

MAGAL SECURITY SYSTEMS LTD  
Form 20-F  
June 29, 2004

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, 2003

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-21388

Magal Security Systems Ltd.  
(Exact name of Registrant as specified in its charter)

Israel  
(Jurisdiction of incorporation or organization)

P.O. Box 70, Industrial Zone, Yahud 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  
(Title of Class)

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:

Ordinary Shares, NIS 1.0 par value per share  
as of December 31, 2003 ..... 8,035,779

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

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

[ ] Item 17 [X]Item 18

This Report on Form 20-F is incorporated by reference into the Registrant's Form F-3 Registration Statement File No. 333-9050.

### INTRODUCTION

Magal Security Systems Ltd. develops, manufactures, markets and sells complex computerized security systems, including a line of perimeter security systems, a video motion detection system, a hardware and software "all in one" security solution which integrates Closed Circuit Television related applications, 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 and in February 1997, we completed a public offering of an additional 2,085,000 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.

We urge you to consider that 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 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. Any other trademarks and trade names appearing in this annual report are owned by their respective holders.

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 June 25, 2004 was NIS

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4.501 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, 2002 and 2003 and for each of the years ended December 31, 2001, 2002 and 2003 from our consolidated financial statements set forth elsewhere in this annual report that have been prepared in accordance with U.S. GAAP. We have

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derived the following selected consolidated financial data as of December 31, 1999, 2000 and 2001 and for each of the years ended December 31, 1999 and 2000 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,				
	1999	2000	2001	2002	2003
	(in thousands except per share data)				
Consolidated Statement of Income					
Data:					
Revenues.....	\$31,967	\$38,571	\$41,020	\$42,966	\$59,361
Cost of revenues.....	16,693	20,523	21,505	23,924	33,378
Gross profit.....	15,274	18,048	19,515	19,042	25,983
Operating expenses:					
Research and development, net....	2,676	2,975	3,054	3,128	4,773
Sales and marketing, net.....	5,820	7,129	7,933	8,642	11,585
General and administrative.....	4,104	4,661	4,949	4,938	5,305
Total operating expenses.....	12,600	14,765	15,936	16,708	21,663
Operating income.....	2,674	3,283	3,579	2,334	4,320
Financial income (expenses), net...	(127)	(214)	40	199	(1,003)
Income before taxes on income					
and write-off of investment in					
affiliate, net of taxes.....	2,547	3,069	3,619	2,533	3,317
Taxes on income.....	259	180	452	645	913
Income before write-off of					
investment in affiliate.....	2,288	2,889	3,167	1,888	2,404
Write-off of investment in					
affiliate, net of taxes.....	357	-	-	-	-
Net income.....	1,931	2,889	3,167	1,888	2,404
Basic net earnings per share.....	\$ 0.25	\$ 0.38	\$ 0.41	\$ 0.24	\$ 0.30
Diluted net earnings per share.....	\$ 0.25	\$ 0.37	\$ 0.40	\$ 0.23	\$ 0.30
Weighted average number of Ordinary					
shares used in computing basic net					
earnings per share.....	7,623	7,663	7,738	7,866	7,948
Weighted average number of Ordinary					
shares used in computing diluted					
net earnings per share.....	7,698	7,750	7,925	8,069	8,029
Cash dividend per share.....	\$ 0.10	\$ 0.10	\$ 0.13	\$ -	\$0.05

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Our board of directors declared stock dividend distributions of 3% in May 2002 and 2003. All net earnings per share data in the above table have been retroactively adjusted to reflect the stock dividends.

	As of December 31,				
	1999	2000	2001	2002	2003
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents.....	\$ 1,963	\$ 3,579	\$ 2,738	\$ 2,519	\$ 4,389
Short and long-term bank deposits..	10,596	11,213	11,849	12,357	12,051
Working capital.....	15,520	20,288	18,391	15,688	21,401
Total assets.....	43,178	48,867	53,347	59,741	71,443
Short-term bank credit (including current maturities of long-term loans).....	7,199	2,765	6,264	10,357	16,438
Long-term loans.....	193	6,302	5,038	4,698	1,873
Total shareholders' equity.....	28,874	30,899	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**

Our revenues are dependent 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 government agencies, government 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 government 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 substantial decrease in our governmental customers' budgets would adversely affect our results of operations.

Because we receive large orders from a relatively small number of customers, our revenues and operating results are subject to substantial periodic variations. Our revenues and operating results for a specific quarter may not be indicative of our future performance, making it difficult for investors to evaluate our future prospects based on the results of any one quarter.

Due to the nature of our customers and products, we receive relatively large orders for our products from a relatively small number of customers. 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. 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 and operating results are subject to very substantial variations. Because our quarterly performance is likely to vary significantly, the results of our operations for any quarter are not necessarily indicative of the results that we might achieve for any subsequent period. Consequently, quarter-to-quarter comparisons of our operating results may not be meaningful.

The loss of one or more of our key customers would result in a loss of a significant amount of our revenues.

Relatively few customers account for a large percentage of our revenues. For the years ended December 31, 2001, 2002 and 2003, revenues generated from sales to the Israeli Ministry of Defense, or MOD, and the Israeli Defense Forces, or IDF, together accounted for 22.5%, 15.9% and 27.2%, respectively, of our revenues. For the years ended December 31, 2001, 2002 and 2003 revenues generated from sales to the State concern civil aviation airlines, or Azal, Azerbaijan airlines, accounted for 10.5%, 1.8% and 0.2% respectively of our revenues. We cannot assure you that the MOD, IDF, Azal 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.

In 2001, we established Smart Interactive Systems, Inc. to meet the growing need for real-time video monitoring services. No assurance can be given that this company will be successful in the future. If this company is unsuccessful, our future results of operations may 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 \$6.4 million in Smart through December 31, 2003. Its operations to date have not been profitable and it has an accumulated deficit of \$4.1 million as of December 31, 2003. Smart's success will be dependent upon its ability to penetrate the market for these services and upon customers' acceptance of these services. If Smart is unable to market its services or if its services are not accepted by customers, we may lose our investment in this company and our future results of operations may be adversely affected.

If we do not receive the government approvals necessary for us to export the products we produce in Israel, our revenues may decrease.

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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

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cannot assure you that we will 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.

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. We cannot assure you that:

- o we will be successful in developing and marketing new products or product features that respond to technological change or evolving industry standards;
- o we will not 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 will adequately meet the requirements of the marketplace and achieve market acceptance.

We face risks associated with doing business in international markets.

We make a large portion of our sales in markets outside of Israel 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 difficulties in staffing and managing foreign operations;
- o longer payment cycles;
- o difficulties in collecting accounts receivable;
- o political instability; and



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- o seasonal reductions in business activities.

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

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We are engaged in a highly competitive business. If we are unable to compete effectively, our revenues 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 will be materially and adversely affected.

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. Although we have identified potential acquisition candidates, we currently have no commitments or agreements with respect to any such acquisitions or investments and we cannot assure you that we will eventually 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 performing acquisitions and managing growth. We cannot assure you that the anticipated benefits of any acquisition will be realized. In addition, 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 goodwill and other 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. In addition, as part of our growth strategy, we developed three new products, DreamBox, Fortis and the Pipeline Security System. We intend to invest extensive funds in the marketing and sales of those products. We cannot assure you that our marketing and sale efforts will 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 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 and distributors. These measures may not be adequate to protect our technology from

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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.

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

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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 cannot assure you that we will continue to be able to obtain such items from these suppliers on satisfactory terms. 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. For example, our subsidiary Senstar-Stellar Corporation, or Senstar, obtains triboelectric sensor cable for its Intelli-FLEX product from a sole supplier. If this sole supplier were to discontinue production of the triboelectric sensor cable, it would adversely affect Senstar's revenues of its Intelli-FLEX product.

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. We cannot assure you that, despite testing by us and our customers, errors will not 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 cannot assure you that we will not 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

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potential harm to our reputation that may result from product defects or implementation errors could be damaging to us.

We are dependent 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 are dependent 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.

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Our failure to retain and attract personnel could harm our business, operations and product development efforts.

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.

Our non-competition agreements with our key employees may not be enforceable. If any of these employees leaves us and joins a competitor, our competitor could benefit from the expertise that our former employee gained while working for us.

We currently have non-competition agreements with all of our key employees in Israel. These agreements prohibit these key employees from directly competing with us or working with our competitors in the event such key employees cease to work for us. Under current U.S. and Israeli law, we may not be able to enforce these non-competition agreements. If we are unable to enforce any of these agreements, our competitors that employ these former employees could benefit from the expertise these former employees gained while working for us. In addition, we do not have non-competition agreements with our U.S. employees.

Volatility of the market price of our ordinary shares could adversely affect our shareholders and us.

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;

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- 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;

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- 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.

### Risk 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. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

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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 at least 30 days and up to 40 days, depending on rank and position, of military reserve duty annually and are subject to being called for active duty under emergency circumstances. There are proposals to increase this annual commitment. 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 continue to deteriorate. In addition, due to significant economic

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measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting all banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers. Following the passing by the Israeli Parliament of laws to implement the economic measures, the Israeli trade unions have threatened further strikes or work-stoppages, and these may have a material adverse effect on the Israeli economy and on us.

We may be adversely affected if the rate of inflation in Israel exceeds the rate of devaluation of the New Israeli Shekel against the dollar.

A portion of our expenses, primarily labor expenses, is incurred in NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the dollar or that the timing of this devaluation will lag behind inflation in Israel. In 2001 and 2002, the inflation rate in Israel exceeded the rate of devaluation of the NIS against the dollar. In 2003 the rate of inflation was negative and the NIS was revaluated vis-a-vis the dollar. Since the beginning of 2004, the NIS has devaluated approximately 2.8% against the dollar. In addition, since part of our revenues are quoted in NIS, and a portion of our expenses are incurred in NIS, our results may be adversely affected by a change in the rate of inflation in Israel if the amount of our revenues in NIS decreases and is less than the amount of our expenses in NIS (or if such decrease is offset on a lagging basis) or if such change in the rate of inflation is not offset, or is offset on a lagging basis, by a corresponding devaluation of the NIS against the dollar and other foreign currencies.

If the rate of inflation in Israel exceeds the rate of devaluation of the NIS in relation to the dollar or the timing of this devaluation lags behind inflation in Israel our expenses in NIS in relation to the dollar will increase and our operating results may be adversely affected.

We currently benefit from government programs and tax benefits that may be discontinued or reduced.

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We currently receive grants and tax benefits under Government of Israel programs. In order to maintain our eligibility for these programs and benefits, we must continue to meet specified conditions, including, but not limited to, making specified investments 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 or pay increased taxes or royalties. The Government of Israel 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 Government of Israel 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 to four

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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 citizens. 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 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, our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, a shareholder of an

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Israeli company has a duty to act in good faith 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.

### 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 manufacturing and research and development facilities are located near Tel Aviv, Israel, in the Yahud Industrial Zone. Our mailing address is P.O. Box 70, Industrial Zone, Yahud 56100, Israel and our telephone number is 972-3-539-1444. Our agent for service of process in the U.S. is Senstar-Stellar Inc., 43184 Osgood Road, Fremont, CA, 94539. 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.

We develop, manufacture, market and sell complex computerized security systems, including a line of perimeter security systems, a video motion detection system, a hardware and software "all in one" security solution which integrates Closed Circuit Television, or CCTV, related applications, security management and control systems, personal emergency location systems, a pipeline security system and we also provide video monitoring services.

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

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#### B. Business Overview.

##### General

We develop, manufacture, market and sell complex computerized security systems, including:

- o a line of perimeter security systems and a video motion detection system, which automatically detect and locate intruders and identify the nature of intrusions
- o the DreamBox, which integrates number of CCTV related applications into one box;
- o security management and control systems that 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;
- o PipeGuard, a pipeline security system; and
- o personal emergency location systems.

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We also provide video monitoring services.

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.

### Industry Background

#### Perimeter Security and Video Motion Detection 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.

#### DreamBox

The DreamBox is an 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 network protocols 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.

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The DreamBox, is sold at a substantially lower price than the cost of the other products 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.

#### 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.

#### Pipeline Security System

As of end of year 2002, 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



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years, and in spite of increasing threats since the 9/11 events 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 such as fiber optic cables.

### 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.

### 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.

### 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:

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**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 improving the sensitivity, detection ability and reliability of our products. During 2003, we invested 8% of our revenues in 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 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 2004 we 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

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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 our three new products 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.

### Products and Services

#### Perimeter Security Systems

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.

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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 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 an intruder detection system and as a physical barrier to infiltration.

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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 and FPS microprocessor-based triboelectric and piezoelectric cable fence sensors are vibration sensitive transducers. Both systems detect any attempt to cut, climb or penetrate the fence and both 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.

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

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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 \$75-\$180 per meter and the Perimitrax system is sold for approximately \$65-\$100 per meter.

Video Motion Detection System

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Our Video Motion Detection System, or DTS, utilizes advanced video image processing technology to detect, locate and track intruders automatically. The system, which was introduced in 1993, experiences fewer false alarms than most competing products because it is able to distinguish automatically between human and other forms of infiltration.

DTS is a detection and tracking system that combines our image processing technology with input from ordinary video surveillance cameras to detect, locate and track intruders without continuous human monitoring. Our DTS image processing and graphics overlay cards and software, when installed in an IBM-compatible personal computer, enable that computer to process video signals, including signals from visible light, infrared and other camera types. Our image processing software incorporates a learning cycle that permits the system to analyze the protected area, including such variable features as changing weather and lighting conditions, to reduce false alarms. A DTS user can program all the parameters used to define an alarm condition, including, for example, intruder speed, object size, threat direction and distance traveled. The user can also designate specific areas within the camera's field of view to be protected. Each camera in a multiple camera system can be monitored using different parameters. Parameters can be switched manually, automatically or by external inputs, and the cameras can be assigned relative priorities for computer monitoring. These features enable the DTS to identify an intruder and then track the intruder in real-time on screen and emit an alarm without the need for continuous human monitoring. Since 1993, we have continued to improve our DTS system to make it more user-friendly and to meet other customer expectations.

When a DTS detects an intruder, the control computer automatically generates an alarm and records the first visual frame of the alarm event on its hard disk. The system's video monitor will then display the intruder's track across the camera's field of view. The intruder's track can also be recorded on an optional computer-controlled videocassette recorder or DVR. Each DTS integrated circuit board can monitor up to four cameras, so that by using eight empty card slots, a single computer can be equipped to monitor up to thirty-two cameras. The DTS system is sold for approximately \$10,000 for the first card and tracking graphics overlay card and \$8,000 each for up to seven additional system cards. Elta Electronics Industries Ltd., a subsidiary of IAI, developed the DTS for us.

### The DreamBox

The DreamBox is an 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 network protocols integration.

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

The DreamBox is sold at a substantially lower price than the cost of the other products 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

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CCTV applications.

By developing this product, we enter 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 enter the field of digital video recording, which is only one of the DreamBox's applications out of many.

### 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 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.

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. We continued to make major improvements to MagNet In 2003.

### 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.

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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 System

PipeGuard, our pipeline security system, provides a solution for securing buried assets, gas and oil pipelines and infrastructure of buried communication lines 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.

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

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 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

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

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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

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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.

### Marketing, Sales and Distribution

We have marketed our 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 recent years, we began investing 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 U.S. and China.

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.

Since 1988 until March 31, 2004, an unaffiliated third party held the exclusive right to distribute our taut wire detection systems in the U.S. and Canada. Since March 31, 2004 we distribute our taut wire detection systems in the U.S. through our subsidiary Perimeter Products Inc., or PPI, and an unaffiliated third party who was granted a non-exclusive right to distribute our taut wire detection systems in the U.S., and in Canada through our subsidiary Senstar.

DTS. Since 1993, we have continued to improve our DTS system to make it more user-friendly and to meet other customer expectations. Our marketing efforts for our DTS system includes participation in exhibitions in Europe, South America and the Far East. In the U.S., we distributed the DTS system through an unaffiliated exclusive distributor who was subject to minimum purchase requirements. This distribution agreement was terminated on March 31, 2004. Since March 31, 2004 we distribute our DTS systems in the U.S. and Canada through our subsidiaries PPI and Senstar, respectively.

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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 contact with potential customers. We offer the MagNet, the Fortis and the DreamBox primarily as part of comprehensive turnkey project solutions or, at the customer's preference, as stand-alone products.

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Pipeline Security System. The target market for the pipeline security system includes 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. Our marketing efforts for the personal emergency location systems consist of direct contact with potential customers, mainly to 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.

The following table shows the breakdown of our consolidated revenues for the calendar years 2001, 2002 and 2003 by operating segment:

	Year Ended December 31,		
	2001	2002	2003
	-----	-----	-----
	(In thousands)		
Perimeter.....	\$ 34,893	\$ 36,435	\$51,077
Projects.....	5,004	5,340	6,720
Video monitoring.....	142	238	403
Other.....	981	953	1,161
	-----	-----	-----
	\$ 41,020	\$ 42,966	\$59,361
	=====	=====	=====

### Seasonality

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

- 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, revenues 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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### Customers

The following table shows the geographical breakdown of our consolidated revenues for the calendar years 2001, 2002 and 2003:

	Year Ended December 31,		
	2001	2002	2003
	-----	-----	-----
	(In thousands)		
U.S.....	\$11,358	\$12,641	\$ 13,292
Europe.....	5,420	6,399	10,616
Israel.....	13,135	11,350	20,503
Azerbaijan.....	4,577	756	106
Canada.....	2,035	4,324	6,338
Others.....	4,495	7,496	8,506
	-----	-----	-----
	\$41,020	\$42,966	\$59,361
	=====	=====	=====

For the years ended December 31, 2001, 2002 and 2003, revenues generated from sales to the MOD and the IDF accounted for 22.5%, 15.9% and 27.2%, respectively, of our revenues. For the years ended December 31, 2001, 2002 and 2003 revenues generated from sales to Azal accounted for 10.5%, 1.8% and 0.2%, respectively, of our revenues. We cannot assure you that the MOD, IDF, Azal or any of our other major customers will maintain their volume of business with us or that, if such volume is reduced, other customers generate 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.

Perimeter Security Systems. 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 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, and in 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 tarmac 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

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escape. Our high-security perimeter systems have already been installed in prisons in Australia, Europe, Israel, North America and the Far East.

Ten of our perimeter intrusion detection systems have been approved by the U.S. Department of the Air Force, as part of the \$498 million Force Protection Integrated Base Defense Security System (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. In April and May 2000, the MOD ordered approximately \$9 million of new perimeter security systems from us. We delivered most of these orders during 2000. In March 2001, we won a \$2 million MOD bid to install a new perimeter security system along Israel's borders. In September 2001, we won a \$1.4 million MOD bid to perform restoration work along the Gaza Strip border and a \$500,000 MOD bid to protect the MOD's headquarters. In July 2002, we received a \$1.5 million order from the MOD to install additional perimeter intrusion detection systems along the Gaza Strip border.

In September 2002, we won 80% of the MOD bids for the installation of intrusion detection systems along the seam line between Israel and the West Bank. The MOD bids were for approximately 125 kilometers, or only one third of the total project. We have won bids having a value of approximately \$15 million to install intrusion detection systems along approximately 100 kilometers. In January 2004, we received follow on orders of approximately \$4 million. As of December 31, 2003, approximately 85% of this project was completed and the remainder will be completed in 2004.

In January 2002, Senstar received a \$1 million contract from Public Works and Government Services Canada on behalf of Correctional Service Canada to supply and install over 700 security cameras and video surveillance equipment to 27 correctional facilities across Canada. In April 2002, Senstar signed a second contract worth approximately \$2.2 million to supply and install Senstar's Perimitrax sensor as part of Correctional Service Canada's overall perimeter detection security system at nine of its facilities. Senstar will also provide operational and maintenance training, as well as a quantity of spare parts and test equipment and integration into the existing perimeter intrusion detection system integration units. Installations at six sites, valued at approximately \$1.6 million, were completed during 2002 and the balance of the contract (\$600,000) was completed during 2003. Since April 2002 approximately \$500,000 was added to the value of the original contract for additional work with \$300,000 completed in 2003 and the balance of \$200,000 to be completed in 2004.

In April 2002, we received orders of approximately \$750,000 to protect major sensitive installations in Israel. Revenues from the majority of these orders was reflected in our 2002 financial results, with the reminder reflected on our 2003 financials. The orders were for a number of our security systems, including our vibration intrusion detection system, video motion detection system, CCTV cameras and other security systems, all controlled by our MagNet

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security management system.

In July 2002, we received a \$850,000 order to protect a major correctional facility in Southeast Asia. We are acting as a sub-contractor for Megason Electronics and Tyco, who won the tender for the

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total protection of this facility. Our part in this project includes providing the perimeter security system, which includes taut wire intrusion detection systems, CCTV cameras and video motion detection systems. This order was completed by the end of the first quarter of 2004.

In December 2002, Senstar- Stellar Inc., or SSI, and Senstar signed contracts to supply perimeter intrusion detection systems to correctional facilities in Canada and to a prison in the state of Pennsylvania. The total amount of both contracts is approximately \$2.3 million, of which orders for \$500,000 were executed in 2002. Senstar will design, supply, install and test its Intelli-Flex fence disturbance systems at twelve Correctional Service Canada institutions located across Canada and will also provide operational and technical training. The Intelli-FLEX sensors will be integrated into the existing perimeter intrusion detection system (PIDS) integration unit. As of December 31, 2003, 90% of this project has been completed and the balance was completed by March 31, 2004.

In August 2003, Senstar Stellar Latin America, our fully owned Mexican subsidiary, received an order of approximately \$1.5 million to install a perimeter security system at sensitive installations in Mexico. As of December 31, 2003, 95% of this project had been completed and the balance was completed by March 31, 2004.

In January 2004, we received a \$700,000 order from the Israeli Prisons Authority, to install a perimeter intrusion detection system around one of the largest prisons in Israel. The order is expected to be completed by the end of the third quarter of 2004. The order includes installation of our perimeter intrusion detection systems, as well as cameras, digital video recording and other security systems, all controlled by our MagNet security management system.

Our fully owned U.S. based subsidiaries, PPI, and SSI, supplied \$4.2 million of products to Homeland Security contractors in 2003 for the protection of various governmental and military sites throughout the United States.

DTS. We are currently focusing our efforts on attracting customers through upgrading outdoor systems that are currently installed at prisons, factories, government buildings and other security-conscious installations. In addition to our traditional customers, customers of this product include private companies and utilities companies such as refineries and electric power stations.

Security Management and Control Systems and Turnkey Projects. Since its introduction, we have sold our security management system and provided turnkey projects to several customers, including large international companies.

In December 1999, we signed an approximately \$5.7 million agreement (including interest) with Azal to protect its international airport in Azerbaijan. We have received \$4.2 million in installment payments under this agreement and will receive the remaining installments according to a predetermined schedule. According to this agreement we are scheduled to receive payments of approximately \$1.3 million in 2004 and \$0.2 million in 2005.

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In March 2000, we received a \$2.7 million order to protect a large industrial facility in India. This order constituted the first stage of a comprehensive security installation for this facility and included a variety of our security systems, all controlled by MagNet. During 2000 and 2001, we received an aggregate of approximately \$800,000 in additional orders.

Since May 2002 we have received orders to protect communication facilities in India totaling \$6 million. We completed 95% of the orders by the end of 2003 and the balance will be completed in

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2004. These orders constitute part of a comprehensive security installation program and follows \$3.5 million in orders executed for a sister company of the same Indian concern.

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. This contract, including the extension, is expected to be completed by the end of 2005.

Video Monitoring Services. We have sold our video monitoring services to banks and various retail operations.

Personal Emergency Location Systems. In 2003, a contract from the State of Michigan, for eight correctional facilities, valued at approximately \$0.6 million was assigned to PPI through our purchase of the business activity of Dominion Wireless Inc. At the end of 2003, 23% of the project was completed. We expect the remainder to be completed by December 2004.

### Recent Developments

In July 2003, PPI acquired the business activity of Dominion Wireless, Inc. for approximately \$902,000. Dominion Wireless develops, produces and manufactures a product that delivers high reliability personal portable duress alarm systems to protect personal in correctional facilities. As of December 31, 2003, the total purchase price was fully paid in cash. Dominion Wireless, Inc. will be entitled over the next two and a half years to an "earn out" of 50% of the operating income related to the acquired activity. When the contingency is resolved and additional consideration, if any, is distributable, we will record the amounts as additional consideration for the acquisition.

During 2002 and 2003, we developed the Fortis command and control system, a fully integrated system that supports decision making and wide-area command and control in real time. The system creates a unified and interactive intelligence picture by drawing data from all sensors showing the displacement of ground forces and adding other relevant information such as video from different sources, auxiliary services and weather conditions. This combined picture, constantly updated, is sent by central command to all forces in the command chain and serves as a uniform basis for operational planning and allocation of tasks. The beta site has been operating successfully since March 2003.

In 2003, we developed the PipeGuard pipeline security system, which

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provides a solution for securing buried assets and infrastructure, including oil and gas pipelines and buried communication lines such as fiber optic cables. PipeGuard utilizes an innovative new 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. Target markets include oil and gas companies, owners and operators of pipelines or communication cables and governmental agencies dealing with security and environment.

During 2002 and 2003, we developed DreamBox, 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 network protocols integration.

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

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The DreamBox is sold for a substantially lower price than the cost of the other products 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 enter 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 enter the field of digital video recording, which is only one of the DreamBox's applications out of many.

### 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,

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many miles of perimeter systems need to be replaced each year.

During 2003, we derived less than 5% 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 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 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.

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Our research and development expenses during 2001, 2002 and 2003 were approximately \$3,331,000, \$3,750,000 and \$5,128,000, 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 8.3%, 16.6% and 6.9%. 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, PPI develops our microphonic fence sensors as well as our microwave detection, personal alarm and small/medium end 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.

We seek co-financing of our development projects from the OCS. Through 2003, we had obtained grants from the OCS of \$128,000 for certain of our research and development projects. We are obligated to pay royalties to the OCS, amounting to 3%-5% of revenues derived from sales of the products funded with these grants, 100% - 150% of the grants received, linked to the U.S. dollar and grants received after January 1, 1999 will also bear interest at the rate of

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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 \$0, \$131,000 and \$80,000 in the years ended December 31, 2001, 2002 and 2003, respectively.

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 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. Grants received for the years up to and including 2003 amounted to \$253,000 and royalties paid during 2001, 2002 and 2003 amounted to \$104,000 \$53,000 and \$0, respectively. As of December 31, 2003, the aggregate contingent obligation amounted to \$96,000.

### Backlog

As of May 31, 2004, our backlog amounted to approximately \$30 million of which approximately \$16 million is expected to be delivered by the end of 2004 and \$8 million is expected to be delivered by the end of 2005 and \$6 million is expected to be delivered thereafter.

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### 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 Yahud, 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. The triboelectric sensor cable for Senstar's Intelli-FLEX product is obtained from a sole supplier. If this sole

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supplier were to discontinue production of the triboelectric sensor cable, it would adversely affect Senstar's revenues of its Intelli-FLEX product.

PPI's manufacturing operations are located at its facility in Fremont, California and consist of development and design, assembly, quality control and final testing. PPI 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., 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 and Siemens AG and Bosch.

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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 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:



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- 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

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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.

Name of Subsidiary -----	Country of Incorporation -----
Senstar-Stellar Corporation	Canada
Perimeter Products Inc.	United States
Senstar-Stellar Inc.	United States
Senstar GmbH	Germany

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Kobb Inc.	United States
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
E.S.E. Ltd.	Israel
Magal Security Systeme S.R.L	Romania (incorporated in April 2003)

### D. Property, Plants and Equipment

Our two-story 2,533 square meter plant is located on a 4,352 square meter parcel in the Yahud 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

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procedure is a statutory requirement 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.

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. Senstar also leases ten acres of land near this facility that is used as an outdoor sensor test and demonstration sites 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, Flair and Flash, and various perimeter monitoring and control systems.

PPI owns a 20,000 square foot facility in Fremont, California. The products that PPI 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 physical plant in Israel by each of Bank Leumi Israel and Union Bank of Israel, each of which ranks pari-passu with the other. In addition, PPI has granted its mortgage lender a first mortgage on its premises.

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 could obtain such facilities at commercially reasonable rates.

### ITEM 5. Operating and Financial Review and Prospects

#### A. Operating Results

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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."

### General

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

### Economic and Other Factors

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Following the terrorist attacks of September 11, 2001, heightened global security concerns have increased the demand for products such as ours, which protect aircraft, national borders and sensitive facilities from terrorism, and we have experienced an increase in inquiries from prospective customers regarding our products. Although we expect demand for our products to increase, because our products are primarily sold to government agencies, government authorities and government-owned companies, many of which have complex and time-consuming procurement procedures, we may not make major sales of our products and may not experience a significant increase in our revenues until, at the earliest, the end of 2004.

In addition, 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. To date, we have won bids having a value of approximately \$19 million to install intrusion detection systems along approximately 150 kilometers. As of December 31, 2003, approximately 85% of this project was completed and the remainder will be completed in 2004. In 2003, the Israeli Government resolved to extend the perimeter system and to build it along 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 the 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. We cannot assure you that Israel will follow through with its decision to build the perimeter system along the seam-line, or if such perimeter system is constructed or rebuilt, that our products will be utilized in its construction.

During 2003, we incurred losses relating to the start-up of the operations of Smart.

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### 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 strengthen presence in existing markets; and
- o offering our comprehensive turnkey solutions.

### 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.

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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 revenues mainly from long-term projects and also from sales of products and rendering maintenance services. Revenues from long-term projects are recognized in accordance with Statement of Position 81-1 "Accounting for Performance of Construction - Type and Certain Production - Type Contracts ("SOP 81-1"), using contract accounting on a percentage of completion method, based on the relationship of actual costs incurred to total costs estimated to be incurred over the duration of the contract and in accordance with the "Input Method." 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. As of December 31, 2003, no such estimated losses were identified.

We apply contract accounting for the following reasons:

- o projects for construction of perimeter systems require planning, development, manufacture and installation of the perimeter system, in accordance with the customer's security requirements; and
- o the project includes various components, e.g. planning of the perimeter system in accordance with technical specifications,

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manufacture of the perimeter system, installation of the perimeter system on-site and installation of electronic parts on-site.

According to ("SOP 81-1"), costs that are incurred for a specific anticipated contract are being deferred, subject to evaluation of their probable recoverability, and only if the costs can be directly associated with a specific anticipated contract.

Revenues from products are recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition," ("SAB No. 104"), when the following criteria are met: persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable and collection is probable.

Deferred revenues include unearned amounts received under maintenance contracts but not yet recognized as revenues.

In November 2002, Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 are applied to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Additionally, companies will be permitted to apply the consensus guidance in this issue to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, "Accounting Changes." The adoption of EITF Issue No. 00-21 did not have a material impact upon our financial position, cash flows or results of operations.

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Management's judgment is required to determine the percentage of completion based on the output measure of the portion of work performed, to match expenses to revenues and to estimate future expenses in order to estimate the provisions for estimated losses on uncompleted contracts.

### Inventories

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, technological obsolescence, excess inventories, discontinued products, and for market prices lower than cost. Management's judgment is required to determine the reserve for obsolete or excess inventory. Inventory on hand may exceed future demand either because the product is outdated, or obsolete, or because the amount on hand is more than can be used to meet future need. We provide for the total value of inventories that we determine to be obsolete based on criteria such as customer demand and changing technologies.

During 2001, 2002 and 2003, we recorded inventories write-offs in a total amounts of \$808,000 \$244,000 and \$601,000, respectively.

Inventory cost is determined as follows:

- o raw materials, parts and supplies - using the "first in, first out" method;

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- o work-in-progress - represents the cost of development in progress; and
- o finished products - on the basis of direct manufacturing cost with the addition of allocable indirect manufacturing costs.

### Income taxes

We account for income taxes in accordance with Statement of Financial Accounting Standard No. 109 "Accounting for Income Taxes," or SFAS No. 109. 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, 2003, our deferred tax asset was \$1.3 million. Our subsidiaries in the U.S., United Kingdom and Mexico have estimated total available carryforward tax losses of \$4,002,000, \$582,000 and \$77,000 respectively, to be offset against future taxable profit for 20 years, an indefinite period and 10 years, respectively. As of December 31, 2003, we recorded a deferred tax asset of approximately \$1.8 million, relating to the

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available net carryforward tax losses. A valuation allowance of \$1.7 million was recorded due to the uncertainty of the tax assets' future realization.

### Goodwill

Goodwill represents excess of the costs over the net fair value of the assets of the businesses acquired. Goodwill that arose from acquisitions prior to July 1, 2001 was amortized until December 31, 2001 on a straight-line basis over a period of 15 years. Under SFAS No. 142, goodwill acquired in a business combination on or after July 1, 2001 will not be amortized.

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 and market capitalization.

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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.

SFAS No. 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase (if necessary) measures the impairment. We completed our first phase impairment analysis related to the adoption of SFAS 142 and found no instances of impairment of our recorded goodwill.

As of December 31, 2003 the goodwill amounted to \$4,145,000.

Impairment of long lived assets:

Our long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long- Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. During the years ended December 31, 2001, 2002 and 2003, no impairment losses were recognized.

Financial statements in U.S. dollars

The majority of our revenues are generated in U.S. dollars. We believe that the U.S dollar is the primary currency of the economic environment in which we operate. Accordingly, we and certain of our subsidiaries use the U.S. dollar as our functional and reporting currency. Therefore, monetary accounts maintained in currencies other than the U.S dollar are remeasured into U.S. dollars in accordance with Statement of the Financial Accounting Standards Board ("FASB") 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.

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The financial statements of certain foreign subsidiaries whose functional currency is not the dollar, have been translated into U.S. 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 (loss) of approximately (\$1) million and \$1.3 million that were included as part of "accumulated other comprehensive income (loss)" within our balance sheet at December 31, 2002 and 2003, respectively. During 2001, 2002 and 2003, foreign currency translation income (loss) of (\$579,000), \$288,000 and \$2,292,000, respectively, were included under "accumulated other comprehensive income (loss)." Had we determined that the functional currency of our subsidiaries was the dollar, these gains (loss) would have increased (decreased) our income for

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each of the years presented.

### Concentrations of credit risk

Financial instruments that potentially subject us and our subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, short and long-term bank deposits, trade receivables and long-term trade receivables.

Our cash and cash equivalents, short-term and long-term bank deposits are invested in major Israeli and U.S. banks. Such deposits in U.S. banks 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 trade receivables 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.

### Derivative instruments

Financial Accounting Standards Board Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), requires companies 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, we 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.

For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the same line item associated with the hedged item in current earnings during the period of the change in fair values. For

derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings.



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To protect against changes in the value of forecasted foreign currency translations and balances, we have instituted a foreign currency hedging program. We hedges portions of our forecasted cash flows and balances denominated in foreign currencies with forward contracts.

During 2003, we entered into forward contracts to hedge a portion of our Euro revenues. These forward contracts are designated as cash flows hedges, as defined by SFAS No. 133, as amended, and we believe are effective as a hedge for these revenues. The effective portion of the gain or loss on derivative instruments that hedge future revenues is included in revenues and in financial expenses in our statement of income.

As of the year ended December 31, 2003, the total losses on derivative instruments were \$278,000, of which \$178,000 was recorded in revenues, and \$100,000 was recorded in financial expenses. As of December 31, 2003, the unrealized losses on forward contracts amounted to \$950,000.

Fair value of financial instruments:

The following methods and assumptions were used by us and our subsidiaries in estimating their fair value disclosures for financial instruments:

- o The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables and other accounts receivable, short-term bank credit, trade payables and other payables approximate their fair value due to the short-term maturity of such instruments.
- o The carrying amount of our long-term trade receivables and long-term deposits approximate their fair value. The fair value was estimated using discounted cash flow analyses, based on our investment rates for similar type of investment arrangements.
- o Long-term loans are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. As of December 31, 2002 the carrying amount of the our long-term borrowing approximate its fair value. As of December 31, 2003 the fair value of the our long-term borrowing was \$5.6 million, compared to the carrying amount of \$5.7 million.

### Results of Operations

Due to the nature of our customers and products, our revenues are often made pursuant to 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

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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:

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	Year Ended December 31,				
	1999	2000	2001	2002	2003
Revenues.....	100%	100%	100%	100%	100%
Cost of revenues.....	53	53	52	56	56
Gross profit.....	47	47	48	44	44
Operating expenses:					
Research and development expenses, net...	8	8	8	7	8
Sales and marketing, net.....	18	18	19	20	20
General and administrative.....	13	12	12	11	9
Operating income .....	8	9	9	6	7
Financial income (expenses), net.....	-	(1)	-	-	(2)
Income before taxes on income and write-off of investment in affiliate, net of taxes.....	8	8	9	6	5
Taxes on income.....	1	1	1	2	1
Income before write-off of investment in affiliate.....	7	7	8	4	4
Write-off of investment in affiliate, net of taxes.....	(1)	-	-	-	-
Net income.....	6%	7%	8%	4%	4%

Years ended December 31, 2003 and 2002

Revenues. Revenues increased by 38% to \$59.4 million in the year ended December 31, 2003, compared with \$43 million in the year ended December 31, 2002. Revenues from sales of perimeter systems in 2003 were \$51.1 million compared to \$36.4 million in 2002, an increase of 40%. Revenues from security turnkey projects increased by 26% to \$6.7 million in 2003, compared with \$5.3 million in 2002. Our main projects in 2003 included the installation of intrusion detection systems along the seam line between Israel and the West Bank and the protection of the Otopeni International Airport in Romania. The devaluation of the U.S. dollar against the Canadian dollar and the NIS increased the revenues that are linked to those currencies in terms of U.S. dollars. Based on our backlog and estimations, we anticipate that our revenues will increase in 2004.

Cost of revenues. Cost of revenues reached \$33.4 million in the year ended December 31, 2003, compared with \$23.9 million in the year ended December 31, 2002. Cost of revenues as a percentage of revenues was 56% in 2003, remained at the same level as in 2002. We anticipate that our cost of revenues as a percentage of revenues will remain at the same level in 2004.

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

Research and development expenses, net. Research and development expenses, net for the year ended December 31, 2003 were \$4.8 million, compared to \$3.1 million for the year ended December 31, 2002, an increase of 53%. Research and development expenses, net amounted to 8% of revenues in 2003, compared to 7% in 2002. Royalty bearing grants and investment tax credits decreased to \$355,000 in 2003 compared to \$622,000 in 2002 due to the decrease of royalty bearing grants received from OCS. The increase in our research and development expenses was attributed to our development of three new products that we launched in the beginning of 2004. We expect that our net research and development expenses will increase in 2004 in connection with the continuation of the development of our products.

Sales and marketing expenses, net. Sales and marketing expenses, net were \$11.6 million for the year ended December 31, 2003 compared to \$8.6 million for the year ended December 31, 2002, an increase of 34%. The increase in sales and marketing expenses in 2003 was primarily due to the increase in our revenues. Sales and marketing expenses amounted to 20% of revenues in both 2003 and 2002. To the extent our revenues will increase in 2004, we expect that our sales and marketing expenses will continue to increase in 2004.

General and administrative expenses. General and administrative expenses were \$5.3 million for the year ended December 31, 2003 compared to \$4.9 million for the year ended December 31, 2002. General and administrative expenses amounted to 9% of revenues in 2003, compared to 11% in 2002. We expect that our general and administrative expenses will remain at the same level in 2004.

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

Years ended December 31, 2002 and 2001

Revenues. Revenues increased by 5% to \$43 million in the year ended December 31, 2002 compared with \$41 million in the year ended December 31, 2001. Revenues from sales of perimeter systems in 2002 were \$36.4 million compared to \$34.9 million in 2001, an increase of 4%. Revenues from security turnkey projects increased by 7% to \$5.3 million in 2002 compared with \$5.0 million in 2001.

Cost of revenues. Cost of revenues reached \$23.9 million in the year ended December 31, 2002 compared with \$21.5 million in the year ended December 31, 2001. Cost of revenues as a percentage of revenues was 56% in 2002, as compared to 52% in 2001, due to a different mix of revenues in each year.

Gross profit. Gross profit for the year ended December 31, 2002 was \$19.0 million compared to \$19.5 million for the year ended December 31, 2001. Gross profit as a percentage of revenues decreased to 44% in 2002 compared with 48% in 2001, due to a different mix of revenues in each year.

Research and development expenses, net. Research and development expenses, net for the year ended December 31, 2002 were \$3.1 million for the two years ended December 31 2001 and 2002.

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Research and development expenses, net amounted to 7% of revenues in 2002 compared to 8% in 2001. Royalty bearing grants and investment tax credits increased to \$622,000 in 2002 compared to \$277,000 in 2001, due to an increase in grants received from the OCS.

Sales and marketing expenses, net. Sales and marketing expenses, net were \$8.6 million for the year ended December 31, 2002 compared to \$7.9 million for the year ended December 31, 2001, an increase of 9%. Sales and marketing expenses amounted to 20% of revenues in 2002 compared with 19% in 2001. The increase in sales and marketing expenses in 2002 was primarily due to an increase expenses incurred in connection with establishing Smart.

General and administrative expenses. General and administrative expenses were \$4.9 million for the year ended December 31, 2002, substantially unchanged from the year ended December 31, 2001. General and administrative expenses amounted to 11% of revenues in 2002 compared to 12% in 2001.

Financial income, net. Financial income, net for the year ended December 31, 2002 was \$199,000 compared to income of \$40,000 for the year ended December 31, 2001.

### Seasonality

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

- 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, revenues are often postponed from the first quarter to subsequent quarters.

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

The dollar cost of our operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is not offset, or is offset on a lagging basis, by a devaluation of the NIS in relation to the dollar. When the rate of inflation in Israel exceeds the rate of devaluation of the NIS against the dollar, companies experience increases in the dollar cost of their operations in Israel. Unless offset by a devaluation of the NIS, inflation in Israel will have a negative effect on our profitability, as we receive payments in dollars or dollar-linked NIS for a portion of our revenues, while we incur a portion of our expenses in NIS.

In addition, since part of our revenues are quoted in NIS, and a portion of our expenses are incurred in NIS, our results may be adversely affected by a change in the rate of inflation in Israel if the amount of our revenues in NIS decreases and is less than the amount of our expenses in NIS (or if such decrease is offset on a lagging basis) or if such change in the rate of inflation is not offset, or is offset on a lagging basis, by a corresponding devaluation of the NIS against the dollar and other foreign currencies.

The following table presents information about the rate of inflation in Israel, the rate of devaluation of the NIS against the dollar, and the rate of inflation in Israel adjusted for the devaluation:

Year ended December 31, -----	Israeli inflation rate % -----	NIS devaluation rate % -----	Israeli inflation adjusted for devaluation % -----
1999	1.3	(0.2)	1.5
2000	0	(2.7)	2.7
2001	1.4	9.3	(7.9)
2002	6.5	7.3	(0.8)
2003	(1.9)	(7.6)	5.7

A devaluation of the NIS in relation to the dollar has the effect of reducing the dollar amount of any of our expenses or liabilities which are payable in NIS, unless those expenses or payables are linked to the dollar. This devaluation also has the effect of decreasing the dollar value of any asset which consists of NIS or revenues payable in NIS, unless the receivables are linked to the dollar. Conversely, any increase in the value of the NIS in relation to the dollar has the effect of increasing the dollar value of any unlinked NIS assets and revenues and reducing the dollar amounts of any unlinked NIS liabilities and expenses.

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 2003, foreign currency fluctuations had a material adverse impact on our results of operations, and financial expenses, net were \$1.0 million. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

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

As of the year ended December 31, 2003, the total losses on derivative instruments were \$278,000, of which \$178,000 was recorded in revenues, and \$100,000 was recorded in financial expenses. As of December 31, 2003, the unrealized losses on forward contracts amounted to \$950,000.

#### Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. 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. There is no indication as to how long the current hostilities will

last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of countries that restrict business with Israel or Israeli companies.

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Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

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

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

#### Economic Conditions

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

#### Trade Agreements

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

Israel and the European Union Community concluded a Free Trade Agreement in July 1975 which confers certain advantages on Israeli exports to most European countries and obligates Israel to lower its tariffs on imports from

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

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### Effective Corporate Tax Rate

Israeli companies are generally subject to tax at the rate of 36% of taxable income. However, certain of our manufacturing facilities have been granted "Approved Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended, commonly referred to as the Investment Law, and, consequently, are eligible, subject to compliance with specified requirements, for tax benefits beginning when such facilities first generate taxable income. The tax benefits under the Investment Law are not available with respect to income derived from products manufactured outside of Israel. We have derived, and expect to continue to derive, a substantial portion of our income from our Approved Enterprise facilities. Subject to certain restrictions, we are entitled to a tax exemption in respect of income derived from our approved facilities for a period of two to four years, commencing in the first year in which such income is earned, and will be entitled to a reduced tax rate of 15% for an additional 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, rather than eight, years.

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

As of December 31, 2003, our subsidiaries in the U.S., Mexico and the United Kingdom had total net available carry forward tax losses of approximately \$4.7 million. A valuation allowance of \$ 1.7 million 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

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

Our working capital at December 31, 2003 was \$21.4 million compared to \$15.7 million at December 31, 2002. Cash and cash equivalents amounted to \$4.4 million at December 31, 2003 compared to \$2.5 million at December 31, 2002. Short and long-term bank deposits (including restricted bank deposits) amounted to \$12.1 million at December 31, 2003 compared to \$12.4 million at December 31, 2002. Our cash and cash equivalents, short and long-term bank deposits 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, and our expected cash flow from operations in 2004 will be sufficient to meet our planned and potential cash requirements in 2004.

We expect to fund our long-term liquidity needs, including contractual obligations and anticipated capital expenditures, from our cash and cash equivalents, operating cash flow and our credit facilities.

Net cash provided from operating activities was \$1.8 million for the year ended December 31, 2003 compared to net cash used from operating activities of \$0.4 million and \$2.5 million for the years ended December 31, 2001 and 2002, respectively. The increase in cash from operations was primarily due to a decrease in unbilled accounts receivable, a decrease in long term trade receivables and an increase in other payables, accrued expenses and trade payables. During 2003, we experienced \$1.9 million in losses attributable to the start-up of operations of Smart. We expect that Smart will operate on a breakeven basis by the end of 2004.

Purchases of property and equipment in 2001, 2002 and 2003 were \$1.2 million, \$1.5 million and \$3.2 million, respectively. Capital expenditures in 2001, 2002 and 2003 were principally for equipment for Smart, computers and other machinery and equipment. We estimate that our capital expenditures for 2004 will total approximately \$6.5 million, of which 7% will be spent in Israel, 92% in the U.S. and Canada and 1% in other countries. As of May 31, 2004, we have spent approximately 30% of this amount. 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 2004 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. See Item 3.D. "Key Information-Risk Factors."

Credit Lines and Other Debt



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We currently have credit lines with Bank Leumi Israel, Union Bank of Israel and Bank Hapoalim Israel totaling \$19.8 million in the aggregate. There are no restrictions as to our use of each of these credit lines. We agreed not to pledge any of our assets without the consent of these banks. In addition, in connection with two of these credit lines, a fixed charge was placed on our physical plant in Israel by each of Bank Leumi Israel and Union Bank of Israel, each of which ranks pari-passu with the other.

We have undertaken to maintain the following financial ratios and terms in respect of our credit lines with each of Bank Leumi Israel and Union Bank of Israel:

- o A ratio of at least 40% of shareholders' equity out of the total assets;
- o Minimal annual net income in the amount of \$1 million; and
- o That the same shareholders maintain the core control in our company.

As of December 31, 2003, we were in compliance with these ratios and terms. These two 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 if we fail to fulfill our undertakings. Our loans under these credit lines are generally denominated in U.S. dollars. However, we may occasionally have short-term NIS-denominated loans.

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In addition, our subsidiaries currently have credit lines with Bank Leumi USA, Royal Bank of Canada and Deutsche Bank totaling \$8.0 million in the aggregate.

As of December 31, 2003, we had approximately \$3.5 million available under our credit lines. In addition, our subsidiaries have approximately \$0.2 million available under their credit lines.

As of December 31, 2003, we had outstanding under our credit lines:

- o short-term NIS-denominated loans of approximately \$6.6 million, bearing interest at a rate of 6.83%;
- o short-term dollar-denominated loans of approximately \$4.3 million, bearing interest at a rate of 2.68%-3.06%. Interest on the outstanding balance is due each quarter;
- o several bank performance and advance payment guarantees totaling approximately \$3.6 million, at an annual cost of 0.5 %-1.0 %; and
- o forward contracts of approximately \$1.7 million.

As of December 31, 2003, Senstar had outstanding, in the aggregate, short-term Canadian \$ denominated loans of \$1.7 million, bearing interest at a rate of Canadian Prime plus 0.5% (5.01% at December 31, 2003). This loan is collateralized by a general security agreement.

As of December 31, 2003, our subsidiaries had outstanding, in the aggregate, \$5.7 million in long-term loans as follows:

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- o \$2.5 million, bearing interest at an annual rate of 4.60%. The interest on the outstanding balance under this loan is due monthly. This loan is due in one installment in April 2004;
- o \$250,000, bearing interest at an annual rate of 4.60%. The interest on the outstanding balance under this loan is due quarterly. This loan is due in one installment in April 2004;
- o \$500,000, bearing interest at an annual rate of 5.662% and collateralized by PPI's assets. The interest on the outstanding balance under this borrowing is due quarterly, with the principal due in one installment in April 2004;
- o \$500,000, bearing interest at an annual rate of 2.875% and collateralized by PPI's assets. This loan is due in one installment in April 2004; and
- o \$1.96 million mortgage loan to PPI bearing interest at a fixed rate of 8.25%. The mortgage is due in 18 quarterly installments of \$64,700, commencing February 2001, with a final payment of approximately \$1.8 million due in November 2005. In connection with this mortgage loan, PPI has granted the bank a first mortgage on its premises. In addition, we have guaranteed the full amount of this mortgage loan.

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In connection with our non-mortgage related loans listed immediately above, Bank Leumi USA placed a \$3.25 million fixed charge on our deposits with that bank.

As of December 31, 2003, Senstar GmbH obtained bank performance guarantees in the amount of \$ 153,000.

As of December 31, 2003, Senstar issued a letter of credit in the amount of \$278,000 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. Through 2003, we had obtained royalty bearing grants from the OCS of \$128,000 for certain of our research and development projects. We are obligated to pay royalties to the OCS, amounting to 3%-5% of revenues derived from sales of the products funded with these grants, 100% - 150% of the grants received, linked to the U.S. dollar and grants received after January 1, 1999 will also bear interest at the rate of LIBOR. The obligation to pay these royalties is contingent on actual sales of the products, and in the absence of such sales no payment is required.

We paid royalties of \$0, \$131,000 and \$80,000 in the years ended December 31, 2001, 2002 and 2003, respectively.

As of December 31, 2003, we had a remaining contingent obligation to pay royalties in the amount of approximately \$1.7 million upon the successful sale of products developed using such research and development programs sponsored by

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the Chief Scientist.

The Israeli Government, through the Fund for the Encouragement of Marketing Activities, awarded us grants for overseas marketing expenses. We are obligated to pay royalties to this fund at the rate of 3% of the increase in export sales, up to the amount of the grants we received. To date, we received \$253,000 in grants from the fund and, during 2001, 2002 and 2003, we paid the fund \$104,000, \$53,000 and \$0, respectively, in royalties. As of December 31, 2003, we had a remaining contingent obligation to the fund of \$96,000.

### Investment Tax Credit

Senstar is eligible for investment tax credits on its research and development activities and on certain current and capital expenditures. During 2001, 2002 and 2003, Senstar recognized \$277,000, \$304,000 and \$216,000, respectively, of investment tax credits as a reduction of research and development expenses.

Senstar has available investment tax credits of approximately \$525,000 to reduce future federal income taxes payable. These credits will expire at various dates from 2006 through 2012.

See also Item 4.B. "Information on the Company-Business Overview-Research and Development; Royalties."

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### 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 Item 5.A. "Operating and Financial Review and Prospects-Operating Results" and Item 5.B. "Operating and Financial Review and Prospects-Liquidity and Financial Resources."

### E. Off-Balance Sheet Arrangements

At December 31, 2003, we have guaranteed the advance payments and the performance of our work to our customers (usually government entities). Such guarantees are required by contract for our performance during the installation and operational period of projects throughout Israel and the rest of the world. The guarantees for installation typically expire soon after certain milestones are met and guarantees for operations typically expire proportionally over the contract period. Our maximum potential amount of future payments we could be required to make under our guarantees at December 31, 2003 was \$3.7 million. This figure includes guarantees of performance for our subsidiary in Germany in the amount of \$153,000. We have not recorded any liability for such amounts, as we expect that our performance will be acceptable and to date, no guarantees were exercised against us.

### F. Tabular Disclosure of Contractual Obligations

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The following table summarizes our minimum contractual obligations and commercial commitments, including obligations of discontinued operations, as of December 31, 2003 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	1-3 Years	3-5 Years	more than 5 years
Long-term debt obligations.....	\$5,714	\$3,841	\$1,873	\$-	\$-
Capital (finance) lease obligations	-	-	-	-	-
Operating lease obligations.....	1,084	357	628	99	-
Purchase obligations.....	-	-	-	-	-
Other long-term liabilities reflected on the company's balance sheet under U.S. GAAP ...	-	-	-	-	-
<b>Total.....</b>	<b>\$6,798</b>	<b>\$4,198</b>	<b>\$2,501</b>	<b>\$99</b>	<b>\$-</b>

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### ITEM 6. Directors, Senior Management and Employees

#### A. Directors and Senior Management

Our directors and executive officers are as follows:

Name	Age	Position
Jacob Even-Ezra.....	73	Chairman of the Board and Chief Executive Officer
Izhar Dekel.....	52	President and Director
Brig. Gen. (Ret.) Emanuel Shaked..	74	Vice President - Africa and Latin America Marketing
Chaim Porat.....	68	Vice President - Far East and Australia Marketing
Yehezkel Farber.....	63	Vice President - Operations
Zvi Dank.....	54	Vice President - Research and Development
Raya Asher.....	36	Vice President - Finance, Chief Financial Officer, Secretary and Director
Asaf Even-Ezra.....	38	Vice President - Israel and West European Marketing
Dany Pizen.....	52	Vice President - East European and CIS Marketing
Ofer Katz.....	55	Vice President - Aviation Security
Nathan Kirsh.....	72	Director
Jacob Nuss.....	56	Director
Jacob Perry .....	60	Director
Menachem Meron.....	76	External Director
Itzhak Hoffi.....	77	External Director

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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. All questions that arise at meetings of the board of directors are decided by majority vote. In the event of a tie, the chairman of the board casts the deciding vote. All directors, other than external directors who serve for three years, hold office until the next annual general meeting of shareholders and until their successors have been elected. Officers serve at the discretion of the board of directors, subject to the terms of any agreement between them and us and the provisions of the Israeli Companies Law, 5739-1999, known as the Companies Law.

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 is a beneficial owner of 18.5% of the ordinary shares of our company held by Mira Mag Inc.

Izhar Dekel has served as our president since 1990. He became a director in 1993. Mr. Dekel served as our finance manager from 1984 to 1990.

Brigadier-General (Ret.) Emanuel Shaked has been our vice president-Africa and Latin America marketing since 1986. Before joining us, Mr. Shaked served as the head of the Operations Department of the IDF, head of special operations, and commander-in-chief of the Paratroop Corps.

Chaim Porat has been our vice president- Far East and Australian marketing since 1988. Prior to joining us, Mr. Porat worked for Beta Engineering Ltd. as the head of its security division.

Yehezkel Farber has been our vice president- operations since 1986. Previously Mr. Farber was the manager of the customer systems department of IAI.

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Zvi Dank has been vice president- research and development with us and our predecessor since 1984. Before joining us, Mr. Dank worked as an electronic engineer in the electronics division of IAI.

Raya Asher joined us in 1998 as vice president-finance, chief financial officer and secretary. Ms. Asher was elected to serve as a director in 2001. 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 out auditors, Kost Forer Gabbay & Kasierer, Certified Public Accountants in Israel, a Member of Ernst & Young Global. Ms. Asher has a M.B.A. in business and a B.A. in accounting and economics from Tel Aviv University.

Asaf Even-Ezra joined us in 1995 and has been our vice president- Israel and West European marketing since 1998. Mr. Even-Ezra also heads our video motion detection division.

Dany Pizen joined us in 1997 as vice president- East European and CIS marketing. 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, where he was a Lt. Colonel.

Ofer Katz joined us in 1984. Before becoming our vice president-

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aviation security in 1995, he served in our software and computer development department as manager of our production line and in operations and special projects.

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 Euron Foundation, the beneficial owner of 81.5% of the total ordinary shares of our company held by Mira Mag Inc.

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. Since 1975, Mr. Nuss has served in various financial management capacities at IAI. IAI is a former shareholder in our company.

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 at 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 executive personal of many public organizations. Mr. Perry is also a Chairman of the Board of Directors of various companies, including Mizrahi Bank B.M., Lipman Electronic Engineering Ltd. and Aeronautics Defense Systems Ltd. Mr. Perry also acts as an advisor to Cellguide Ltd.

Menachem Meron has served as an external director as of June 2001 and as a director since 1993. Since 1988 Mr. Meron has been the general manager of IFTIC Ltd., an international consulting company. Mr. Meron provide consulting services to Solomon Smith Barney, Citigroup, Lockheed Martin and Northrop Grumman Corporation. Mr. Meron currently serves on the boards of directors of the following companies, PAZ Lubricants and Chemicals Co. Ltd., Polar Investments Ltd., and Supercom Ltd. Mr. Meron, a retired Major General of the IDF, has previously served as the director general of the Israeli Ministry of Defense.

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Itzhak Hoffi has served as an external director as of June 2001 and as a director since December 1996. Mr. Hoffi is also a member of the boards of directors of various companies, including: Palram Industries (1990) Ltd. and Bank Leumi Le Israel Ltd. From 1994 until 2000, and since May 2002, Mr. Hoffi has served as chairman of the board of Tadiran Ltd. From 1982 to 1990, Mr. Hoffi served as general manager of the Israel Electric Corporation Ltd. From 1974 until 1982, Mr. Hoffi was the head of the Mossad, Israeli's secret intelligence service.

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 the relationships between Jacob Even-Ezra, Asaf Even-Ezra and Izhar Dekel, there are no other family relationships among our directors and senior executives.

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Shlomo Yanai, who served as our director from January 2003, resigned in June 2004.

### B. Compensation

During the fiscal year ended December 31, 2003, 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, for 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 external 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 Companies Law, the board of directors must approve all compensation arrangements for the CEO 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 CEO's approval. Directors' compensation arrangements (other than external directors) also require audit committee approval before board approval and shareholder approval. However, pursuant to recent 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.

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

During 2003, we did not grant any options to purchase ordinary shares to 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.

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### C. Board Practices

We are subject to the provisions of the Companies Law, which became effective on February 1, 2000, superseding most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983. The Companies Law authorizes the Minister of Justice to adopt regulations exempting from the provisions described below companies, such as us, whose shares are traded both in Israel and outside of Israel.

#### Appointment of Directors and Term of Office

Our directors, other than our external directors as described below, are appointed by our shareholders at our annual general meeting and hold office

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until the next annual general meeting. 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. Our officers serve at the discretion of the board of directors, subject to the terms of any agreement between them and us and the provisions of the Companies Law.

### Directors' Service Contracts

See Item 6.B. "Directors, Senior Management and Employees-Compensation" above.

### Alternate Directors

Our articles of association provide that any director may, by written notice to us, appoint another person to serve as an alternate director, subject to the approval of the board of directors. Under the Companies Law, any person who is not a director or an alternate director may act as an alternate director, but the same person may not act as an alternate for several directors. An alternate director may be appointed for one meeting or for another specified period or until notice is given of the cancellation of the appointment. To our knowledge, no director currently intends to appoint any other person as an alternate director, except if the director is unable to attend a meeting of the board of directors.

### External Directors

Under the Companies Law, companies incorporated under the laws of Israel whose shares have been offered to the public in Israel or outside of Israel are required to appoint two external directors. The Companies Law requires that the external directors be residents of Israel. However, the Minister of Justice of the State of Israel has promulgated regulations exempting certain qualifying dual listed companies, such as us, from the applicability of certain provisions of the Companies Law. The Companies Regulations (Concessions for Public Companies Whose Shares are Registered in a Stock Exchange outside Israel), 5760-2000, as amended, define "double foreign company" as a public company whose shares

- o have been offered to the public outside of Israel or were registered on a non-Israeli stock exchange prior to February 1, 2000; and
- o were registered on a stock exchange in Israel after such date.

Pursuant to these regulations, an external director of a double foreign company need not be an Israeli resident.

The Companies Law provides that a person may not be appointed as an external director if the person or the person's relative, partner, employer or any entity under the person's control, has, as of the date of the person's appointment to serve as an external director, or had, during the two years preceding that date, any affiliation with the company, any entity controlling the company or any entity controlled by the company or by this controlling entity. The term affiliation includes:



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- o an employment relationship;
- o a business or professional relationship maintained on a regular basis;
- o control; and
- o service as an officer holder.

The Companies Law further provides that if at the time the external directors are appointed a company's board of directors is comprised solely of members of the same gender, then at least one of the external directors must be of a different gender than the other directors.

No person may serve as an external director if the person's position or other business creates, or may create, conflicts of interest with such person's responsibilities as an external director. Until the lapse of two years from termination of office, a company may not engage an external director to serve as an office holder and cannot employ or receive services from that person, either directly or indirectly, including through a corporation controlled by that person.

External directors are elected by a majority vote at a shareholders' meeting, provided that either:

- o the majority of shares voted at the meeting including at least one third of the shares of non-controlling shareholders voted at the meeting, vote in favor of the election; or
- o the total number of shares voted against the election of the external director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an external director is three years and may be extended for an additional three years. Each of the external directors is required to serve on the company's audit committee. Each other committee of a company's board of directors is required to include at least one external director. An external director is entitled to compensation as provided in regulations under the Companies Law and is prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

Under the Nasdaq rules, we are required to have at least two independent directors on our board of directors. In addition, the majority of the members of our audit committee must be independent. Mr. Meron and Mr. Hoffi qualify as independent directors under the Nasdaq rules and as external directors under the Companies Law.

### 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

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audit function 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.

Our audit committee consists of three board members who satisfy the "independence" requirements of the Securities and Exchange Commission, Nasdaq and Israeli Law for audit committee members. Our audit committee is currently composed of Messrs. Menachem Meron, Itzhak Hoffi and Jacob Nuss, each of whom satisfies these requirements. The audit committee meets at least once each quarter.

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 external directors are serving as members of the audit committee and at least one of the external directors was present at the meeting in which an approval was granted.

The audit committee reviewed our audited financial statements for the year ended December 31, 2003 and members of the committee met with both management and our external auditors to discuss those financial statements. Management and the external auditors have represented to the audit committee that the financial statements were prepared in accordance with U.S. GAAP. Members of the audit committee have received from and discussed with the external auditors their written disclosure and letter regarding their independence from our company as required by Independence Standards Board Standard No. 1. Members of the audit committee also discussed with the external auditors any matters required to be discussed by Statement on Auditing Standards No. 61. Based upon these reviews and discussions, the audit committee has recommended to the board of directors that the audited financial statements be included in our Annual Report on Form 20-F for the year ended December 31, 2003.

### Internal Auditor

Under the 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 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. Daniel Spira, CPA (Isr.) is our internal auditor.

### Approval of Specific Related-Party Transactions

The 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 care that a reasonable office holder in the same position would have acted under the same circumstances. An office holder's duty of care includes a duty to use reasonable means to obtain:

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- 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.

an office holder's 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;
- 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 due to his position as an office holder.

The Companies Law requires that an office holder of a company 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, the office holder must also disclose any personal interest held by:

- o the office holder's spouse, siblings, parents, grandparents, descendents, spouse's descendents 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 Israeli law, an extraordinary transaction is a transaction:

- o other than in the ordinary course of business;
- o other than on market terms; or
- o that is likely to have a material impact on a company's profitability, assets or liabilities.

Under the 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.

If the transaction is an extraordinary transaction, both the audit committee and the board of directors must approve the transaction. Under specific circumstances, shareholder approval may also be required. An office holder who has a personal interest in a matter that is being considered at a meeting of the board of directors or the audit committee may not be present at such meeting or vote on such matter.

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Under the Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder includes 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, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval may include either at least one-third of the shareholders who have no personal interest in the transaction and are present and voting, in person, by proxy or by written ballot, at the meeting, or a majority of the voting power present and voting, 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 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 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 that shareholder 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 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 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 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;

- 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

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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 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 the recent amendment to these regulations, directors' compensation and employment arrangements do not require shareholder approval provided certain criteria are met. Also, 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 Companies Law. 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

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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 made to 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 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

The Companies Law provides that a company may not exonerate office holders from liability for a breach of their duty of loyalty, but may exonerate in advance office holders from their liability to the company, in whole or in part, for a breach of their duty of care. Our articles of association provide that, subject to any restrictions imposed by the Companies Law, we may enter into an insurance contract providing coverage for the liability of any of our office holders for:

- o a breach of their duty of care to us or to another person;
- o a breach of their duty of loyalty to us, provided that they acted in good faith and had reasonable grounds to assume that their act would not prejudice our interests; and
- o a financial liability imposed upon them in favor of another person for an act performed by them in their capacity as office holders.

In addition, we may indemnify office holders against the following expenses or liabilities imposed upon them in their capacity as office holders:

- o a financial liability imposed on them in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court; and
- o reasonable litigation expenses, including attorneys' fees, incurred by such office holders or imposed upon them by a court, in connection with proceedings instigated by us against them or that are instigated on our behalf or by another person, or as a result of a criminal charge from which they were acquitted or a criminal charge in which they were convicted for a criminal offense that does not require proof of intent.

The Companies Law provides that a company may not indemnify an office holder nor enter into an insurance contract which would provide coverage for any monetary liability incurred as a result of any of the following:

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- o a breach by an officer holder of their duty of loyalty, unless the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- o a breach by an office holder of their duty of care if such breach was committed intentionally or recklessly;
- o an act or omission with the intent to unlawfully derive a personal benefit; or
- o a fine levied against the office holder as a result of a criminal offense.

Under the Companies Law, the shareholders of a company may include in, or amend a company's articles of association to include, either of the following:

- o a provision authorizing the company to grant in advance an undertaking to indemnify an office holder, provided that the undertaking is limited to specified classes of events that the board of directors deem foreseeable at the time of grant and is limited to an amount determined by the board of directors to be reasonable under the circumstances; or
- o a provision authorizing the company to retroactively indemnify an office holder.

In addition, pursuant to the Companies Law, indemnification of, and procurement of insurance coverage for, a company's office holders must be approved by the audit committee and the board of directors. In the case of directors, shareholder approval is also required.

We currently maintain a directors and officers liability insurance policy with a per claim and aggregate coverage limit of \$5 million.

### D. Employees

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.

As of December 31, 2002, we employed 266 full-time employees, of whom 26 were employed in general management and administration, 46 in marketing, 37 in production management, 111 in production, installation and maintenance, and 46 in engineering and research and development. Of our 266 full-time employees, 120 were employed in Israel, 44 were employed in the U.S., 80 were employed in Canada and 22 were employed in various other countries.

As of December 31, 2001, we employed 235 full-time employees, of whom 30 were employed in general management and administration, 35 in marketing, 30 in production management, 100 in production, installation and maintenance, and 40 in engineering and research and development. Of our 235 full-time employees, 103 were employed in Israel, 38 were employed in the U.S., 73 were employed in Canada and 21 were employed in various other countries.

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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, 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 June 24, 2004. The percentage of outstanding ordinary shares is based on 8,205,422 ordinary shares outstanding as of June 24, 2004.

Name	Number of Ordinary Shares Owned(1)	Percentage of Outstanding Ordinary Shares
Jacob Even-Ezra(2) (6) (7)...	476,656	5.81%
Izhar Dekel(3) (7).....	-	-
Brig. Gen. (Ret.)		
Emanuel Shaked.....	-	-
Chaim		
Porat.....	-	-
Yehezkel Farber.....	-	-
Zvi Dank.....	-	-
Raya Asher.....	-	-
Asaf Even-Ezra(4) (6).....	107,073	1.3%
Dany Pizen.....	-	-
Ofer Katz.....	-	-
Nathan Kirsh(5).....	1,415,097	17.25 %
Jacob Nuss.....	-	-
Jacob Perry.....	-	-
Menachem Meron.....	-	-
Itzhak Hoffi.....	-	-

\*Less than 1%

- (1) Except as otherwise noted and pursuant to applicable community property laws, each person named in the table has sole voting and investment power with respect to all ordinary shares listed as owned by such person. Does not include shares that may be acquired pursuant to the exercise of options.
- (2) Includes Mr. Even-Ezra's beneficial ownership of 321,218 ordinary shares held by Mira Mag, Mr. Even-Ezra is the beneficial owner of an additional



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134,220 ordinary shares, and 21,218 ordinary shares held by a trustee.

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- (3) Does not include any of the 321,218 ordinary shares held by Mira Mag in which Mr. Dekel's wife, Ornit Dekel, has an interest.
- (4) Includes one-third, or 107,073 of the 321,218 ordinary shares held by Mira Mag in which Mr. Even-Ezra has an interest.
- (5) The number of ordinary shares beneficially owned by Mr. Kirsh represents Mr. Kirsh's beneficial ownership of 1,415,097 ordinary shares held by Mira Mag. Mr. Kirsh is a trustee of the Eurona Foundation, which owns an 84.5% interest in Mira Mag.
- (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 June 24, 2004, the directors and executive officers listed above, as a group, held options to purchase 143,045 of our ordinary shares at a weighted average exercise price of \$5.64 per share, expiring between January 2005 and January 2009.

### Stock Option Plan

On February 25, 1993, our board of directors adopted a stock option plan pursuant to which stock options may be granted to employees, officers, directors and consultants of us or any of our subsidiaries. The purpose and intent of our stock option plan is to enhance our ability to attract and retain experienced and competent employees, officers, directors and consultants by providing them with opportunities to purchase our ordinary shares.

Our stock option plan is administered by our board of directors, which has the authority pursuant to the Companies Law to determine the persons to whom options are granted, the number of ordinary shares to be covered by each option, the time or times at which options are granted or exercised, and the terms and provisions of the options. 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. The board of directors may terminate or amend the plan in any respect, except that without prior shareholder approval the total number of shares which may be issued under the plan may not be increased, except by adjustment upon a recapitalization or distribution of a stock dividend.

In May 2000, our shareholders approved an amendment to our stock option plan to increase the number of ordinary shares reserved for issuance upon the exercise of options under the plan to 757,200 and to extend the term of the plan for an additional four years until February 2005. In July 2002, our shareholders approved an amendment to our plan to increase the number of ordinary shares reserved for issuance upon the exercise of options under the plan by an additional 500,000 ordinary shares. In addition, in July 2002 and in July 2003 our shareholders approved the payment of a 3% stock dividend to our shareholders. Pursuant to the provisions of our stock option 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.

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In July 2002, our shareholders approved an amendment to the plan according to which stock options granted under the plan are exercisable at a price per share that is at least 75% of the average market price per share during the 90-day period preceding the grant of the options. Prior to this amendment, stock options granted under the plan were exercisable at a price per share that was 75% of the average market price per share during the 90-day period preceding the grant of the options.

As of December 31, 2003, options to 223,216 shares were outstanding and additional 611,542 were available for grant.

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On October 27, 2003, our board of directors approved the 2003 Israeli Share Option Plan ("the 2003 plan") subject to shareholder approval. 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.

Until December 31, 2003, we did not grant any stock options under the 2003 plan.

Grants of stock options under the plans 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 plan are to be valued for this purpose at their market value at the time the options are granted.

### 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 June 24, 2004, 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)
Mira Mag Inc.(3).....	1,736,315	21.16%
Jacob Even-Ezra(4).....	529,701	6.41%

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- (1) Ordinary shares beneficially owned include shares that may be acquired pursuant to options that are exercisable within 60 days of June 24, 2004.
- (2) The percentage of outstanding ordinary shares is based on 8,205,422 ordinary shares outstanding as of June 24, 2004. Ordinary shares deemed beneficially owned by virtue of the right of any person to acquire such shares within 60 days of June 24, 2004, are treated as outstanding only for the purposes of determining the percent owned by such person.
- (3) Mira Mag is the holder of 1,736,315 ordinary shares. The beneficial owners and their percentage interest in these shares are: The Eurona Foundation 81.5%, or 1,415,097 ordinary shares, and Jacob Even-Ezra's three children 18.5%, or 321,218 ordinary shares. Jacob Even-Ezra beneficially owns all of the 321,218 shares held by Mira Mag in which his children, Ornit Dekel and Guy and Asaf Even-Ezra, have an interest. The purpose of the Eurona Foundation, the trustees of which are Prinz Michael von Liechtenstein, Altenbach 8, P.O. Box 339, FL-9490 Vaduz, Liechtenstein, and Nathan Kirsh, Kapola Estate, Ezulwini, Swaziland, is to provide for the education, maintenance and support of the family of Nathan Kirsh and such other persons as the foundation's board may determine.

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- (4) Includes Mr. Even-Ezra's beneficial ownership of 321,218 ordinary shares held by Mira Mag (see footnote (3) above) and Mr. Even-Ezra's beneficial ownership of an additional 187,265 ordinary shares and 21,218 ordinary shares held by a trustee.

As of June 24, 2004 there were 55 holders of ordinary shares of record registered with a U.S. mailing address, including banks, brokers and nominees. These holders of record represented less than 1% of our total outstanding ordinary shares. Because these holders of record include banks, brokers and nominees, the beneficial owners of these ordinary shares may include persons who reside outside the U.S. On June 24, 2004, we had approximately 7,758 beneficial holders of our ordinary shares.

### Significant Changes in the Ownership of Major Shareholders

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.

### B. Related Party Transactions.

#### 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

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1998 we filed a registration statement on Form F-3, File No. 333-9050, for the ordinary shares held by Mira Mag.

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

### Sales to a Former Principal Shareholder

We sell our perimeter systems to IAI, which was one of our principal shareholders, until July 2003. Jacob Nuss, one of our directors, is currently the deputy vice-president-internal auditing of IAI, and since 1975, has served in various financial management capacities at IAI. The terms of the contracts under which we make sales to IAI were negotiated on an arms'-length basis and the terms of such contracts are no more favorable to IAI than those it could have obtained from an unaffiliated third party. Our sales to IAI during the years ended December 31, 2001, 2002 and 2003 were \$261,000, \$111,000 and \$88,000 respectively.

### Sales to a Principal Shareholder

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, 2001, 2002 and 2003 were \$10,000, \$77,000 and \$108,000 respectively.

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### 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 April 2000, we extended the term of Mr. Even-Ezra's employment agreement until January 2004. In October 2003, the appointment of Mr. Even-Ezra as chairman of the board was extended until January 2006 and as CEO for such a period until a new CEO is appointed. Under the Companies Law such dual positions require shareholders approval which must be renewed every three years. In December 2000, our board of directors amended the term of Mr. Dekel's employment agreement. Under the amended agreement, the term of Mr. Dekel's employment will continue until such time as it is terminated by us or by Mr. Dekel pursuant to the terms of the agreement.

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.

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

In 2003, the total amount of our revenues from our facilities located outside of Israel to customers outside of Israel was approximately \$29.8 million, or 50% of our total revenues. The total amount of our export revenues from our Israel facilities to countries outside of Israel was approximately \$9.1 million, or 15% of our total revenues.

### Legal Proceedings

During 2002, several administrative petitions were filed against us by competitors concerning our winning, the tenders published by the MOD for the installation of intrusion detection systems along the seam line between Israel and the West Bank. The main claim was that the conditions for the tenders gave us an advantage. We have defended these petitions claiming, among others, that the competitors delayed in filing their claim. The court refused to issue any interim decree preventing us from commencing our work and the decision was upheld by the Supreme Court of Israel. Only one of these claims is still pending and awaits the court resolution of certain preliminary matters. According to our legal counsel, we have good defenses against the aforementioned claims, therefore, no allowance was recorded in the financial statements.

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 for

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approximately \$730,000 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 actions. According to our legal counsel, we have good defenses against the aforementioned claims. The action is in its preliminary stages.

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% 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% of our net income in 2000. In each of August 2002 and 2003, we paid a 3% 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, a total of \$401,000, representing approximately 17% of our

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net income in 2003. In April 2004, our board resolved to pay an additional 5% stock dividend to our shareholders as a final dividend for the year 2003. The payment of the stock dividend is subject to our shareholders' approval.

### B. Significant Changes.

Except as otherwise disclosed in this annual report, there has been no material change in our financial position since December 31, 2003.

## ITEM 9. The Offer and Listing

### A. Offer and Listing Details

#### 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.

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:

Year	Nasdaq National Market		Tel Aviv Stock Exchange	
	High	Low	High	Low
1999.....	\$3.9375	\$2.1875	NIS --	NIS --
2000.....	4.825	2.8125	--	--
2001.....	14.24	2.9375	64.00	20.50
2002.....	13.49	4.57	59.60	22.24
2003.....	9.97	4.74	42.68	22.69

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#### Quarterly Stock Information

The following table sets forth, for each of the full financial quarters in 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 Exchange	
	High	Low	High	Low
2002				
First Quarter.....	\$13.49	\$8.50	NIS 59.60	NIS 40.50
Second Quarter.....	12.80	8.50	59.40	43.00
Third Quarter.....	11.65	5.95	53.40	30.64
Fourth Quarter.....	6.93	4.57	31.90	22.24
2003				
First Quarter.....	\$6.28	\$4.84	NIS 29.66	NIS 24.15
Second Quarter.....	6.81	4.74	28.23	22.69
Third Quarter.....	9.97	5.55	42.68	25.62

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Fourth Quarter..... 9.50 7.55 42.23 33.74

### Monthly Stock Information

The following table sets forth, for each month in the last six months of 2003, 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 Exchange	
	High	Low	High	Low
2003				
----				
July	\$9.03	\$5.55	NIS 37.17	NIS 25.62
August	9.97	6.00	42.68	36.33
September	9.13	7.75	40.45	35.79
October	9.00	7.55	38.27	35.35
November	9.50	8.47	42.23	37.76
December	8.94	7.60	37.47	33.74

### B. Plan of Distribution

Not applicable.

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### 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.

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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, manufacture 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.

On February 1, 2000, the Companies Law, came into effect and superseded most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983, except for certain provisions which relate to bankruptcy, dissolution and liquidation of companies. The Companies Law authorizes the Minister of Justice to adopt regulations exempting from the provisions of the Companies Law, certain of which are described below, companies, such as us, whose shares are traded outside of Israel. Under the Companies Law, various provisions of such law, some of which are detailed below, overrule the current provisions of our articles of association.

### 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 resolution of the general meeting of our shareholders. The board of directors may, subject to the provisions of the 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 external director.

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According to the 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.

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 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 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 external directors) require the approval of our audit committee before board and shareholder



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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 arrangement 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 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.

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### 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 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.

#### 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 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.

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.

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#### 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.

#### 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 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 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 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 before 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

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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.

### Provisions Restricting a Change in Control of Our Company

The 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 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 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 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% shareholder of the company. However, this rule does not apply if there already is another 25% shareholder of the company. Similarly, if there already is another shareholder who holds more than 25% but less than 50% of the company's outstanding share capital, 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 45% shareholder of the Company. However, under the Companies Law, if following any acquisition of shares the acquirer would hold 90% or more of the company's shares, the acquisition must be made by means of a tender offer for all of the shares of the class. These rules do not apply if the acquisition is made by way of a private placement. In addition,

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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

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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 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 summary of the current tax structure applicable to companies in Israel, with special reference to its effect on us and our shareholders. The following also contains a discussion of Israeli government programs benefiting us. To the extent that the discussion is based on new tax legislation that has not been subject to judicial or administrative interpretation, we cannot assure you that the tax authorities will accept the views expressed in the discussion in question. The discussion is not intended, and should not be taken, as legal or professional tax advice and is not exhaustive of all possible tax considerations.

#### 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

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approved a number of amendments to the tax reform, which came into effect on January 1, 2003.

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

### General Corporate Tax Structure

Israeli companies are subject to company tax at a rate of 36% of taxable income. However, the effective tax rate payable by a company that derives income from an approved enterprise, discussed further below, may be considerably less. See "-Law for the Encouragement of Capital Investments, 1959." Subject to relevant tax treaties, dividends or interest received by an Israeli company from its foreign subsidiaries are generally subject to tax regardless of such company's status as an approved enterprise.

### Law for the Encouragement of Industry (Taxes), 1969

According to the Law for the Encouragement of Industry (Taxes), 1969, generally referred to as the Industry Encouragement Law, an industrial company is a company resident in Israel, at least 90% of the income of which, in a given tax year, determined in Israeli currency exclusive of income from

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specified government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Under the Industry Encouragement Law, industrial companies are entitled to the following preferred corporate tax benefits:

- o deduction of purchases of know-how and patents over an eight-year period for tax purposes, at a rate of 12.5% per year;
- o deduction of specified expenses incurred for a public issuance of securities over a three-year period for tax purposes;
- 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.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority.

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 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 36%, 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 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 exemption period or within 12 years after the period. The company must withhold this tax at the source, regardless of whether the dividend is converted into foreign currency.

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.



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### 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

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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 exceed 25% 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 three approved enterprise expansion programs which were approved in 1992, 1997 and 2001, respectively, and under which we are entitled to tax benefits. The periods of benefits for two of our approved enterprise programs will expire in 2003 and 2007, respectively, and the period of benefits for our third approved enterprise program has not yet begun. 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 Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development, 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 for the payment of royalties from the sale of products developed under the program. Regulations under the Research Law generally provide for the payment of royalties to the OCS of 3%-5% on sales of products and services derived from technology developed using these grants until 100% of the dollar-linked grant is repaid. Upon full repayment of the grant, there is no further liability for royalties.

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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 Chief Scientist, some of the manufacturing volume may be performed outside Israel, provided that the we pay royalties at an increased rate and the aggregate repayment amount is increased. The increase in royalties depends upon the manufacturing volume that is performed outside of Israel, as follows:

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Manufacturing volume outside of Israel	Royalties to the Chief Scientist as a percentage of grant
less than 50%	120%
between 50% and 90%	150%
more than 90%	300%

Under the Research Law, the technology developed with OCS grants may not be transferred to third parties without the prior approval of a governmental committee. However, such approval is not required for the export of any products developed using the grants. Approval of the transfer of technology may be granted in specific circumstances if the recipient abides by the provisions of the Research Law and related regulations, including the restrictions on the transfer of know-how and the obligation to pay royalties in an amount that may be increased. We cannot assure you that any consent, if requested, will be granted.

Effective for grants received from the OCS under programs approved after January 1, 1999, the outstanding balance of the grants will be subject to interest equal to the 12 month LIBOR applicable to dollar deposits that is published on the first business day of each calendar year.

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 as follows:
- o Where a company's equity, as calculated under the Inflationary

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Adjustments Law, exceeds the depreciated cost of fixed assets, a deduction from taxable income is permitted equal to the excess multiplied by the applicable annual rate of inflation. The maximum deduction permitted in any single tax year is 70% of taxable income, with the unused portion permitted to be carried forward.

- o Where a company's depreciated cost of fixed assets exceeds its equity, then the 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.

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- o Gains on traded securities, which are normally exempt from tax, are taxable in specified circumstances. However, securities dealers are subject to the regular tax rules applicable to business income in Israel.

Pursuant to the Inflationary Adjustments Law, results for tax purposes are measured in real terms in accordance with changes in the Israeli CPI. The discrepancy between the change in the Israeli CPI and the change in the exchange rate of the NIS to the dollar, each year and cumulatively, may result in a significant difference between taxable income and the income denominated in dollars as reflected in our financial statements (see note 14 of the notes to our consolidated financial statements). A foreign investors' company may, subject to certain conditions, elect to measure results, for tax purposes, in dollar terms.

Until 2002, we measured the results for tax purposes in terms of earnings in NIS, after certain adjustments for increases in Israel's CPI. Commencing January 1, 2003, the basis for remeasurement is the changes in the exchange rate of the U.S. dollar.

For the years 2001 and 2002, the differences between the change in Israel's CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, we have not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

### Capital Gains Tax

Israeli law generally imposes a capital gains tax on the sale of capital assets located in Israel, including shares in Israeli companies, by both residents and non-residents of Israel. Unless a Specific exemption is available or unless a tax treaty between Israel and the shareholder's country of residence provides otherwise. 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.

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Prior to the tax reform, sales of our ordinary shares by individuals were generally exempt from Israeli capital gains tax for so long as they were quoted on Nasdaq or listed on a stock exchange in a country appearing in a list approved by the Controller of Foreign Currency and we qualified as an Industrial Company. The above was also applicable following the dual listing of our shares in the Israeli Stock Exchange.

Pursuant to the tax reform, generally, capital gains tax is imposed at a rate of 15% on real gains derived on or after January 1, 2003, from the sale of shares in companies (i) publicly traded on the Tel Aviv Stock Exchange ("TASE") or; (ii) (subject to a necessary determination by the Israeli Minister of Finance) Israeli companies publicly traded on a recognized stock exchange outside of Israel (such as Magal).

This tax rate does not apply to: (i) dealers in securities; (ii) shareholders that report in accordance with Chapter B to the Inflationary Adjustment Law; or (iii) shareholders who acquired their shares prior to an initial public offering (that are subject to a different tax arrangement).

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The tax basis of shares acquired prior to January 1, 2003 will be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003. However, a request may be made to the tax authorities to consider the actual adjusted cost of the shares as the tax basis if it is higher than such average price.

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares publicly traded on a the TASE, and are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange outside of Israel, provided however that such capital gains are not derive from a permanent establishment in Israel and provided that such shareholders did not acquire their shares prior to an initial public offering.

However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In any event, the provisions of the tax reform will not affect the exemption from capital gains tax for gains accrued before January 1, 2003, as described above. In some instances where our shareholders may be liable for Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

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

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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.

### 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 other than bonus shares, or stock dividends, income tax at the rate of up to 25% is withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident is 25%. However, under the Investment Law, dividends generated by an Approved Enterprise are taxed at the rate of 15%. Furthermore, dividends not generated by an Approved Enterprise paid to a U.S. company holding 10% or more of our ordinary shares are taxed at a rate of 12.5%.

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Under an amendment to the Inflationary Adjustments Law, non-Israeli corporations might be subject to Israeli taxes on the sale of traded securities of an Israeli company, subject to the provisions of any applicable double taxation treaty or unless a specific exemption is available.

For information with respect to the applicability of Israeli capital gains taxes on the sale of ordinary shares by United States residents, see above "-- Capital Gains Tax on Sales of Our Ordinary Shares."

### 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, non-resident aliens of the U.S. or 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.

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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.

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.

### Taxation of Dividends

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 principles. You will be required to include this amount of dividends in gross income as ordinary income (see "-New Tax Law Applicable to Dividends and Long-Term Capital Gain," below). Distributions in excess of our earnings and profits will be treated as a non-taxable return of

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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.

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, subject to certain limitations set out in the Code (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 (see "-New Tax Law Applicable to Dividends and Long-Term Capital Gain," below). Dividends generally will be treated as foreign-source passive income or financial services income for United States foreign tax credit purposes. Foreign income taxes exceeding the credit limitation for the year of payment or accrual may be carried back for two taxable years and forward for five taxable years in order to reduce U.S. federal income taxes, subject to the

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credit limitation applicable in each of such years. Other restrictions on the foreign tax credit include a prohibition on the use of the credit to reduce liability for the U.S. individual and corporation alternative minimum taxes by more than 90%. 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 30-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder 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.

### 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 amount 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

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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, 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.

New Tax Law Applicable to Dividends and Long-Term Capital Gain

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Under recently enacted amendments to the Code, dividends received by noncorporate U.S. Holders from certain foreign corporations, and long-term capital gain realized by noncorporate U.S. Holders, generally are subject to U.S. federal income tax at a reduced maximum tax rate of 15 percent through December 31, 2008. Dividends received with respect to ordinary shares should qualify for the 15 percent rate. The rate reduction does not apply to dividends received from PFICs, see discussion below, or in respect of certain short-term or hedged positions in common stock 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 rate reduction. U.S. Holders of ordinary shares should consult their own tax advisors regarding the implications of these rules in light of their particular circumstances.

### 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, then, 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, dividends would not qualify for the reduced maximum tax rate, discussed above, and

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- 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,
- 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 gain recognized upon the disposition of ordinary shares would be taxable as ordinary income, and



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- 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.

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.

### 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 fourth lowest 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.

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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.

### 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 450 Fifth Street, N.W., 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.

### 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.

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

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

#### Interest Rate Sensitivity

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### Principal Amount by Expected Maturity Weighted Average Interest Rate

-----  
(U.S. dollars in thousands)

	2004	2005	2006	2007	Total	Fair Value at 12/31/03
	----	----	----	----	-----	-----
Liabilities:						
Short Term Loans.....	\$12,597	-	-	-	\$12,597	\$12,597
Weighted Average Interest Rate...	5.3%	-	-	-	-	
Long Term Loans.....	\$3,841	\$1,873	-	-	\$5,714	\$5,564
Weighted Average Interest Rate ..	4.60%	8.25%	-	-	-	

#### 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 2004 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 2004, the NIS has increased approximately 2.5% against the dollar. We are also subject to exchange rate fluctuations related to our activities in Canada.

Since part of our revenues are quoted in NIS, and a portion of our expenses are incurred in NIS, our results may be adversely affected by a change in the rate of inflation in Israel if the amount of our revenues in NIS decreases and is less than the amount of our expenses in NIS (or if such decrease is offset on a lagging basis) or if such change in the rate of inflation is not offset, or is offset on a lagging basis, by a corresponding devaluation of the NIS against the dollar and other foreign currencies. A hypothetical 10 percent devaluation in the rate of exchange of the NIS against the dollar, with all other variables held constant, on the exposed revenues would result in an approximately \$280,000 decrease in our expected revenues for 2004.

We periodically enter into foreign exchange contracts to offset the risk of currency exchange rate fluctuations in connection with certain sales and purchase transactions. During 2003, we entered into forward contracts to hedge a portion of our Euro revenues. These forward contracts are designated as cash flow hedges, as defined by SFAS No. 133, as amended, and we believe they are effective as a hedge against these Euro denominated revenues. The effective portion of the gain or loss on such derivative instruments is included in revenues and in financial expenses in our statement of income.

As of the year ended December 31, 2003, our total losses on derivative instruments were \$278,000, of which \$178,000 was recorded in revenues, and \$100,000 was recorded in financial expenses. As of December 31, 2003, the unrealized losses on forward contracts amounted to \$950,000.

#### ITEM 12. Description of Securities Other Than Equity Securities

Not applicable.

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### 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

Pursuant to the Israeli Securities Law, a company may not register its shares on any Israeli stock exchange unless its share capital consists of only one class of shares. Further, pursuant to the Israeli Securities Law, an Israeli company whose shares are traded on a stock exchange outside of Israel or on Nasdaq, may register its shares on an Israeli stock exchange under a simplified and expedited process. In connection with effectuating the dual registration of our ordinary shares on Nasdaq and the Tel Aviv Stock Exchange, we were required by the Israeli Securities Law to cancel all of our issued and outstanding deferred shares, by repurchasing such deferred shares. Accordingly, following approval by our audit committee, our board of directors, and our shareholders at our 2001 annual general meeting, we entered into an agreement pursuant to which we purchased 186,480 deferred shares from Mira Mag and 65,520 deferred shares from IAI for aggregate consideration equal to the aggregate nominal value of such deferred shares. Subsequent to such purchase, and following approval by our shareholders at our 2001 annual general meeting, we amended our articles of association to reclassify the deferred shares we purchased from Mira Mag and IAI and pursuant to the Companies Law, such shares are currently deemed dormant shares.

#### ITEM 15. Controls and Procedures

During the year 2003, we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 of the Securities Exchange Act of 1934. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us required to be included in our periodic SEC filings.

There have been no significant changes in our internal controls or other factors which could significantly affect internal controls subsequent to the date we carried out the evaluation.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

#### ITEM 16. [Reserved]

#### ITEM 16A. Audit Committee Financial Expert

Our board of directors has determined that Jacob Nuss meets the definition of an audit committee financial expert, as defined in Item 401 of Regulation S-K.

## 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 Accounting 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.

Services Rendered	Year Ended December 31,			
	2002		2003	
	Fees	Percentages	Fees	Percentages
Audit (1).....	\$191,345	60.5	\$197,043	71.3
Audit-related (2)....	18,006	5.7	14,695	5.3
Tax (3).....	106,799	33.8	64,738	23.4
Other .....	-	-	-	-
Total .....	\$316,150	100.0	\$276,476	100.0

- 
- (1) Audit fees consist of services that would normally be provided in connection with statutory and regulatory filings or engagements.
- (2) 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, 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.

## 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 accountants, 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

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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.

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ITEM 16D. Exemptions from the Listing Requirements and Standards for Audit Committee

Not applicable.

ITEM 16E. Purchase of Equity Securities by the Issuer and Affiliates and Purchasers

Issuer Purchase of Equity Securities

Not applicable.

### 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
1.2**	Articles of Association of the Registrant
2.1***	Specimen Share Certificate for Ordinary Shares
2.2****	The Registrant's Stock Option Plan (1993), as amended
2.4*****	Form of Underwriters' Warrant Agreement
2.5*****	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
10.1*****	Form of Underwriting Agreement
21	List of Subsidiaries of the Registrant
23.1	Consent of Kost Forer Gabbay & Kasierer
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended

Exhibit No.	Description
32.1	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
32.2	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.
-----	
*	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.
****	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.

MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

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IN U.S. DOLLARS

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ERNST & YOUNG

o Kost Forer Gabbay & Kasierer  
3 Aminadav St. o Phone: 972-3-6232525  
Tel-Aviv 67067, Israel Fax: 972-3-5622555

REPORT OF INDEPENDENT AUDITORS

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, 2002 and 2003, and the related consolidated statements of income, changes in shareholders' equity and comprehensive income (loss) and cash flows for each of the three years in the period ended December 31, 2003. 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 conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that



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we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, 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, 2002 and 2003, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

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

Tel-Aviv, Israel  
February 10, 2004

Except for Note 10e, for which the date is February 18, 2004

Except for Note 18, for which the date is April 28, 2004

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### MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

#### CONSOLIDATED BALANCE SHEETS

-----  
U.S. dollars in thousands

	December 31,	
	2002	2003
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 2,519	\$ 4,389
Short-term bank deposits (Note 11c)	3,708	5,750
Restricted bank deposit	-	3,250
Trade receivables (net of allowance for doubtful accounts - \$ 150 in 2002 and \$ 187 in 2003)	9,133	14,885

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Unbilled accounts receivable	7,691	5,072
Other accounts receivable and prepaid expenses	2,256	3,332
Deferred income taxes	602	979
Inventories (Note 3)	*) 8,112	11,777
	-----	-----
Total current assets	*) 34,021	49,434
-----	-----	-----
LONG-TERM INVESTMENTS AND TRADE RECEIVABLES:		
Long-term trade receivables (Note 2g)	1,510	300
Long-term bank deposits	8,649	3,051
Severance pay fund	1,724	1,960
	-----	-----
Total long-term investments and trade receivables	11,883	5,311
-----	-----	-----
PROPERTY AND EQUIPMENT, NET (Note 5)	*) 9,128	11,505
	-----	-----
DEFERRED INCOME TAXES	511	335
	-----	-----
INTANGIBLE ASSETS, NET (Note 6)	342	713
	-----	-----
GOODWILL (Note 6)	3,856	4,145
	-----	-----
Total assets	\$ 59,741	\$ 71,443
-----	=====	=====

\*) 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)

	December 31,	
	2002	2003
	-----	-----
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit (Note 7)	\$ 9,266	\$ 12,597
Current maturities of long-term loans (Note 9)	1,091	3,841
Trade payables	4,192	5,077
Other accounts payable and accrued expenses (Note 8)	3,784	6,518

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Total current liabilities	18,333	28,033
-----	-----	-----
LONG-TERM LIABILITIES:		
Unrealized losses on forward contracts	-	561
Long-term loans (Note 9)	4,698	1,873
Accrued severance pay	1,679	1,992
	-----	-----
Total long-term liabilities:	6,377	4,426
-----	-----	-----
COMMITMENTS AND CONTINGENT LIABILITIES (Note 10)		
SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS):		
Share capital (Note 12): Ordinary shares of NIS 1 par value:		
Authorized: 19,748,000 shares at December 31, 2002 and 2003;		
Issued and outstanding: 7,666,370 and 8,035,779 shares at		
December 31, 2002 and 2003, respectively	2,600	2,683
Additional paid-in capital	21,791	24,098
Deferred stock compensation	(3)	-
Accumulated other comprehensive income (loss)	(1,006)	479
Retained earnings	11,649	11,724
	-----	-----
Total shareholders' equity and comprehensive income (loss)	35,031	38,984
-----	-----	-----
Total liabilities and shareholders' equity and		
----- comprehensive income (loss)	\$ 59,741	\$ 71,443
	=====	=====

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 INCOME

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

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Revenues (Note 15 and 16)	\$ 41,020	\$ 42,966	\$ 59,361
Cost of revenues	21,505	23,924	33,378
	-----	-----	-----
Gross profit	19,515	19,042	25,983
	-----	-----	-----
Operating expenses:			

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Research and development, net (Note 17a)	3,054	3,128	4,773
Sales and marketing, net	7,933	8,642	11,585
General and administrative	4,949	4,938	5,305
	-----	-----	-----
Total operating expenses	15,936	16,708	21,663
	-----	-----	-----
Operating income	3,579	2,334	4,320
Financial income (expenses), net (Note 17b)	40	199	(1,003)
	-----	-----	-----
Income before taxes on income	3,619	2,533	3,317
Taxes on income (Note 14)	452	645	913
	-----	-----	-----
Net income	\$ 3,167	\$ 1,888	\$ 2,404
	=====	=====	=====
Basic net earnings per share (Note 13)	\$ 0.41	\$ 0.24	\$ 0.30
	=====	=====	=====
Diluted net earnings per share (Note 13)	\$ 0.40	\$ 0.23	\$ 0.30
	=====	=====	=====
Weighted average number of Ordinary shares used in computing basic net earnings per share	7,737,512	7,866,477	7,947,778
	=====	=====	=====
Weighted average number of Ordinary shares used in computing diluted net earnings per share	7,924,849	8,069,138	8,028,626
	=====	=====	=====

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 AND COMPREHENSIVE INCOME (LOSS)

U.S. dollars in thousands

	Deferred shares	Ordinary shares	Additional paid-in capital	Deferred stock compensation	Accumulated other comprehensive income (loss)	Ret ea
	-----	-----	-----	-----	-----	-----
Balance as of January 1, 2001	\$ 72	\$ 2,478	\$ 19,474	\$ (58)	\$ (715)	\$
Dividend declared and paid	-	-	-	-	-	-
Exercise of share options	-	19	125	-	-	-
Exercise of warrants	-	11	(11)	-	-	-
Purchase of deferred shares	(72)	-	11	-	-	-
Deferred stock compensation	-	-	34	(34)	-	-
Amortization of deferred stock compensation	-	-	-	72	-	-

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Stock dividend	-	75	2,037	-	-	(
Comprehensive income:						
Net income	-	-	-	-	-	
Foreign currency translation adjustments	-	-	-	-	(579)	
	-----	-----	-----	-----	-----	-----
Total comprehensive income						
Balance as of December 31, 2001	-	2,583	21,670	(20)	(1,294)	
Exercise of share options	-	13	125	-	-	
Exercise of warrants	-	4	(4)	-	-	
Amortization of deferred stock compensation	-	-	-	17	-	
Comprehensive income:						
Net income	-	-	-	-	-	
Foreign currency translation adjustments	-	-	-	-	288	
	-----	-----	-----	-----	-----	-----
Total comprehensive income						
Balance as of December 31, 2002	-	2,600	21,791	(3)	(1,006)	1
Declared dividend	-	-	-	-	-	
Exercise of share options	-	30	432	-	-	
Amortization of deferred stock compensation	-	-	-	3	-	
Stock dividend	-	53	1,875	-	-	(
Comprehensive income:						
Net income	-	-	-	-	-	
Unrealized losses on forward contracts, net	-	-	-	-	(807)	
Foreign currency translation adjustments	-	-	-	-	2,292	
	-----	-----	-----	-----	-----	-----
Total comprehensive income						
Balance as of December 31, 2003	\$ -	\$ 2,683	\$ 24,098	\$ -	\$ 479	\$ 1
	=====	=====	=====	=====	=====	=====

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 CASH FLOWS

-----  
U.S. dollars in thousands

Year ended December 31,

-----  
2001                      2002                      2003  
-----

Cash flows from operating activities:

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Net income	\$ 3,167	\$ 1,888	\$ 2,404
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,362	1,096	1,399
Gain on sale of property and equipment	(27)	(15)	(9)
Accrued interest on short and long-term deposits	38	(508)	(199)
Amortization of deferred stock compensation	72	17	3
Increase in trade receivables	(595)	(2,861)	(4,103)
Decrease in related parties receivables	65	1	28
Decrease (increase) in unbilled accounts receivable	(3,151)	(2,101)	2,708
Increase in other accounts receivable and prepaid expenses	(4)	(1,822)	(836)
Decrease (increase) in deferred income taxes	(136)	444	(88)
Decrease (increase) in inventories	766	*) 468	(2,586)
Decrease (increase) in long-term trade receivables	(2,213)	705	1,210
Increase (decrease) in other payables and accrued expenses	682	(532)	1,727
Increase (decrease) in trade payables	(392)	786	10
Accrued severance pay, net	(2)	(72)	77
	-----	-----	-----
Net cash provided by (used in) operating activities	(368)	*) (2,506)	1,745
	-----	-----	-----
Cash flows from investing activities:			
Purchase of short-term and long-term bank deposits	(674)	-	-
Proceeds from short-term deposits	-	-	505
Proceeds from sale of property and equipment	48	35	33
Purchase of property and equipment	(1,158)	*) (1,527)	(3,194)
Purchase of know-how and patents	(18)	(14)	(48)
Acquisition of activity regarding personal portable duress alarm system (a)	-	-	(902)
	-----	-----	-----
Net cash used in investing activities	(1,802)	*) (1,506)	(3,606)
	-----	-----	-----

\*) 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 STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

Year ended December 31,

-----  
2001                      2002                      2003  
-----

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Cash flows from financing activities:

-----			
Short-term bank credit, net	1,085	3,911	3,098
Proceeds from long-term bank loans	1,350	-	43
Principal payment of long-term bank loans	(180)	(158)	(103)
Purchase of deferred shares	(61)	-	-
Proceeds from exercise of employee stock options	144	138	462
Dividend paid	(942)	-	-
	-----	-----	-----
Net cash provided by financing activities	1,396	3,891	3,500
	-----	-----	-----
Effect of exchange rate changes on cash and cash equivalents	(67)	(98)	231
	-----	-----	-----
Increase (decrease) in cash and cash equivalents	(841)	(219)	1,870
Cash and cash equivalents at the beginning of the year	3,579	2,738	2,519
	-----	-----	-----
Cash and cash equivalents at the end of the year	\$ 2,738	\$ 2,519	\$ 4,389
	=====	=====	=====

Supplemental disclosures of cash flows activities:

(i) Cash paid during the year for:

Interest	\$ 925	\$ 932	\$ 1,099
	=====	=====	=====
Taxes	\$ 202	\$ 1,415	\$ 1,544
	=====	=====	=====

(ii) Non-cash activities:

Declared dividend	\$ -	\$ -	\$ 401
	=====	=====	=====

(a) Acquisition of activity regarding personal portable duress alarm system:

Net fair value of the assets acquired at the acquisition date was as follows:

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

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

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

-----  
U.S. dollars in thousands

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### NOTE 1:- GENERAL

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

As for major customer data, see Note 16b.

- b. Acquisition of activity in the field of Personal Emergency locating systems:

On July 1, 2003, the Company's subsidiary acquired the business activity of Dominion Wireless Inc. ("DW") for an aggregate purchase price of \$ 902, out of which \$ 74 is attributed to purchase costs.

As of December 31, 2003, the total purchase price was fully paid in cash. DW will be entitled to an "earn out" of 50% of operating income related to the acquired activity. When the contingency is resolved and additional consideration, if any, is distributable, the Company will record the amounts as additional consideration for the acquisition.

DW developed, manufactured, sold and supported personal duress alarm systems that locate an individual with accuracy and reliability in correctional and other institutions.

The acquisition of the business activity of DW has expanded the product line of the Company and enables the Company to offer its customers a comprehensive range of security systems.

The acquisition was accounted for using the purchase method of accounting as determined in Statement of the Financial Accounting Standards Board ("FASB") No. 141, "Business Combinations", and accordingly, the purchase price has been allocated to the assets acquired based on the estimated fair value 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, as follows:

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

The amount of the excess cost attributable to the 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.

The amount allocated to technology is amortized on a straight-line basis over a period of 8 years.

The operations of DW are included in the consolidated statements since July 1, 2003.



MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

## NOTE 1:- GENERAL (Cont.)

The unaudited pro forma information below assumes that the acquisition had been consummated on January 1, 2002 and 2003, and includes the effect of amortization of intangible assets from that date. This data is presented for information purposes only and is not necessarily indicative of the results that would have been achieved had the acquisition taken place on those dates. The pro forma information is as follows:

	Year ended December 31,	
	2002	2003
	Unaudited	
Revenues	\$ 47,474	\$ 59,933
Net income	\$ 579	\$ 1,910
Basic net earnings per share	\$ 0.07	\$ 0.24
Diluted net earnings per share	\$ 0.07	\$ 0.24

## c. Inventories write-off:

The Company periodically assesses the valuation of its inventories with respect to slow-moving items, revenue forecasts and technological obsolescence. When inventories on hand exceed the foreseeable demand or become obsolete, the value of excess inventory, is written off.

During 2001, 2002 and 2003, the Company recorded inventories write-offs in a total amount of \$ 808, \$ 244 and \$ 601, respectively.

## d. The Company depends on limited sources for components and if it is unable to obtain these components when needed, it will experience delays in manufacturing its products and the financial results may be adversely affected.

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

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

## a. Use of estimates:

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

b. Financial statements in U.S. dollars:

The majority of the revenues, of the Company and certain of its subsidiaries is generated in U.S. dollars ("dollar"). 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 and certain of its subsidiaries is the dollar.

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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.)

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with Statement of the Financial Accounting Standards Board ("FASB") 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 certain foreign subsidiaries whose functional currency is not the dollar, 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).

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less.

e. Short-term, long-term bank deposits and structured note:

Short-term bank deposits have maturities of more than three months and less than one year. Deposits are presented at their cost, including accrued interest. As of December 31, 2003, the

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deposits are in dollars and bear interest at a weighted average rate of 4.1%

A bank deposit structured note with maturity of more than one year is included in long-term investments. This structured note is based on the changes in the LIBOR rate. As of December 31, 2003, total interest amounted to \$ 50. The structured note is accounted for in accordance with the provisions of FASB Emerging Issues Task Force Issue No. 96-12, "Recognition of Interest Income and Balance Sheet Classification of Structured Notes" (EITF No. 96-12").

f. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items or technological obsolescence.

Cost is determined as follows:

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

Work-in-progress - represents the cost of production in progress.

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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.)

Finished products - on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

g. Long-term trade receivables:

Long-term receivables from extended payment agreements are recorded at estimated present value determined based on current rates of interest and reported at the net amounts in the accompanying financial statements. Imputed interest is recognized, using the effective interest method as a component of financial income in the statements of income.

h. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation.

Depreciation is computed by the straight-line method over the estimated useful lives of the assets as follows:

	%
	-----
Buildings	4
Machinery and equipment	10-33 (mainly at 10)

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Motor vehicles	15
Promotional display	25-50
Office furniture and equipment	6-33
Leasehold improvements	Over the term of the lease

i. Impairment of long-lived assets:

The Company's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. During the years ended December 31, 2001, 2002 and 2003, no impairment losses were recognized.

j. Intangible assets:

Intangible assets subject to amortization that arose from acquisitions prior to July 1, 2001, are being amortized on a straight-line basis over their useful life in accordance with APB Opinion No. 17, "Intangible Assets" ("APB No. 17").

Intangible assets acquired in a business combination for which the date is on or after July 1, 2001, should be 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 Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" ("SFAS No. 142").

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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 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Know-how is amortized over 8 to 10 years, and patents are amortized over a period of 10 years. Know-how includes know-how of a taut wire perimeter intrusion detection line and know-how of the VMD system.

Registered patents to protect proprietary technology incorporated in the Company's products and unauthorized use of our proprietary technology by third parties.

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Technology in the field of portable duress alarm systems enables the Company to produce premier personal emergency location systems.

k. Goodwill:

Goodwill represents excess of the costs over the net fair value of the assets of the businesses acquired. Goodwill that arose from acquisitions prior to July 1, 2001, was amortized until December 31, 2001, on a straight-line basis over a period of 15 years. Under SFAS No. 142, goodwill acquired in a business combination on or after July 1, 2001, shall not be amortized.

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, and market capitalization. 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.

In accordance with Accounting Principles Board ("APB") Opinion No. 20, "Accounting Changes", the effect of these accounting changes is reflected prospectively. Supplemental comparative disclosure, as if the change had been retroactively applied, is as follows (in thousands, except per share data):

	Year ended December 31,		
	2001	2002	200
Net income:			
Reported net income	\$ 3,167	\$ 1,888	\$ 2
Goodwill amortization	404	-	
Adjusted net income	\$ 3,571	\$ 1,888	\$ 2
Reported basic net earnings per share	\$ 0.41	\$ 0.24	\$
Reported diluted net earnings per share	\$ 0.40	\$ 0.23	\$
Goodwill amortization	\$ 0.05	\$ -	\$
Adjusted basic net earnings per share	\$ 0.46	\$ 0.24	\$
Adjusted diluted net earnings per share	\$ 0.45	\$ 0.23	\$

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. Research and development costs:

Research and development costs, net of grants received, are charged to the statement of income as incurred.

## m. Warranty costs:

The Company provides a warranty for up to 12 months, at no extra charge. The Company 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. Factors that affect the Company's warranty liability include the number of units, historical rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in the Company's warranty allowance during the period are as follows:

	Year ended December 31,	
	2002	2003
	-----	-----
Balance at the beginning of the year	\$ 174	\$ 159
Warranties issued during the year	237	203
Settlements made during the year	(238)	(159)
Changes in liability for pre-existing warranties during the year including expirations	(14)	(2)
Foreign currency translation adjustment	-	13
	-----	-----
Balance at the end of the year	\$ 159	\$ 214
	=====	=====

## n. Income taxes:

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standard No. 109 "Accounting for Income Taxes" ("SFAS No. 109"). 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 Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

## o. Revenue recognition:

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The Company generates revenues mainly from long-term projects and also from sales of products and rendering maintenance services.

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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.)

Revenues from long-term projects are recognized in accordance with Statement of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" ("SOP 81-1"), using contract accounting on a percentage of completion method, based on the relationship of actual costs incurred to total costs estimated to be incurred over the duration of the contract and in accordance with the "Input Method". 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. As of December 31, 2003, no such estimated losses were identified.

The Company applies contract accounting for the following reasons:

Projects for construction of Perimeter Systems require planning, development, manufacture and installation of the Perimeter System, in accordance with the customer's security requirements.

The project includes various components, e.g. planning of the Perimeter System in accordance with technical specifications, manufacture of the Perimeter System, installation of the Perimeter System on-site and installation of electronic parts on-site.

According to ("SOP 81-1"), costs that are incurred for a specific anticipated contract are being deferred, subject to evaluation of their probable recoverability, and only if the costs can be directly associated with a specific anticipated contract.

Revenues from products are recognized in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition" ("SAB No. 104") when the following criteria are met: persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable and collection is probable.

Deferred revenues include unearned amounts received under maintenance contracts but not yet recognized as revenues.

In November 2002, Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables". EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 are applied to revenue arrangements entered into in fiscal periods beginning after June

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15, 2003. Additionally, companies will be permitted to apply the consensus guidance in this issue to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, "Accounting Changes". The adoption of EITF Issue No. 00-21 did not have a material impact on the Company's financial position, cash flows or results of operations.

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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. Advertising expenses:

Advertising expenses are charged to the statement of income as incurred. Advertising expenses for the years ended 2001, 2002 and 2003, were \$ 349, \$ 372 and \$ 422, respectively.

q. Concentrations of credit risk:

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, short and long-term bank deposits, trade receivables and long-term trade receivables.

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

The trade receivables of the Company and its subsidiaries are derived from sales to large and solid organizations located mainly in Israel, the United States, Canada and Europe. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection and by a general reserve. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees.

For derivative instruments, see Note 2v.

r. Stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44"), in accounting for its employee stock option plans. Under APB 25,



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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.

Proforma information regarding net income and net earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the grant date using a Black and Scholes option pricing model with the following weighted-average assumptions for 2000 and 2001: risk-free interest rates of 5% and 3%, respectively, dividend yields of 3% for each year, a volatility factor of the expected market price of the Company's Ordinary shares of 0.556 and 0.628, respectively, and a weighted average life of the option of two years.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period.

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### MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

Proforma information under SFAS No. 123:

	Year ended December 31,		
	2001	2002	2003
Net income as reported:	\$ 3,167	\$ 1,888	\$ 2,
Add - stock based compensation as reported	72	17	
Deduct - total stock-based compensation determined under fair value method	(238)	(246)	(
Proforma net income	\$ 3,001	\$ 1,659	\$ 2,
Proforma basic net earnings per share	\$ 0.40	\$ 0.22	\$ 0
Proforma diluted net earnings per share	\$ 0.39	\$ 0.22	\$ 0

#### s. Royalty-bearing grants:

Royalty-bearing grants from the Government of Israel for funding

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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 \$ 0, \$ 318 and \$ 128 in 2001, 2002 and 2003, respectively.

The Company also received royalty-bearing grants from the Fund for Encouragement of Marketing Activity. These grants are recognized at the time the Company is entitled to such grants on the basis of the costs incurred and included as a deduction of sales and marketing expenses. Total grants recognized amounted to \$ 0, \$ 42 and \$ 40 in 2001, 2002 and 2003, respectively.

t. Severance pay:

The Company's liability for 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 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, 2001, 2002 and 2003, amounted to approximately \$ 241, \$ 60 and \$ 313, 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 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

u. Fair value of financial instruments:

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

The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables and other accounts receivable, short-term bank credit, trade payables and other payables approximate their fair value due to the short-term maturity of such instruments.

The carrying amount of the Company's long-term trade receivables

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and long-term deposits approximate their fair value. The fair value was estimated using discounted cash flows analyses, based on the Company's investment rates for similar type of investment arrangements.

Long-term loans are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. As of December 31, 2002, the carrying amount of the Company's long-term borrowing approximates its fair value. As of December 31, 2003, the fair value of the Company's long-term borrowing was \$ 5,564, compared to the carrying amount of \$ 5,714.

As for derivative instruments, see Note 2v, below.

### v. Derivative instruments:

Financial Accounting Standards Board Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), requires companies 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, the 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.

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

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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 (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

To protect against changes in the value of forecasted foreign

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currency translations and balances, the Company has instituted a foreign currency hedging program. The Company hedges portions of its forecasted cash flows and balances denominated in foreign currencies with forward contracts.

During 2003, the Company entered into forward contracts to hedge a portion of Euro revenues. These forward contracts are designated as cash flows hedges, as defined by SFAS No. 133, as amended, and are all highly effective as hedges of these revenues. The effective portion of the gain or loss on derivative instruments that hedges future revenues is included in revenues and in financial expenses in the statements of income.

As of the year ended December 31, 2003, the total losses on derivative instruments amounted to \$ 278, of which \$ 178 was recorded in revenues, and \$ 100 was recorded in financial expenses.

As of December 31, 2003, the unrealized losses on forward contracts amounted to \$ 950.

w. Basic and diluted earnings per share:

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

x. Reclassification:

Certain amounts from prior years have been reclassified to conform to the current year's presentation. The reclassification had no effect on previously reported net loss, shareholders' equity or cash flows. The Company reclassified inventory to property and equipment in the amount of \$ 139.

y. Impact of recently issued accounting standards:

In January 2003, the FASB issued FASB Interpretation 46 ("FIN 46"), "Consolidation of Variable Interest Entities". FIN 46 clarifies the application of Accounting Research Bulletin 51, Consolidated Financial Statements", for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest ("variable interest entities"). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date.

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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 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Company is in the process of determining what impact, if any, the adoption of the provisions of FIN 46 will have on its financial condition or results of operations. Certain transitional disclosures required by FIN 46 in all financial statements initially issued after January 31, 2003, have been included in the accompanying financial statements. As of December 31, 2003, the Company does not expect the adoption of FIN 46 to have material impact on its consolidated financial statements.

In April 2003, the FASB issued SFAS No. 149 ("SFAS No. 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities". SFAS No. 149 amends and clarifies (1) the accounting guidance on derivative instruments (including certain derivative instruments embedded in other contracts) and (2) hedging activities that fall within the scope of FASB Statement No. 133 ("SFAS No. 133"), "Accounting for Derivative Instruments and Hedging Activities". SFAS 149 amends SFAS No. 133 to reflect decisions made (1) as part of the Derivatives Implementation Group ("DIG") process that effectively required amendments to SFAS No. 133, (2) in connection with other projects dealing with financial instruments, and (3) regarding implementation issues related to the application of the definition of a derivative. SFAS No. 149 is effective (1) for contracts entered into or modified after June 30, 2003, with certain exceptions, and (2) for hedging relationships designated after June 30, 2003. The guidance is to be applied prospectively.

Generally, SFAS No 149 improves financial reporting by (1) requiring that contracts with comparable characteristics be accounted for similarly and (2) clarifying when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is not expected to have a material impact on the Company's financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This Statement establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatory redeemable financial instruments

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of nonpublic entities. The Company does not expect that the adoption of this standard will have a material effect on its financial position or results of operations.

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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 (except share and per share data)

NOTE 3:- INVENTORIES

	December 31,	
	2002	2003
Raw materials	\$ 4,702	\$ 6,843
Work in progress	1,242	2,513
Finished products	*) 2,168	2,421
	\$*) 8,112	\$ 11,777
	=====	=====

\*) Reclassified.

NOTE 4:- LONG-TERM TRADE RECEIVABLES

The Company signed an agreement with a customer, according to which the payments schedule is for a period ending in February 2005.

As of December 2003, the aggregate annual maturities of the long-term trade receivables are as follows:

2004	\$1,284
2005	300
	-----
	1,584
Less - current maturities	1,284
	-----
	\$ 300
	=====

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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 5:- PROPERTY AND EQUIPMENT

a. Comprised as follows:

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	December 31,	
	2002	2003
Cost:		
Land and buildings	\$ 7,846	\$ 8,215
Machinery and equipment	*) 3,545	6,253
Motor vehicles	1,333	1,414
Promotional display	2,895	3,659
Office furniture and equipment	2,186	2,609
Leasehold improvements	23	23
	-----	-----
	*) 17,828	22,173
	-----	-----
Accumulated depreciation:		
Buildings	1,744	2,098
Machinery and equipment	2,416	2,940
Motor vehicles	608	738
Promotional display	2,229	2,891
Office furniture and equipment	1,682	1,980
Leasehold improvements	21	21
	-----	-----
	8,700	10,668
	-----	-----
Depreciated cost	\$*) 9,128	\$11,505
	=====	=====

\*) Reclassified.

- b. Depreciation expenses amounted to \$ 858, \$ 1,014 and \$ 1,241 for the years ended December 31, 2001, 2002 and 2003, respectively.
- c. As for charges, see Note 11.

NOTE 6:- GOODWILL AND OTHER INTANGIBLE ASSETS, NET

- a. Intangible assets:

	December 31,	
	2002	2003
Original amounts:		
Know-how	\$ 1,502	\$ 1,502
Patents	1,913	2,381
Technology	-	436
	-----	-----
	3,415	4,319
	-----	-----
Accumulated amortization:		
Know-how	1,267	1,342
Patents	1,806	2,237
Technology	-	27
	-----	-----
	3,073	3,606
	-----	-----
Amortized cost	\$ 342	\$ 713
	=====	=====

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- GOODWILL AND OTHER INTANGIBLE ASSETS, NET (Cont.)

Amortization expenses related to intangible assets amounted to \$ 100, \$ 82 and \$ 137 for the years ended December 31, 2001, 2002 and 2003, respectively.

- b. Estimated amortization of the intangible assets for the years ended:

	December 31,
	-----
2004	143
2005	137
2006	129
2007	75
2008 and thereafter	229
	-----
	713
	=====

- c. Goodwill:

	December 31,	
	-----	-----
	2002	2003
	-----	-----
Original amounts	\$ 5,443	\$ 5,908
Accumulated amortization	1,587	1,763
	-----	-----
	\$ 3,856	\$ 4,145
	=====	=====

Amortization expenses amounted to \$ 404, \$ 0 and \$ 0 for the years ended December 31, 2001, 2002 and 2003, respectively.

NOTE 7:- SHORT-TERM BANK CREDIT

- a. As of December 31, 2003, the Company and its subsidiaries have authorized credit lines totaling \$ 27,800, and unused credit lines in the amount of \$ 3,748.

The Company has undertaken to maintain the following financial ratios and terms in respect of its short-term and long-term bank credit and loans:

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



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the Company.

As of December 31, 2003, the Company was in compliance with these ratios and terms.

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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 7:- SHORT-TERM BANK CREDIT (Cont.)

b.

Linkage terms	Interest rate		December 31,		
	2002	2003	2002	2003	
	%				
Short-term bank loan	U.S. \$	2.28	2.68	\$ 500	\$ 500
Short-term bank loan	U.S. \$	3.17	3.06	4,600	3,800
Short-term bank loan	Canadian \$	5	5.01	843	1,680
Short-term bank loan	NIS	10.24	6.83	3,323	6,610
				\$9,266	\$ 12,590
				\$9,266	\$ 12,590

c. As for charges, see Note 11.

NOTE 8:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2002	2003
Employees and payroll accruals	\$ 1,414	\$ 1,951
Accrued expenses	1,922	2,116
Deferred revenues	84	324
Unrealized losses on forward contracts	-	489
Declared dividend	-	401
Income tax payable	124	641
Other	240	596
	\$ 3,784	\$ 6,518
	\$ 3,784	\$ 6,518

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 9:- LONG-TERM LOANS

	Linkage terms	Interest rate		December 31,	
		2002	2003	2002	2003
		%			
Bank (1)	U.S. \$	4.60	4.60	\$ 2,500	\$ 2,500
Bank (2)	U.S. \$	4.60	4.60	250	250
Bank (3)	U.S. \$	2.87	2.87	500	500
Bank (4)	U.S. \$	5.66	5.66	500	500
				3,750	3,750
Mortgage payable (5)	U.S. \$	8.25	8.25	2,039	1,964
				5,789	5,714
Less - current maturities				1,091	3,841
				\$ 4,698	\$ 1,873

As for financial ratios and terms in respect of long-term loans, see also Note 7a.

As for charges, see Note 11.

As of December 2003, the aggregate annual maturities of the long-term loans are as follows:

2004	\$3,841
2005	1,873
	-----
	\$5,714
	=====

- (1) Interest on the outstanding balance is due monthly. The loan is due in one installment on April 1, 2004.
- (2) Interest on the outstanding balance is due each quarter. The loan is due in one installment on April 2, 2004.
- (3) The loan is due on April 15, 2004.
- (4) The loan is due on April 15, 2004.
- (5) The loan is due in 18 quarterly installments of \$ 64.7 each, commencing from February 28, 2001 and thereafter, until a final payment of \$ 1,807 on November 30, 2005.

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AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

## NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES

### a. Royalty commitments to the Chief Scientist:

The Company participated in programs sponsored by the Israeli Government for the support of research and development activities. Through 2003, the Company had obtained grants from Office of the Chief Scientist of Israel's Ministry of Industry and Trade ("the OCS") of \$ 128 for certain research and development projects of the Company. The Company is obligated to pay royalties to the OCS, amounting to 3%-5% of the sales of the products and other related revenues generated from such projects, up to 100% of the grants received, linked to the U.S. dollar and grants received after January 1, 1999 will also bear interest at the rate of LIBOR. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales no payment is required.

Royalties paid amounted to \$ 0, \$ 131 and \$ 80 for the years ended December 31, 2001, 2002 and 2003, respectively.

As of December 31, 2003, the Company had remaining contingent obligations to pay royalties in the amount of approximately \$ 1,700 upon the successful sale of products developed using such research and development programs sponsored by the Chief Scientist.

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

Grants received for the years up to and including 2003, amounted to \$ 253 and royalties paid during 2001, 2002 and 2003, amounted to \$ 104, \$ 53 and \$ 0, respectively. As of December 31, 2003, the aggregate contingent obligation amounted to \$ 96.

### c. Lease commitments:

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

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

2004	\$	357
2005		329
2006		170
2007		129
2008		99
		-----
		\$ 1,084
		=====

Total rent expenses for the years ended December 31, 2001, 2002

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and 2003, were approximately \$ 122, \$ 183 and \$ 368, 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 (except share and per share data)

#### NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

d. Guarantees:

1. As of December 31, 2003, the Company and its subsidiaries obtained bank performance guarantees and advance payment guarantees from several banks mainly in Israel in the amount of \$ 3,714.
2. As of December 31, 2003, the Company obtained bank guarantees in an amount of \$ 1,964, in order to secure mortgage payable by a subsidiary.
3. As of December 31, 2003, the Company and its subsidiaries issued a letter of credit in the amount of \$ 278, as per the suppliers' demand.

e. Legal proceedings:

In June 2000, Rapiscan Security Products Inc. ("Rapiscan") filed a lawsuit against the Company claiming sums allegedly due to Rapiscan in the context of an agreement between Rapiscan and the Company amounting to \$ 1,600. The Company filed a counter-claim in the amount of approximately \$ 1,350. The financial statements as of December 31, 2003 include a liability to pay Rapiscan of approximately \$ 1,000, as estimated by the Company's management (see also Note 18b).

In April 2003, a competitor filed a civil action suit against the Company and others. The plaintiff alleged that its failure in the field trials of the perimeter systems executed by the MOD during 1996-1997, resulted from intentional damage to its fence and diversion of the results of certain intrusion tests made by a former employee of Magal, who was then a soldier in the IDF. The plaintiff alleged that the Company was the employer of this employee during 1995 and the Company still employed him as an agent during the field trials. The plaintiff requested the courts to annul the field trial and for approximately \$ 730 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. According to its legal counsel, the Company had valid grounds for defense against the aforementioned claims and, therefore, no provision was recorded in the financial statements. The action is in the preliminary stage.

- f. In July 2003, the Company's subsidiary acquired the business activity of DW. According to the agreement, the Company's

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subsidiary paid \$ 902 and, in addition, over the next two and a half years, DW will be entitled to an "Earn Out" of 50% of operating profits related to the acquired activity (see Note 1b).

### NOTE 11:- CHARGES

As collateral for all of the Company and its subsidiaries' liabilities to banks:

- a. A fixed charge has been placed on the Company's property.
- b. The Company agreed not to pledge any of its assets without the consent of several banks.
- c. A fixed charge in the amount of \$ 3,250 has been placed on the Company's bank deposits.

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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 (except share and per share data)

### NOTE 11:- CHARGES (Cont.)

- d. The Company's subsidiary has two bank loans in the aggregate amount of \$ 1,000 due on April 15, 2004, collateralized by substantially all of the subsidiary's assets, and a \$ 1,964 mortgage note payable, collateralized by a first mortgage on the land and building.

### NOTE 12:- SHAREHOLDERS' EQUITY

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

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

- b. Deferred shares:

Prior to the Company's initial public offering in 1993, the Company's existing shareholders agreed to put into escrow 252,000 of the Ordinary shares held by them and to convert all, or a portion, of such escrowed shares into "Deferred shares", in the event (after taking into account the effect of the stock dividend) that specified audited after tax net income levels were not achieved by the Company in each of the three fiscal years in the period ended December 31, 1995.

Since the Company did not achieve such levels of net income, 252,000 Ordinary shares have been converted into Deferred shares of NIS 1 par value each. The Deferred shares entitle their

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holders, upon the liquidation of the Company, to the par value of these shares, but confer no other rights.

During 2001, the Company listed its shares for trade on the Tel-Aviv Stock Exchange. Pursuant to the Israeli Securities Law, the Company was required to purchase its Deferred shares. The annual general meeting that was held on May 16, 2001 approved the purchase of 252,000 Deferred shares by the Company at their nominal value.

### c. Stock Option Plan:

On February 25, 1993, the Company's Board of Directors authorized a stock option plan ("the plan"), under which options may be granted to employees, directors, officers and consultants of the Company or its subsidiaries.

According to the plan, the exercise price shall be at least 75% of the average of the closing prices of the shares of the Company on the NASDAQ National Market during the 90 days period preceding such grant. The plan was supposed to be terminated on February 25, 2001.

On May 31, 2000, the Company's Board of Directors approved an extension period to the plan in which options may be granted to employees until February 2005. Stock options that have not been exercised will expire, in any case, after five years from the date of grant. All the options have a vesting period of two years. Any options that are cancelled or forfeited before expiration become available for future grant.

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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 12:- SHAREHOLDERS' EQUITY (Cont.)

During 2000, the Company's Board of Directors and the general meeting of shareholders, also approved an increase in the number of options that may be granted to employees by 250,000 options, and during 2002, was increased by an additional 500,000 options.

On October 27, 2003, the Company's Board of Directors approved the 2003 Israeli Share Option Plan ("the 2003 plan"). The Board has elected to allot the options under Israel's capital gain tax treatment. Until December 31, 2003, the Company did not grant any stock options under 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.

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Subject to shareholder approval, the plan will be effective for ten years and shall be terminated on October 2013.

A summary of the Company's stock options activities in 2001, 2002 and 2003, is as follows:

	Options outstanding			
	Available for grant	Number of options outstanding	Range of exercise price	Weighted average exercise price
Balance at January 1, 2001	316,200	257,300	\$ 2-2.36	\$ 2.09
Options granted	(234,400)	234,400	\$ 2.43-5.62	\$ 5.27
Options exercised	-	(79,300)	\$ 1.61-2	\$ 1.80
<hr style="border-top: 1px dashed black;"/>				
Balance at December 31, 2001	81,800	412,400	\$ 1.61-5.62	\$ 3.93
Options available for grant	500,000	-	\$ -	\$ -
Options forfeited	1,648	(1,648)	\$ -	\$ -
Options granted upon stock dividend	2,454	11,232	\$ -	\$ -
Options exercised	-	(63,750)	\$ 2-2.36	\$ 2.17
<hr style="border-top: 1px dashed black;"/>				
Balance at December 31, 2002	585,902	358,234	\$ 1.61-5.62	\$ 4.23
Options forfeited	7,828	(7,828)	\$ -	\$ -
Options granted upon stock dividend	17,812	10,256	\$ -	\$ -
Options exercised	-	(137,446)	\$ 1.61-5.62	\$ 3.55
<hr style="border-top: 1px dashed black;"/>				
Balance at December 31, 2003	611,542	223,216	\$ 2.29-5.62	\$ 4.61

The weighted average fair values of options granted during the years ended December 31, 2001, 2002 and 2003, were:

	For exercise price on the grant date that:				
	Equals market price			Less than market	
	Year ended December 31,			Year ended Decem	
	2001	2002	2003	2001	2002
Weighted average exercise prices	\$5.62	\$ -	\$ -	\$ 2.69	\$ -
Weighted average fair value on grant date	\$2.04	\$ -	\$ -	\$ 1.91	\$ -

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MAGAL SECURITY SYSTEMS LTD.  
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### NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

The options outstanding as of December 31, 2003 have been separated into ranges of exercise price as follows:

Options outstanding and exercisable as of December 31, 2003	Weighted average remaining contractual life (years)	Weighted average exercise price
6,365	0.48	\$ 2.29
53,045	1.01	\$ 2.36
11,670	2.26	\$ 2.89
152,136	2.49	\$ 5.62
----- 223,216 =====		\$ 4.61 =====

84,000, 118,450 and 223,216 options were exercisable on December 31, 2001, 2002 and 2003, respectively, with a weighted average exercise price of \$ 1.93, \$ 2.14 and \$ 4.61, respectively.

The total employee stock compensation expenses recorded in 2001, 2002 and 2003, were \$ 72, \$ 17 and \$ 3, respectively, and were amortized based on the vesting period.

d. Dividends:

Dividends, if any, will be declared and paid in dollars. The Company has determined that it will not distribute dividends out of tax-exempt profits.

In 2001, the Company's Board of Directors decided on a dividend of \$ 0.13 per share for the year 2001.

In December 2003, the Company's Board of Directors decided on dividend of \$ 0.05 per share for the year 2003. A total of \$ 401 was paid in January 2004.

e. Warrants to underwriters:

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

f. The Company's Board of Directors decided on a distribution of stock dividend of 3% in May 2002 and 2003. All net earnings per share data have been retroactively adjusted to reflect the stock dividend.

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



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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 12:- SHAREHOLDERS' EQUITY (Cont.)

h. Accumulated other comprehensive income:

	Year ended December 31,		
	2001	2002	2003
Foreign currency translation adjustments	\$ (1,294)	\$ (1,006)	\$ 1,286
Unrealized losses on forward contracts, net	-	-	(807)
	\$ (1,294)	\$ (1,006)	\$ 479

NOTE 13:- NET EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted net earnings per share:

	Year ended December 31,		
	2001	2002	2003
Numerator:			
Net income	\$ 3,167	\$ 1,888	\$ 2,000
Denominator:			
Denominator for basic earnings per share - weighted-average number of shares outstanding	7,737,512	7,866,477	7,947,000
Effect of diluting securities:			
Employee stock options and warrants to underwriters	187,337	202,661	80,000
Denominator for diluted net earnings per share - adjusted weighted average shares and assumed conversions	7,924,849	8,069,138	8,028,000
Basic net earnings per share	\$ 0.41	\$ 0.24	\$ 0.25
Diluted net earnings per share	\$ 0.40	\$ 0.23	\$ 0.25

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands

NOTE 14:- TAXES ON INCOME

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

The Company has been granted the status of an "Approved Enterprise" under the law. Currently, there are 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 the second 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.

The Company received final approval for this expansion.

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 Company had completed its investment program and, accordingly, the period of benefits under this program began in 1998 and will terminate in 2007.

3. On August 13, 2001, 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 end in 2012.

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the above law, regulations published thereunder and the letters of approval for

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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.

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.

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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 14:- TAXES ON INCOME (Cont.)

Income from sources other than "Approved Enterprise", during the benefit period will be subject to tax at regular rate of 36%.

By virtue of this 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 36%), its effective tax rate is the result of a weighted combination of the various applicable rates and tax-exemptions. The computation is made for income derived from each program on the basis of formulas determined in the law and in the approvals.

The tax-exempt income attributable to the "Approved Enterprises" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If the retained tax-exempt income is distributed in a manner other than in the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not chosen the alternative tax benefits (currently - 15%), and an income tax liability would be incurred of approximately \$ 900.

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

Under Israeli law, results for tax purposes are measured in real terms, in accordance with the changes in Israel's Consumer Price Index ("Israel's CPI"), or in the exchange rate of the dollar for a "foreign investors' company". Until 2002, results of tax purposes were measured in terms of earnings in NIS, after certain adjustments for increases in Israel's CPI. Commencing January 1, 2003, the basis for remeasurement is the changes in the exchange rate of the U.S. dollar.

For the years 2001 and 2002, the differences between the change in Israel's CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements.

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In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

- 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.

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MAGAL SECURITY SYSTEMS LTD.  
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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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

- d. Israeli tax reform:

On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant to the reform, resident companies are subject to Israeli tax on income, accrued or derived in Israel or abroad. In addition, the concept of a "controlled foreign corporation" was introduced, according to which an Israeli company becomes subject to Israeli taxes on certain income of a non-Israeli subsidiary, if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains.

- e. A 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,		
	2001	2002	2003
Income before taxes as reported in the statements of income	\$ 3,619	\$ 2,533	\$ 3,
Tax rate	36%	36%	
Theoretical tax expense	\$ 1,303	\$ 912	\$ 1,
Increase (decrease) in taxes:			
Tax adjustments in respect of inflation in Israel	214	11	
Non-deductible items, net	75	(24)	
Deferred taxes on losses for which valuation allowance was provided	-	442	

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Tax exemption applicable to "Approved Enterprises" and exempted income	(928)	(293)	(
Taxes in respect of prior years	(200)	(279)	(
Other	(12)	(124)	
	-----	-----	-----
Taxes on income in the statements of income	\$ 452	\$ 645	\$
	=====	=====	=====
Per share amounts (basic and diluted) of the tax benefit resulting from "Approved Enterprises"	\$ 0.12	\$ 0.04	\$ 0
	=====	=====	=====

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

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- TAXES ON INCOME (Cont.)

f. Taxes on income included in the statement of income:

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Current taxes:			
Domestic	\$ 500	\$ 269	\$ 398
Foreign	138	211	534
Deferred income taxes:			
Domestic	(39)	(30)	-
Foreign	53	474	88
Taxes in respect of prior years:			
Domestic	(200)	(279)	(107)
	-----	-----	-----
Taxes on income	\$ 452	\$ 645	\$ 913
	=====	=====	=====

g. 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 Company and its subsidiaries deferred tax assets are as follows:

	December 31,	
	2002	2003
	-----	-----
Operating loss carryforward	\$ 1,409	\$ 1,813
Reserves and tax allowances	1,308	1,183
	-----	-----

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Total deferred assets before valuation allowance	2,717	2,996
Valuation allowance	(1,604)	(1,682)
	-----	-----
Net deferred tax assets	\$ 1,113	\$ 1,314
	=====	=====
Domestic	\$ 69	\$ 212
Foreign	1,044	1,102
	-----	-----
	\$ 1,113	\$ 1,314
	=====	=====

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

	Year ended December 31,		
	2001	2002	2003
	-----	-----	-----
Domestic	\$ 3,320	\$ 2,217	\$ 2,217
Foreign	299	316	1,100
	-----	-----	-----
	\$ 3,619	\$ 2,533	\$ 3,317
	=====	=====	=====

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MAGAL SECURITY SYSTEMS LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- TAXES ON INCOME (Cont.)

- i. Investment tax credit:

One of the Company's subsidiaries is eligible for investment tax credits on its research and development activities and on certain current and capital expenditures. During fiscal year 2003, the subsidiary recognized \$ 216 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 \$ 525, which will expire at various dates from 2006 through 2012.

- j. Net operating losses carryforward:

The Company's subsidiaries in the U.S., the U.K. and Latin America have estimated total available carryforward tax losses of \$ 4,002, \$ 582 and \$ 77, respectively, to offset against future taxable profit for 20 years, an indefinite period and 10 years, respectively. As of December 31, 2003, the Company recorded a deferred tax asset of approximately \$ 1,813, relating to the available net carryforward tax losses.

A valuation allowance of \$ 1,682 was recorded due to the uncertainty of the tax assets' future realization.

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Utilization of U.S. net operating losses may be subject to a substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

### NOTE 15:- RELATED PARTIES TRANSACTIONS

	Year ended December 31,		
	2001	2002	2003
Sales to related parties	\$ 271	\$ 188	\$ 196

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

### NOTE 16:- SEGMENTS INFORMATION

The Company develops, manufactures, markets and sells complex computerized security systems on a worldwide basis. These products are grouped into three major categories, which represent the Company's operating and reportable segments as follows:

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

The data is presented in accordance with SFAS 131, "Disclosure About Segments of an Enterprise and Related Information".

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

### NOTE 16:- SEGMENTS INFORMATION (Cont.)

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

	Year ended December 31,							
	2001					2000		
	Perimeter	Projects	Video monitoring	Other	Total	Perimeter	Projects	Vi mo
Revenues	\$ 34,893	\$ 5,004	\$ 142	\$ 981	\$41,020	\$ 36,435	\$ 5,340	\$
Depreciation and amortization	\$ 1,304	\$ 9	\$ 28	\$ 21	\$ 1,362	\$ 927	\$ 9	\$
Operating income, before financial expenses and taxes on income	\$(*) 3,303	\$(*) 1,758	\$ (626)	\$ (856)	\$ 3,579	\$(*) 2,948	\$(*) 2,024	\$
Financial income (expenses), net					40			
Taxes on income					452			
Net income					\$ 3,167			

	Year ended December 31,				
	2003				
	Perimeter	Projects	Video monitoring	Other	Total
Revenues	\$ 51,077	\$ 6,720	\$ 403	\$ 1,161	\$59,361
Depreciation and amortization	\$ 1,056	\$ 20	\$ 292	\$ 10	\$1,378
Operating income, before financial expenses and taxes on income	\$ 4,120	\$ 2,431	\$(1,870)	\$ (361)	\$4,320



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Financial	=====	=====	=====	=====
income				
(expenses),				
net				(1,003)
Taxes on income				913
				---
Net income				\$2,404
				=====

	December 31,							
	-----							200
	2001							
	-----							V
	Perimeter	Projects	Video	Other	Total	Perimeter	Projects	mo
	-----	-----	monitoring	-----	-----	-----	-----	-----
Total assets	\$ 11,911	\$ 18	\$ 324	\$ 30	\$ 12,283	\$ 12,066	\$ 30	
	=====	=====	=====	=====	=====	=====	=====	

	December 31,				
	-----				
	2003				
	-----				
	Perimeter	Projects	Video	Other	Total
	-----	-----	monitoring	-----	-----
Total assets	\$ 12,763	\$ 88	\$ 2,787	\$ 12	\$15,650
	=====	=====	=====	=====	=====

\*) Reclassified.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16:- SEGMENTS INFORMATION (Cont.)

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

	Year ended December 31,		
	-----		
	2001	2002	2003

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	-----	-----	-----
Israel's Ministry of Defense and Israel's Defense Forces	22.5%	15.9%	27.2%
	=====	=====	=====
The State concern civil aviation airlines "AZAL"	10.5%	1.8%	0.2%
	=====	=====	=====

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,		
	-----	-----	-----
	2001	2002	2003
	-----	-----	-----
1. Revenues:			
Israel	\$13,135	\$ 11,350	\$20,503
Europe	5,420	6,399	10,616
USA	11,358	12,641	13,292
Azerbaijan	4,577	756	106
Canada	2,035	4,324	6,338
Others	4,495	7,496	8,506
	-----	-----	-----
	\$41,020	\$ 42,966	\$59,361
	=====	=====	=====
2. Long-lived assets:			
Israel	\$ 3,623	\$ 3,566	\$ 3,466
Europe	666	786	980
USA	5,812	*) 6,299	8,246
Canada	2,133	2,286	2,854
Others	49	47	104
	-----	-----	-----
	\$12,283	\$*) 12,984	\$15,650
	=====	=====	=====

\*) Reclassified.

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MAGAL SECURITY SYSTEMS LTD.  
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 17:- SELECTED STATEMENTS OF INCOME DATA

a. Research and development expenses, net:

	Year ended December 31,		
	-----	-----	-----
	2001	2002	2003
	-----	-----	-----

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Expenses	\$ 3,331	\$ 3,750	\$ 5,128
Less - royalty-bearing grants and investment tax credit	277	622	355
	-----	-----	-----
	\$ 3,054	\$ 3,128	\$ 4,773
	=====	=====	=====

b. Financial income (expenses):

Financial expenses:			
Interest on long-term debt	\$ (398)	\$ (371)	\$ (298)
Interest on short-term bank credit	(502)	(640)	(808)
Foreign exchange losses	(42)	(6)	(692)
	-----	-----	-----
	(942)	(1,017)	(1,798)
	-----	-----	-----
Financial income:			
From interest	705	732	672
Foreign exchange gains	277	484	123
	-----	-----	-----
	982	1,216	795
	-----	-----	-----
	\$ 40	\$ 199	\$ (1,003)
	=====	=====	=====

NOTE 18: SUBSEQUENT EVENTS

- a. In April 2004, the Company's Board of Directors decided to distribute a 5% stock dividend. The annual general meeting of shareholders has not yet approved this decision.
- b. On February 18, 2004, the court approved a settlement agreement between the Company and Rapiscan regarding the matter discussed in Note 10e. According to the agreement, the Company will pay Rapiscan approximately \$ 653. The reduction of \$ 347 of the \$ 1,000 estimated liability recorded at year end will be reflected in operations during the first quarter of 2004.

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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.

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By: /s/ Jacob Even-Ezra  
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Name: Jacob Even-Ezra  
Title: Chairman of the Board and  
Chief Executive Officer  
Date: June 29, 2004