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

[X] 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 [X] No [ ]

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

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.

TABLE OF CONTENTS

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

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

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.

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

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:

- we will be successful in developing and marketing new products or product features that respond to technological change or evolving industry standards;
- we will not experience difficulties that could delay or prevent the successful development, introduction and marketing of these new products and features; or
- 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:

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

- seasonal reductions in business activities.

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

We are engaged in a highly competitive business. If we are unable to compete effectively, our revenues 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

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.

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

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.

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:

- political, economic and other developments in the State of Israel;
- terrorist attacks and other acts of war, and any response to them;
- actual or anticipated variations in our quarterly operating results or those of our competitors;
- announcements by us or our competitors of technological innovations or new and enhanced products;

- developments or disputes concerning proprietary rights;
- introduction and adoption of new industry standards;
- changes in financial estimates by securities analysts;
- market conditions or trends in our industry;
- changes in the market valuations of our competitors;
- announcements by us or our competitors of significant acquisitions;

- entry into strategic partnerships or joint ventures by us or our competitors; and
- 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.

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

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.

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

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

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. 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."

B. Business Overview.

General

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

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

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.

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

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:

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 expend 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

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:

- in-depth threat analysis;
- determination of the appropriate hardware and software solutions;
- training sessions for systems operators; and
- 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:

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

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

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

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

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

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.

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

to an event allows the control room operator to effectively stop a developing incident by broadcasting a warning message directed at the intruder. In addition, the control room operator can replay video images captured before and after the event to verify a criminal intrusion. Smart operators are then able

to respond to the intrusion quickly and effectively by summoning police assistance or an entity's appropriate internal security response team. Smart central monitoring station is able to provide instantaneous security responses across the U.S.

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.

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.

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:

- our customers are mainly budget-oriented organizations with lengthy decision processes which tend to mature late in the year; and
- due to weather and other conditions, 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.

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

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

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

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.

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

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 an 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

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.

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,

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.

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:

- in Israel, we develop a wide range of products including our taut wire, mechanical vibration, video and high-end SMS systems and PipeGuard;
- in California, PPI develops our microphonic fence sensors as well as our microwave detection, personal alarm and small/medium end control systems; and
- 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

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.

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

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.

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:

- 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;

- that any patents issued or licensed to us will not be challenged, invalidated or circumvented; or

- as to the degree or adequacy of protection any patents or patent applications may or will afford.

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

technology by third parties may impair our ability to compete effectively. We could become subject to litigation regarding intellectual property rights, which could seriously harm our business.

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

Government Regulation of Certain Exports

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

C. Organizational Structure.

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

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

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 Sisteme 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

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

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

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.

Business Challenges/Areas of Focus

Our primary business challenges and areas of focus include:

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

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:

- 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
- 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 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.

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:

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

- work-in-progress - represents the cost of development in progress; and
- 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

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.

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.

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

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 h