 in which case the provisions of the amendment will not apply.

### FINANCIAL BENEFITS

An approved enterprise is also entitled to a grant from the Government of Israel for investments in certain production facilities located in designated areas within Israel, provided it did not elect the alternative benefits program. Grants are available for enterprises situated in development areas and for high-technology or skill-intensive enterprises in Jerusalem. The investment grant is computed as a percentage of the original cost of the fixed assets for which the approved enterprise has been granted.

From time to time, the Government of Israel has discussed reducing the benefits available to companies under the Investment Law. In 1996, the investment grant was decreased from 38% to 34% and in January 1997 the grant was reduced to 20%. Currently, grants generally range between 10% and 20%. If the benefits available under the Investment Law are terminated or substantially reduced, it could have a material adverse effect on our future investments in Israel.

For companies such as ours, whose foreign shareholders hold more than 25%

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of the company's outstanding ordinary shares, future approved enterprises would entitle such companies to receive reduced tax rates for up to ten tax years, rather than the maximum seven tax years applicable to companies with a smaller foreign investment.

As long as we are in compliance with the conditions set forth in the certificates of approval granted to us, our income derived from our approved enterprise expansion programs will be tax exempt for the prescribed period and thereafter will enjoy reduced tax rates as detailed above. If we violate these conditions, we may be required to refund the amount of tax benefits we previously received in addition to Israeli CPI linkage adjustments and interest costs.

We currently have two approved enterprise expansion programs which were approved in 1997 and 2001, and under which we are entitled to tax benefits. The periods of benefits for two of our approved enterprise programs will expire in 2007 and in 2012, respectively. The benefits we receive in connection with our approved enterprise programs are conditioned upon the fulfillment of a marketing plan filed by us with the Investment Center.

### LAW FOR THE ENCOURAGEMENT OF INDUSTRY (TAXES), 1969

Under the Law for the Encouragement of Industry (Taxes), 1969, or the Industry Encouragement Law, "Industrial Companies" are entitled to certain corporate tax benefits, including, among others:

- o Deduction, under certain conditions, of purchases of know-how and patents over an eight-year period for tax purposes;

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- o right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies; and
- o accelerated depreciation rates on equipment and buildings; and
- o Deductions over a three-year period of expenses in connection with the issuance and listing of shares on the Tel Aviv Stock Exchange, or TASE or, on or after January 1, 2003, on a recognized stock market outside of Israel.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. Under the Industry Encouragement Law, an "Industrial Company" is a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, capital gains, interest and dividends, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is an enterprise owned by an Industrial Company, whose major activity in a given tax year is industrial production activity.

We believe that we currently qualify as an industrial company as defined by the Industry Encouragement Law. We cannot assure you that we will continue to qualify as an industrial company or that the benefits described above will be available to us in the future.

### LAW FOR THE ENCOURAGEMENT OF INDUSTRIAL RESEARCH AND DEVELOPMENT, 1984

Under the Law for the Encouragement of Industrial Research and Development,

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1984, or the Research Law, research and development programs that meet specified criteria and are approved by a governmental committee of the OCS are eligible for grants of up to 50% of certain of the project's expenditures, as determined by the research committee.

In exchange, the recipient of such grants is required to pay the OCS royalties from the revenues derived from products incorporating technology developed within the framework of the approved research and development program or derived from such program (including ancillary services in connection with such program), usually up to 100% of the U.S. dollar-linked value of the total grants received in respect of such program, plus LIBOR interest.

The terms of the Israeli government participation also require that products developed with government grants be manufactured in Israel. However, under the regulations of the Research Law, upon the approval of the OCS, some of the manufacturing volume may be performed outside Israel, provided that the grant recipient pays royalties at an increased rate. The Research Law also allows for the approval of grants in cases in which the applicant declares that part or all of the manufacturing will be performed outside of Israel or by non-Israeli residents and the research committee is convinced that this is essential for the execution of the program. The Research Law also provides that know-how developed under an approved research and development program may not be transferred to third parties in Israel without the prior approval of the research committee. The Research Law further provides that the know-how developed under an approved research and development program may not be transferred to any third parties outside Israel. No approval is required for the sale or export of any products resulting from such research and development.

However, In June 2005, an amendment to the Research Law became effective, which amendment was intended to make the Research Law more compatible with the global business environment by, among other things, relaxing restrictions on the transfer of manufacturing rights outside Israel and on the transfer of OCS-funded know-how outside of Israel. The amendment permits the OCS, among other things, to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of demanding the recipient to pay increased royalties as described above. The amendment further permits, under certain circumstances and subject to the OCS's prior approval, the transfer outside Israel of know-how that has been funded by OCS, generally in the following cases: (a) the grant recipient pays to the OCS a portion of the consideration paid for such funded know-how (according to certain formulas), (b) the grant recipient receives know-how from a third party in exchange for its funded know-how, or (c) such transfer of funded know-how arises in connection with certain types of cooperation in research and development activities.

The Research Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and interested parties to notify the OCS of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a non-Israeli becoming an interested party directly in the recipient and requires the new interested party to undertake to the OCS to comply with the Research Law. In addition, the rules of the OCS may require prior approval of the OCS or additional information or representations in respect of certain of such events. For this purpose, "control" is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the

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company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. "Means of control" refers to voting rights or the right to appoint directors or the chief executive officer. An "interested party" of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any non-Israeli who acquires 5% or more of our ordinary shares will be required to notify the OCS that it has become an interested party and to sign an undertaking to comply with the Research Law.

The funds generally available for grants by the OCS were reduced for 2003, and the Israeli authorities have indicated that the government may further reduce or abolish grants from the OCS in the future. Even if these grants are maintained, we cannot assure you that we will receive OCS grants in the future. In addition, each application to the OCS is reviewed separately, and grants are based on the program approved by the research committee. Generally, expenditures supported under other incentive programs of the State of Israel are not eligible for grants from the OCS.

### TAXATION UNDER INFLATIONARY CONDITIONS

The Income Tax Law (Inflationary Adjustments), 1985, generally referred to as the Inflationary Adjustments Law, represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing rapid inflation. The Inflationary Adjustments Law is highly complex. Its features which are material to us can be described as follows:

- o There is a special tax adjustment for the preservation of equity whereby some corporate assets are classified broadly into fixed assets and non-fixed assets.
- o Where a company's equity, as defined in such law, exceeds the depreciated cost of fixed assets, a deduction from taxable income that takes into account the effect of the applicable annual rate of inflation on such excess is allowed up to a ceiling of 70% of taxable income in any single tax year, with the unused portion permitted to be carried forward on a linked basis. If the depreciated cost of fixed assets exceeds a company's equity, then such excess multiplied by the applicable annual rate of inflation is added to taxable income.
- o Subject to specified limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the increase in the Israeli CPI.

### STAMP TAX

Under the Stamp Tax on Documents Law, certain documents are subject to stamp tax. Promulgated regulations provide for a gradual phase-out of the stamp tax by 2008. A new regulation abolished the Stamp Tax for documents signed after January 1, 2006. We may be liable to pay stamp tax with respect to documents that were signed in the period beginning June 1, 2003 and ending on December 31, 2005. Based on the advice of our counsel, our management believes that the potential costs arising from this matter are not material.

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### CAPITAL GAINS TAX ON SALES OF OUR ORDINARY SHARES

As of January 1, 2003, when the recent Israeli tax reform came into effect, individuals and companies on which the provisions of the income tax law (Inflationary Adjustments), 1985 are not imposed, are subject to a 15% tax rate on the real capital gains derived on or after January 1, 2003 from the sale of shares in Israeli companies publicly traded on a recognized stock exchange outside of Israel. This will be the case so long as our securities remain listed on NASDAQ or traded on a stock exchange in Israel or another country.

Under a recent amendment to the income tax ordinance, effective as of January 1, 2003 and with respect to sales of shares on or after January 1 2006, individuals are subject to a 20% tax rate on the real capital gains derived on or after January 1, 2003 from the sale of shares. Substantial individual shareholders (who are defined as shareholders of 10% or more of the shares of the company on the date of the sale of the shares or any date during the 12 months before the sale of the shares) are subject to a 25% tax rate on the real capital gains derived on or after January 1, 2003 from the sale of shares. Companies on which the provisions of the income tax law (Inflationary Adjustments), 1985 were not imposed before January 1, 2006 are subject to 25% tax rate on real capital gains derived on or after January 1, 2003 from the sale of the shares. Notwithstanding the above, companies on which the provisions of the income tax law (Inflationary Adjustments), 1985 were imposed before January 1, 2006 are subject to regular corporate tax rate on real capital gains derived on the sale of the shares.

The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

Under income tax regulations non-Israeli residents, who sell shares of an Israeli company publicly traded on a recognized stock exchange outside of Israel, will be exempt from tax subject to the satisfaction of all following conditions:

- o The capital gain is not attributable to a permanent establishment in Israel.
- o The shares were purchased after the first initial public offering on the recognized stock exchange outside of Israel.

Pursuant to the Convention between the governments of the United States of America and Israel with respect to taxes on income, as amended, or the "U.S.-Israel Tax Treaty", the sale, exchange or disposition of ordinary shares by a person who (i) holds the ordinary shares as a capital asset, (ii) qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty and (iii) is entitled to claim the benefits afforded to such person by the U.S.-Israel Tax Treaty generally will not be subject to the Israeli capital gains tax unless such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding such sale, exchange or disposition, subject to certain conditions. In this case, the sale, exchange or disposition of ordinary shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, such Treaty U.S. Resident would be permitted to claim a credit for such taxes against the U.S. federal income tax imposed with respect to such sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The Treaty does not relate to U.S. state or local taxes.

#### TAXATION OF NON-RESIDENT HOLDERS OF SHARES

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends after January 1, 2006 other than bonus shares or stock dividends, income tax at the rate of 20% will be withheld on dividends distributed to Israeli individual shareholders or to non-residents.

The foregoing tax rates are withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence (for instance, under the provisions of the Treaty between Israel and the United States a 12.5% tax rate is imposed on dividends not generated by an approved enterprise if the non-resident is a U.S. corporation that holds 10% of a company's voting power, and 15% on dividends generated by an approved enterprise). In addition under the Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a U.S. resident within the meaning of the Treaty will be 25%.

#### TAX REFORM

On January 1, 2003, the Law for Amendment of the Income Tax Ordinance (Amendment No.132), 5762-2002, known as the Tax Reform, came into effect, following its enactment by the Israeli Parliament on July 24, 2002.

The tax reform, aimed at broadening the categories of taxable income and reducing the tax rates imposed on employment income, introduced the following, among other things:

- o Reduction of the tax rate levied on capital gains (other than gains deriving from the sale of listed securities) derived after January 1, 2003, to a general rate of 25% for both individuals and corporations. With respect to assets acquired prior to January 1, 2003, the reduced tax rate will apply to a proportionate part of the gain, in accordance with the holding periods of the asset, before or after January 1, 2003, on a linear basis;
- o Imposition of Israeli tax on all income of Israeli residents, individuals and corporations, regardless of the territorial source of income, including income derived from passive sources such as interest, dividends and royalties;
- o Introduction of controlled foreign corporation, or CFC, rules into the Israeli tax structure. Generally, under such rules, an Israeli resident who holds, directly or indirectly, 10% or more of the rights in a foreign corporation whose shares are not publicly traded, in which more than 50% of the rights are held directly or indirectly by Israeli residents, and a majority of whose income in a tax year is considered passive income, will be liable for tax on the portion of such income attributed to his holdings in such corporation, as if such income were distributed to him as a dividend;
- o Imposition of capital gains tax on capital gains realized by individuals as of January 1, 2003 from the sale of shares of publicly



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traded companies (such gain was previously exempt from capital gains tax in Israel). For information with respect to the applicability of Israeli capital gains taxes on the sale of ordinary shares, see "Capital Gains Tax on Sales of Our Ordinary Shares" above; and

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- o Introduction of a new regime for the taxation of shares and options issued to employees and officers (including directors).

The material consequences of the amendment applicable to our company include, among other things, imposing a tax upon all income of Israeli residents, individuals and corporations, regardless of the territorial source of the income and certain modifications in the qualified taxation tracks of employee stock options. In addition, a foreign tax credit was introduced, allowing us to credit the income tax paid by our subsidiaries abroad against our tax liabilities on dividends paid to us by such subsidiaries.

### UNITED STATES FEDERAL INCOME TAX CONSEQUENCES

The following is a summary of certain material U.S. federal income tax consequences that apply to U.S. Holders who hold ordinary shares as capital assets. This summary is based on the United States Internal Revenue Code of 1986, as amended (the "Code"), Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. This summary does not address all tax considerations that may be relevant with respect to an investment in ordinary shares. This summary does not discuss all the tax consequences that may be relevant to a U.S. Holder in light of such holder's particular circumstances or to U.S. Holders subject to special rules, including persons that are non-U.S. Holders, broker-dealers, financial institutions, certain insurance companies, investors liable for alternative minimum tax, tax-exempt organizations, regulated investment companies, taxpayers whose functional currency is not the U.S. dollar, persons who hold the ordinary shares through partnerships or other pass-through entities, persons who acquired their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services, investors that actually or constructively own 10 percent or more of our voting shares, and investors holding ordinary shares as part of a straddle or appreciated financial position or as part of a hedging or conversion transaction.

If a partnership or an entity treated as a partnership for U.S. federal income tax purposes owns ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of common shares.

This summary does not address the effect of any U.S. federal taxation other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or foreign taxation.

You are urged to consult your tax advisors regarding the foreign and United States federal, state and local tax considerations of an investment in ordinary shares.

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For purposes of this summary, the term "U.S. Holder" means an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States, a corporation or other entity taxable as a corporation created or organized in or under the laws of the United States or any political subdivision thereof, an estate whose income is subject to U.S. federal income tax regardless of its source, or a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

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### TAXATION OF DIVIDENDS

Subject to the discussion below under the heading "Passive Foreign Investment Companies," the gross amount of any distributions received with respect to ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes, to the extent of our current and accumulated earnings and profits as determined for U.S. federal income tax purposes. You will be required to include this amount of dividends in gross income as ordinary income. Distributions in excess of our current and accumulated earnings and profits will be treated as a non taxable return of capital to the extent of your tax basis in the ordinary shares and any amount in excess of your tax basis will be treated as gain from the sale of ordinary shares. See "Disposition of Ordinary Shares" below for the discussion on the taxation of capital gains. Dividends will not qualify for the dividends received deduction generally available to corporations under Section 243 of the Code.

Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on such day may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Subject to complex limitations, any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with respect to each such class of income. Dividends generally will be treated as foreign source passive income or, in the case of certain U.S. Holders, financial services income for United States foreign tax credit purposes. U.S. Holders should note that recently enacted legislation eliminates the "financial services income" category with respect to taxable years beginning after December 31, 2006. Under this legislation, the foreign tax credit limitation categories will be limited to "passive category income" and "general category income." Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced rate of tax, see discussion below. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder

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is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

Subject to certain limitations, "qualified dividend income" received by a noncorporate U.S. Holder in tax years beginning on or before December 31, 2010 will be subject to tax at a reduced maximum tax rate of 15 percent. Distributions taxable as dividends paid on the ordinary shares should qualify for the 15 percent rate provided that either: (i) we are entitled to benefits under the income tax treaty between the United States and Israel (the "Treaty") or (ii) the ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that the ordinary shares currently are readily tradable on an established securities market in the United States. However, no assurance can be given that the ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied. With respect to the ordinary shares, the U.S. Holder must have held such shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. The rate reduction also does not apply to dividends received from passive foreign investment companies, see discussion below, or in respect of certain hedged positions or in certain other situations. The legislation enacting the reduced tax rate contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

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### DISPOSITION OF ORDINARY SHARES

If you sell or otherwise dispose of ordinary shares, you will recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amounts realized on the sale or other disposition and your adjusted tax basis in the ordinary shares. Subject to the discussion below under the heading "Passive Foreign Investment Companies," such gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if you have held the ordinary shares for more than one year at the time of the sale or other disposition. In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A U.S. Holder who receives payment in NIS and converts NIS into United States dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of ordinary shares,

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provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service (the "IRS"). In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

### PASSIVE FOREIGN INVESTMENT COMPANIES

For U.S. federal income tax purposes, we will be considered a passive foreign investment company ("PFIC") for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. Holders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

Based on our current and projected income, assets and activities, we believe that we are not currently a PFIC nor do we expect to become a PFIC in the foreseeable future. However, because the determination of whether we are a PFIC is based upon the composition of our income and assets from time to time, there can be no assurances that we will not become a PFIC for any future taxable year.

If we are treated as a PFIC for any taxable year, dividends would not qualify for the reduced maximum tax rate, discussed above, and, unless you elect either to treat your investment in ordinary shares as an investment in a "qualified electing fund" (a "QEF election") or to "mark to market" your ordinary shares, as described below:

- o you would be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over the holding period for such ordinary shares,

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- o the amount allocated to each year during which we are considered a PFIC other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax rate, as the case may be, in effect for that year and an interest charge would be imposed with respect to the resulting tax liability allocated to each such year,
- o the amount allocated to the current taxable year and any taxable year before we became a PFIC would be taxable as ordinary income in the current year, and
- o you would be required to make an annual return on IRS Form 8621 regarding distributions received with respect to ordinary shares and any gain realized on your ordinary shares.

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If you make either a timely QEF election or a timely mark-to-market election in respect of your ordinary shares, you would not be subject to the rules described above. If you make a timely QEF election, you would be required to include in your income for each taxable year your pro rata share of our ordinary earnings as ordinary income and your pro rata share of our net capital gain as long-term capital gain, whether or not such amounts are actually distributed to you. You would not be eligible to make a QEF election unless we comply with certain applicable information reporting requirements.

Alternatively, if the ordinary shares are considered "marketable stock" and if you elect to "mark-to-market" your ordinary shares, you will generally include in income any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions generally would be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss on the disposition of ordinary shares with respect to which the mark-to-market election is made, is treated as ordinary income or loss (except that loss on a disposition of ordinary shares is treated as capital loss to the extent the loss exceeds the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years). Gain or loss from the disposition of ordinary shares (as to which a mark-to-market election was made) in a year in which we are no longer a PFIC, will be capital gain or loss.

### BACKUP WITHHOLDING AND INFORMATION REPORTING

Payments in respect of ordinary shares may be subject to information reporting to the U.S. Internal Revenue Service and to U.S. backup withholding tax at a rate equal to the third highest income tax rate applicable to individuals (which, under current law, is 28%). Backup withholding will not apply, however, if you (i) are a corporation or come within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability, and a U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

Any U.S. holder who holds 10% or more in vote or value of our ordinary shares will be subject to certain additional United States information reporting requirements.

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### U.S. GIFT AND ESTATE TAX

An individual U.S. Holder of ordinary shares will be subject to U.S. gift and estate taxes with respect to ordinary shares in the same manner and to the same extent as with respect to other types of personal property.

### F. DIVIDENDS AND PAYING AGENTS.

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Not applicable.

### G. STATEMENTS BY EXPERTS.

Not applicable.

### H. DOCUMENTS ON DISPLAY.

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended, applicable to foreign private issuers and fulfill the obligations with respect to such requirements by filing reports with the Securities and Exchange Commission. You may read and copy any document we file with the Securities and Exchange Commission without charge at the Securities and Exchange Commission's public reference room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549, and on the Securities and Exchange Commission Internet site (<http://www.sec.gov>) and on our website [www.magal-ssl.com](http://www.magal-ssl.com). Copies of such material may be obtained by mail from the Public Reference Branch of the Securities and Exchange Commission at such address, at prescribed rates. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the public reference room.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements with the Securities and Exchange Commission as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. A copy of each report submitted in accordance with applicable U.S. law is available for public review at our principal executive offices.

In addition, since we are also listed on the TASE, we submit copies of all our filings with the SEC to the Israeli Securities Authority and TASE. Such copies can be retrieved electronically through the TASE internet messaging system ([www.maya.tase.co.il](http://www.maya.tase.co.il)) and, in addition, with respect to filings made as of November 2003, through the MAGNA distribution site of the Israeli Securities Authority ([www.magna.isa.gov.il](http://www.magna.isa.gov.il)).

### I. SUBSIDIARY INFORMATION.

Not applicable.

### ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to a variety of risks, including changes in interest rates and foreign currency fluctuations.

#### INTEREST RATE RISK

Our exposure to market risk for changes in interest rates is related to our long-term and short-term loans.

Our financial expenses are sensitive primarily to LIBOR, since the majority of our short-term loans bear a LIBOR-based interest rate.

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The table below presents principal amounts and related weighted average interest rates by date of maturity for our loans:

INTEREST RATE SENSITIVITY PRINCIPAL AMOUNT BY EXPECTED MATURITY WEIGHTED AVERAGE INTEREST RATE (U.S. DOLLARS IN THOUSANDS)					
	2006	2007	2008	2009-2010	TOTAL
	-----	----	----	-----	-----
<b>LIABILITIES:</b>					
Short Term Loans	\$ 18,068	-	-	-	\$ 18,068
Weighted Average Interest Rate	4.62%	-	-	-	
Long Term Loans	\$ 3,647	155	163	1,335	\$ 5,300
Weighted Average Interest Rate	3.83%	5.45%	5.45%	5.45%	

### FOREIGN CURRENCY EXCHANGE RISK

We sell most of our products in North America, Europe and Israel. The majority of our revenues and expenditures are denominated in dollars. A portion of our revenues in Israel are made in NIS, and we expect to make NIS denominated revenues in 2006 as well. Our foreign currency exposure with respect to our revenues is mitigated, and we expect it will continue to be mitigated, through salaries, materials and support operations, in which part of these costs are denominated in NIS. Since the beginning of 2006, the NIS has appreciated by approximately 3.6% against the dollar. We are also subject to exchange rate fluctuations related to our activities in Canada.

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

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

During the years ended December 31, 2003, 2004 and 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

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in Euros and Polish Zlotys. We have designated the forward instruments as cash flow hedges for accounting purposes.

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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.

### ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

## PART II

### ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

### ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

### ITEM 15. CONTROLS AND PROCEDURES

Our management, including our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this annual report on Form 20-F. Based upon that evaluation, our chief executive officer and chief financial officer have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by our company in reports that we file or submit under the U.S. Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information was made known to them by others within the company, as appropriate to allow timely decisions regarding required disclosure.



## ITEM 16. [RESERVED]

## ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Board of Directors has determined that Mrs. Anat Winner, an independent director, meets the definition of an audit committee financial expert, as defined in Item 401(h) of Regulation S-K. For a brief listing of Mrs. Winner's relevant experience, see Item 6.A. "Directors, Senior Management and Employees -- Directors and Senior Management."

## ITEM 16B. CODE OF ETHICS

We have adopted a code of ethics that applies to our chief executive officer and all senior financial officers of our company, including the chief financial officer, chief accounting officer or controller, or persons performing similar functions. The code of ethics is publicly available on our website at [www.magal-ssl.com](http://www.magal-ssl.com). Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.

## ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

## FEES PAID TO INDEPENDENT PUBLIC ACCOUNTANTS

The following table sets forth, for each of the years indicated, the fees paid to our independent public accountants and the percentage of each of the fees out of the total amount paid to the accountants.

The following table sets forth, for each of the years indicated, the fees paid to our principal independent registered public accounting firm, Kost Forer Gabbay & Kasierer. All of such fees were pre-approved by our Audit Committee.

	Year Ended December 31,	
	2004	2005
Services Rendered	Fees	Fees
Audit (1)	\$275,311	\$266,936
Audit-related (2)	17,404	10,000
Tax (3)	18,183	45,100
Other (4)	19,380	184,124
Total	\$330,278	\$506,160

- Audit fees consist of services that would normally be provided in connection with statutory and regulatory filings or engagements.
- Audit-related fees relate to assurance and associated services that traditionally are performed by the independent accountant, including: attest services that are not required by statute or regulation; accounting consultation and audits in connection with mergers,

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acquisitions and divestitures; employee benefit plans audits; and consultation concerning financial accounting and reporting standards.

3. Tax fees relate to services performed by the tax division for tax compliance, planning, and advice.
4. Other fees in 2005 include mainly fees related to our public offering.

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### PRE-APPROVAL POLICIES AND PROCEDURES

Our audit committee has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent public accounting firm, Kost Forer Gabbay & Kasierer and their affiliates. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the scope of the engagement of our independent auditor, or on an individual basis. Any proposed services exceeding general pre-approved levels also requires specific pre-approval by our audit committee. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the SEC, and also requires the audit committee to consider whether proposed services are compatible with the independence of the public accountants.

### ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEE

Not applicable.

### ITEM 16E. PURCHASE OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

#### ISSUER PURCHASE OF EQUITY SECURITIES

Neither we nor any affiliated purchaser has purchased any of our securities during 2005.

## PART III

### ITEM 17. FINANCIAL STATEMENTS

We have responded to Item 18 in lieu of this item.

### ITEM 18. FINANCIAL STATEMENTS

The Financial Statements required by this item are found at the end of this annual report, beginning on page F-1.

### ITEM 19. EXHIBITS

The exhibits filed with or incorporated into this annual report are listed on the index of exhibits below:

EXHIBIT NO.	DESCRIPTION
1.1*	Memorandum of Association of the Registrant

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- 1.2\*\* Articles of Association of the Registrant
- 2.1\*\*\* Specimen Share Certificate for Ordinary Share
- 2.2\*\*\*\* The Registrant's Stock Option Plan (1993), as amended

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EXHIBIT NO.	DESCRIPTION
2.3*****	Registration Rights Agreement, dated as of November 18, 1996, by and among the Registrant, Mira Mag Inc., Israel Aircraft Industries Ltd. and Jacob Even-Ezra
8	List of Subsidiaries of the Registrant
12.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
12.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
13.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
13.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
15.1	Schedule of Valuation and Qualifying Accounts
15.2	Consent of Kost Forer Gabbay & Kasierer
15.3	Consent of Salles, Sainz - Grant Thornton, S. C.

\* Previously filed as an exhibit to our Registration Statement on Form F-1 (No. 33-57438), filed with the Commission on January 26, 1993, as amended, and incorporated herein by reference.

\*\* Previously filed as an exhibit to our Registration Statement on Form F-1 (No. 33-57438), filed with the Commission on January 26, 1993, as amended, and incorporated herein by reference and an amendment thereto previously filed as an exhibit to our Registration Statement on Form S-8 (No. 333-6246), filed with the Commission on January 7, 1997 and incorporated herein by reference and further amendments thereto previously filed as an exhibit to our Annual Report on Form 20-F for the fiscal year ended December 31, 2000, filed with the Commission on June 29, 2001 and incorporated herein by reference.

\*\*\* Previously filed as an exhibit to our Registration Statement on Form 8-A, filed with the Commission on March 18, 1993, as amended, and incorporated herein by reference.

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\*\*\*\* Previously filed as an exhibit to our Registration Statement on Form S-8 (No. 333-6246), filed with the Commission on January 7, 1997 and incorporated herein by reference and further amendments thereto previously filed as an exhibit to our Annual Report on Form 20-F for the fiscal year ended December 31, 2000, filed with the Commission on June 29, 2001 and incorporated herein by reference.

\*\*\*\*\* Previously filed as an exhibit to our Registration Statement on Form F-2 (No.333-5970), filed with the Commission on November 8, 1996, as amended, and incorporated herein by reference.

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### MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

#### CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2005

IN U.S. DOLLARS

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#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE SHAREHOLDERS OF

MAGAL SECURITY SYSTEMS LTD.

We have audited the accompanying consolidated balance sheets of Magal Security Systems Ltd. ("the Company") and its subsidiaries as of December 31, 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

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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 & KASIERER  
A Member of Ernst & Young Global

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

		D ----- 2004 -----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents		\$11,964
Short-term bank deposits		-
Trade receivables (net of allowance for doubtful accounts of \$ 320 and \$ 306 at December 31, 2004 and 2005, respectively)		*) 15,102
Unbilled accounts receivable		*) 5,595
Other accounts receivable and prepaid expenses		3,858
Deferred income taxes		488
Inventories (Note 3)		12,702 -----

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TOTAL current assets	49,709
-----	
LONG-TERM INVESTMENTS AND RECEIVABLES:	
Long-term trade receivables	344
Long-term bank deposits	2,994
Structured notes	3,000
Severance pay fund	2,142
-----	
TOTAL long-term investments and receivables	8,480
-----	
PROPERTY AND EQUIPMENT, NET (Note 4)	14,659
-----	
DEFERRED INCOME TAXES	186
-----	
OTHER INTANGIBLE ASSETS, NET (Note 5)	656
-----	
GOODWILL	4,286
-----	
TOTAL assets	\$77,976
=====	

\*) Reclassified.

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

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

-----  
U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	2004
-----	
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Short-term bank credit (Note 6)	\$ 15,61
Current maturities of long-term debt (Note 8)	1,84
Trade payables	3,18
Customer advances	
Other accounts payable and accrued expenses (Note 7)	6,66
Unrealized losses on hedging forward contracts	78
-----	
TOTAL current liabilities	28,10
-----	

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### LONG-TERM LIABILITIES:

Unrealized losses on hedging forward contracts	65
Long-term bank debt (Note 8)	3,50
Accrued severance pay	2,17
	-----

TOTAL long-term liabilities 6,32  
-----

### 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	2,82
Additional paid-in capital	32,52
Deferred stock compensation	(47
Accumulated other comprehensive income	1,63
Retained earnings	7,03
	-----

TOTAL shareholders' equity 43,54  
-----

TOTAL liabilities and shareholders' equity \$ 77,97  
=====

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

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### MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

#### CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS (EXCEPT PER SHARE DATA)

	YEAR ENDED DEC	
	*) 2003	*) 2004
Revenues	\$58,655	\$ 60,468
Cost of revenues	32,847	33,226
	-----	-----
Gross profit	25,808	27,242
	-----	-----
Operating expenses:		
Research and development, net (Note 15a)	4,773	4,683
Selling and marketing, net	11,427	12,519
General and administrative	5,305	5,771
Award granted by principal shareholders	-	1,200
	-----	-----

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TOTAL operating expenses	21,505	24,173
	-----	-----
Operating income (loss)	4,303	3,069
Financial expenses, net (Note 15b)	1,003	762
	-----	-----
Income (loss) before income taxes	3,300	2,307
Income taxes (tax benefit) (Note 12)	910	1,133
	-----	-----
Income (loss) from continuing operations	2,390	1,174
Gain (loss) from discontinued operations, net (Note 16)	14	(121)
	-----	-----
Net income (loss)	\$ 2,404	\$ 1,053
	=====	=====
Basic net earnings (loss) per share from continuing operations	\$ 0.30	\$ 0.13
Basic net loss per share from discontinued operations	-	(0.01)
	-----	-----
Basic net earnings (loss) per share (Note 11)	\$ 0.30	\$ 0.12
	=====	=====
Diluted net earnings (loss) per share from continuing operations	\$ 0.30	\$ 0.13
Diluted net loss per share from discontinued operations	-	(0.01)
	-----	-----
Diluted net earnings (loss) per share (Note 11)	\$ 0.30	\$ 0.12
	=====	=====

\*) Reclassified.

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

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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	ADDITION PAID-IN CAPITAL
	-----	-----	-----
Balance as of January 1, 2003	7,666,370	\$ 2,600	\$21,791
Declared dividend	-	-	-
Exercise of stock options	137,446	30	432



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Amortization of deferred stock compensation	231,963	-	-
Stock dividend	-	53	1,875
Comprehensive income:			
Net income	-	-	-
Unrealized losses on forward contracts, net	-	-	-
Foreign currency translation adjustments	-	-	-
	-----	-----	-----
Total comprehensive income			
Balance as of December 31, 2003	8,035,779	2,683	24,098
Exercise of stock options	225,338	51	916
Deferred stock compensation related to officers' options grant	-	-	661
Amortization of deferred stock compensation related to officers' options grant	-	-	-
Award granted by principal shareholders	-	-	1,200
Stock dividend	411,331	91	5,651
Comprehensive income:			
Net income	-	-	-
Unrealized gains on forward contracts, net	-	-	-
Foreign currency translation adjustments	-	-	-
	-----	-----	-----
Total comprehensive income			
Balance as of December 31, 2004	8,672,448	2,825	32,526
Issuance of share capital, net	1,700,000	395	14,793
Amortization of deferred stock compensation related to officers' options grant	-	-	-
Deferred taxes on stock options	-	-	190
Comprehensive income:			
Net loss	-	-	-
Unrealized gains on forward contracts, net	-	-	-
Foreign currency translation adjustments	-	-	-
	-----	-----	-----
Total comprehensive income			
Balance as of December 31, 2005	10,372,448	\$ 3,220	\$47,509
	=====	=====	=====
Accumulated unrealized earnings on forward contracts, net			
Accumulated foreign currency translation adjustments			
Accumulated other comprehensive income as of December 31, 2005			

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

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### CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

	YEAR ENDED DEC	
	2003	2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 2,404	\$ 1,053
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Loss (gain) from discontinued operations	(14)	121
Depreciation and amortization	1,378	1,966
Gain on sale of property and equipment	(9)	(18)
Decrease (increase) in accrued interest on short-term and long-term bank deposits	(199)	657
Amortization of deferred stock compensation	3	184
Decrease (increase) in trade receivables, net	*) (2,977)	*) 3,956
Decrease in receivables from related parties	28	-
Decrease (increase) in unbilled accounts receivable	*) 1,533	*) (4,130)
Decrease (increase) in other accounts receivable and prepaid expenses	(836)	16
Decrease (increase) in deferred income taxes	(88)	178
Decrease (increase) in inventories	(2,581)	(552)
Decrease (increase) in long-term trade receivables	1,210	(44)
Increase (decrease) in trade payables	49	(1,953)
Increase in other accounts payable and accrued expenses	1,727	880
Increase in customer advances	-	-
Accrued severance pay, net	77	(2)
Award granted by principal shareholders	-	1,200
Realized losses (gains) on hedging forward contract	-	476
	1,705	3,988
Net cash provided by (used in) continuing operations		
Net cash provided by (used in) discontinued operations	19	(310)
	1,724	3,678
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of short-term deposits	-	-
Purchase of long-term bank deposits	-	(3,000)
Proceeds from sale of long-term deposits	-	-
Purchase of structured notes	(3,000)	-
Redemption of structured notes	-	-
Proceeds from sale of short-term bank deposits	3,505	8,400
Proceeds from sale of property and equipment	33	59
Purchase of property and equipment	(3,194)	(4,858)
Purchase of know-how and patents	(48)	(89)
Acquisition of the business activity of Dominion Wireless Inc. (a)	(902)	-
	(3,606)	512

\*) 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
CASH FLOWS FROM FINANCING ACTIVITIES:		
Short-term bank credit, net	3,098	2,895
Proceeds from long-term bank loans	43	-
Principal payment of long-term bank loans	(103)	(365)
Proceeds from exercise of employee stock options	462	967
Proceeds from issuance of shares, net	-	-
Dividend paid	-	(401)
Net cash provided by financing activities	3,500	3,096
Effect of exchange rate changes on cash and cash equivalents	252	289
Increase (decrease) in cash and cash equivalents	1,870	7,575
Cash and cash equivalents at the beginning of the year	2,519	4,389
Cash and cash equivalents at the end of the year	\$ 4,389	\$ 11,964
SUPPLEMENTAL DISCLOSURES OF CASH FLOWS ACTIVITIES:		
Cash paid during the year for:		
Interest	\$ 1,099	\$ 1,093
Taxes	\$ 1,544	\$ 1,164
NON-CASH ACTIVITIES:		
Declared dividend	\$ 401	\$ -
(a) ACQUISITION OF THE BUSINESS ACTIVITY OF DOMINION WIRELESS INC.:		
Net fair value of the assets acquired at the acquisition date was as follows:		
Inventories	\$ 376	
Property and equipment	90	

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Technology	436
	-----
	\$ 902
	=====

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

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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

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-----  
 UNAUDITED  
 -----

Inventories	\$376
Property and equipment	90
Technology	436
	-----
	\$902
	=====

\*) Reclassified.

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MAGAL SECURITY SYSTEMS LTD.  
 AND ITS SUBSIDIARIES

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 =====

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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".

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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



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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

1. 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.

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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.

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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,

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	2003 -----	2004 -----
Net income (loss) as reported:	\$ 2,404	\$ 1,053
Add: stock-based compensation expenses determined under the intrinsic value based method included in the reported net income	3	184
Deduct: stock-based compensation expenses determined under fair value based method for all awards	(111)	(198)
	-----	-----
Pro forma net income	\$ 2,296 =====	\$ 1,039 =====
Basic net earnings (loss) per share, as reported	\$ 0.30 =====	\$ 0.12 =====
Diluted net earnings (loss) per share, as reported	\$ 0.30 =====	\$ 0.12 =====
Pro forma basic net earnings (loss) per share	\$ 0.29 =====	\$ 0.12 =====
Pro forma diluted net earnings (loss) per share	\$ 0.29 =====	\$ 0.12 =====

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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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.

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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,

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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



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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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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
	=====	=====

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MAGAL SECURITY SYSTEMS LTD.  
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### 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

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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
	-----	-----
	27,438	30,528
	-----	-----
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
	-----	-----
	12,779	14,941
	-----	-----
Depreciated cost	\$14,659	\$15,587
	=====	=====

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.

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MAGAL SECURITY SYSTEMS LTD.  
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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
	-----	-----
	3,577	3,725
	-----	-----
Accumulated amortization:		
Know-how	396	446

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Patents	2,443	2,575
Technology	82	135
	-----	-----
	2,921	3,156
	-----	-----
Amortized cost	\$ 656	\$ 569
	=====	=====

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:

DECEMBER 31,  
-----

2006	\$111
2007	102
2008	93
2009	86
2010	177
	----
	\$569
	=====

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MAGAL SECURITY SYSTEMS LTD.  
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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
			-----	-----
			\$15,618	\$18,068
			=====	=====
Weighted average interest	4.64	4.62		

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rates at the end of the year

Total authorized credit lines approximate	\$33,245 =====	\$48,895 =====
Unutilized credit lines approximate	\$ 6,352 =====	\$15,781 =====

- (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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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

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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
		%		
		-----		-----
Bank loan	U.S. \$	3.10	3.10	\$2,500
Bank promissory note	U.S. \$	-	5.45	-
Bank promissory note	U.S. \$	-	5.45	-
Bank promissory note (1)	U.S. \$	3.05	5.175	500
Bank promissory note (1)	U.S. \$	3.50	5.625	500
				-----
				3,500
Mortgage payable	U.S. \$	8.25	-	1,849
				-----
				5,349
Less - current maturities				1,849
				-----
				\$3,500
				=====
Weighted average interest rates at the end of the year		4.91	4.33	

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

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- (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	1,162
	-----
	\$ 5,300
	=====

- 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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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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	37
	-----
	\$ 821
	=====

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

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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.



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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.

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MAGAL SECURITY SYSTEMS LTD.  
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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.

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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.

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MAGAL SECURITY SYSTEMS LTD.  
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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		
	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF OPTION
Outstanding at the beginning of the year	358,234	\$4.23	223,216	\$4.61	105,0
Granted	-	\$ -	100,000	\$7.66	238,0
Adjustment as a result of stock					

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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	223,216	\$4.61	105,000	\$7.66	343,000
	=====	=====	=====	=====	=====
Exercisable options at the end of the year	223,216	\$4.61	-	\$ -	231,200
	=====	=====	=====	=====	=====

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
5,000	\$13	24	-
-----			-----
343,000	\$ 8.35		231,200
=====	=====		=====

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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 10:- SHAREHOLDERS' EQUITY (CONT.)

d. Dividends:

- Dividends, if any, will be declared and paid in U.S. dollars. Dividends paid to shareholders in Israel will be converted into NIS on the basis of the exchange rate prevailing at the date of payment. The Company has determined that it will not distribute

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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	
	2003	2004
Numerator:		
Income (loss) from continuing operations	\$ 2,390	\$ 1,174
Gain (loss) on discontinued operations	14	(121)
	-----	-----
Net income (loss)	\$ 2,404	\$ 1,053
	=====	=====
Denominator:		
Denominator for basic net earnings per share - weighted-average number of shares outstanding	7,947,778	8,581,348
Effect of diluting securities:		
Employee stock options and warrants to underwriters	80,848	55,031
	-----	-----
Denominator for diluted net earnings per share - adjusted weighted average shares and assumed exercises	8,028,626	8,636,379
	=====	=====
Basic net earnings (loss) per share from continuing operations	\$ 0.30	\$ 0.13
Basic net loss per share from discontinued operations	-	(0.01)
	-----	-----
Basic net earnings (loss) per share	\$ 0.30	\$ 0.12
	=====	=====
Diluted net earnings (loss) per share form continuing operations	\$ 0.30	\$ 0.13
Diluted net loss per share from discontinued operations	-	(0.01)
	-----	-----
Diluted net earnings (loss) per share	\$ 0.30	\$ 0.12
	=====	=====

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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.

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AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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:

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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.

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT PER SHARE DATA)

NOTE 12:- TAXES ON INCOME (CONT.)

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

	YEAR ENDED DECEMBER 31,		
	2003	2004	2005
Income (loss) before taxes as reported in the statements of income	\$ 3,300	\$ 2,307	\$ (3,000)
Tax rate	36%	35%	
Theoretical tax expense (tax benefit)	\$ 1,188	\$ 807	\$ (1,188)
Increase (decrease) in taxes:			
Non-deductible items, net	17	(400)	
Deferred taxes on losses for which valuation allowance was provided	298	1,163	
Tax exemption applicable to "Approved Enterprises" and exempted income	(440)	(302)	
Taxes in respect of prior years	(107)	(23)	
Other	(46)	(112)	
Taxes on income (tax benefit) in the statements of income	\$ 910	\$ 1,133	\$ 910
Per share amounts (basic and diluted) of the tax benefit resulting from "Approved Enterprises"	\$ 0.06	\$ 0.03	\$ 0.06

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



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Current taxes:			
Domestic	\$	395	\$ 460
Foreign		534	518
Deferred income taxes (tax benefit):			
Domestic		-	(70)
Foreign		88	248
Taxes in respect of prior years:			
Domestic		(107)	-
Foreign		-	(23)
		-----	-----
Taxes on income (tax benefit) from continuing operations		910	1,133
Taxes on income (tax benefit) from discontinued operations		3	(32)
		-----	-----
Total taxes on income	\$	913	\$ 1,101
		=====	=====

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MAGAL SECURITY SYSTEMS LTD.  
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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
	-----	-----
Total deferred assets before valuation allowance	2,966	4,886
Valuation allowance	(2,292)	(2,871)
	-----	-----
Net deferred tax assets	\$ 674	\$ 2,015
	=====	=====
Domestic	\$ 288	\$ 1,553
Foreign	386	462

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-----	-----
\$ 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.

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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
	=====	=====

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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.

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MAGAL SECURITY SYSTEMS LTD.  
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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 END		
						2003		
		VIDEO		TOTAL				
PERIMETER	PROJECTS	MONITORING	OTHER		PERIMETER	PROJECTS	MON	

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Revenues	\$ 51,077	\$ 6,720	\$ 403	\$ 455	\$ 58,655	\$ 46,342	\$11,375	\$
	=====	=====	=====	=====	=====	=====	=====	=====
Depreciation and amortization	\$ 1,056	\$ 20	\$ 292	\$ 10	\$ 1,378	\$ 1,252	\$ 11	\$
	=====	=====	=====	=====	=====	=====	=====	=====
Operating income (loss), before financial expenses and taxes on income	\$ 5,803	\$ 936	\$ (1,870)	\$ (566)	\$ 4,303	\$ 4,978	\$ 1,430	\$
	=====	=====	=====	=====		=====	=====	=====
Financial expenses, net					(1,003)			
Taxes on income					910			
Gain (loss) on discontinued operations, net					14			
					-----			
Net income					\$ 2,404			
					=====			

DEC

2003

	PERIMETER	PROJECTS	VIDEO MONITORING	OTHER	TOTAL	PERIMETER	PROJECTS	V MON
	-----	-----	-----	-----	-----	-----	-----	-----
Total long-lived assets	\$13,476	\$88	\$2,787	\$12	\$16,363	\$13,576	\$192	\$5
	=====	=====	=====	=====	=====	=====	=====	=====

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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%
	=====	=====	=====

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\*) 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
	=====	=====	=====

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MAGAL SECURITY SYSTEMS LTD.  
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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	\$ 5,420
Less - royalty-bearing grants and investment tax credit	355	405	160
	-----	-----	-----
	\$ 4,773	\$ 4,683	\$ 5,260

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	=====	=====	=====
b. Financial income (expenses):			
Financial expenses:			
Interest on long-term debt	\$ (298)	\$ (289)	\$ (62)
Interest on short-term bank credit	(808)	(849)	(63)
Forward contracts loss	-	-	(11)
Foreign exchange losses	(692)	(161)	(31)
	-----	-----	-----
	(1,798)	(1,299)	(1,67)
	-----	-----	-----
Financial income:			
Interest on short-term and long-term bank deposits and structured notes	672	496	70
Foreign exchange gains	123	41	16
	-----	-----	-----
	795	537	87
	-----	-----	-----
	\$ (1,003)	\$ (762)	\$ (80)
	=====	=====	=====

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.

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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
	----	-----	-----

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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.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

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

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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.

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SIGNATURE

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

MAGAL SECURITY SYSTEMS LTD.

By: /s/ Jacob Even-Ezra

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Jacob Even-Ezra  
Chairman of the Board and  
Chief Executive Officer  
Date: July 14, 2006

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