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ELTEK LTD  
Form 20-F  
June 30, 2005

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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, 2004

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 0-28884

ELTEK LTD.

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

ISRAEL

(Jurisdiction of incorporation or organization)

4 DREZNER STREET, SGOOLA INDUSTRIAL ZONE, P.O. BOX 159, PETACH TIKVA 49101,  
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 0.6 PAR VALUE  
(Title of Class)

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

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

ORDINARY SHARES, PAR VALUE NIS 0.6 ..... 5,491,711  
(as of December 31, 2004)

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

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to follow:

Item 17 [x] Item 18 [ ]

This Annual Report on Form 20-F is incorporated by reference into our Form S-8 Registration Statements File Nos. 333-12012 and 333-123559.

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### INTRODUCTION

Eltek Ltd., incorporated in 1970 under the laws of the State of Israel, develops, manufactures, markets and sells printed circuit boards, or PCBs, including High Density Interconnect, or HDI, multi-layered and flex-rigid boards for the telecommunications, defense and aerospace and medical technology industries. Our principal customers include manufacturers of defense and aerospace equipment, medical equipment, telecom and networking equipment and industrial equipment, as well as contract electronic manufacturers. Our ordinary shares are listed on the NASDAQ SmallCap Market (symbol: ELTK). Our European manufacturing and marketing subsidiary named Kubatronik Leiterplatten GmbH, or Kubatronik, is located in Geislingen Germany and is our only active subsidiary. As used in this annual report, the terms "we," "us" and "our" mean Eltek Ltd. and its subsidiaries, unless otherwise indicated.

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 Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. We urge you to consider that statements which use the terms "anticipate," "believe," "do not believe," "expect," "plan," "intend," "estimate," "anticipate" and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3.D. "Key Information- Risk Factors"

Our consolidated financial statements appearing in this annual report are prepared in New Israeli Shekels, or NIS, and in accordance with generally accepted accounting principles in Israel, or Israeli GAAP, which vary in certain significant respects from generally accepted accounting principles in the United States, or U.S. GAAP, as described in Note 28 to the consolidated financial statements. 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. Amounts stated in dollars in this report, except where the context otherwise indicates, have been translated from NIS at a specified rate solely for convenience and should not be construed as representations that the NIS

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amount actually represents such dollar amount or could be converted into dollars at the rate indicated. The translations of NIS amounts into dollars appearing throughout this annual report have been made at the representative rate of exchange on December 31, 2004 of NIS 4.308 = \$1.00, as published by the Bank of Israel. See Item 3.A. "Key Information -- Selected Financial Data -- Exchange Rate Information".

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

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

The following table presents selected consolidated financial data as of the dates and for each of the periods indicated. You should read the selected

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consolidated financial data set forth below together with Item 5. "Operating and Financial Review and Prospects" as well as our consolidated financial statements and notes thereto appearing elsewhere in this annual report.

The selected consolidated financial data as of December 31, 2004 and 2003 and for the three years ended December 31, 2004 have been derived from our audited consolidated financial statements and notes thereto included elsewhere in this annual report. The selected consolidated financial data as of December 31, 2002, 2001 and 2000 and for the fiscal year ended December 31, 2001 and the nine-month period ended December 31, 2000 have been derived from our audited consolidated financial statements and notes thereto which are not included in this annual report.

Our consolidated financial statements have been audited by the firm of Somekh Chaikin, an independent registered public accounting firm in Israel, a member firm of KPMG International. Our consolidated financial statements have been prepared in accordance with Israeli GAAP, which vary in certain significant respects from U.S. GAAP, as described in Note 28 to the financial statements.

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### STATEMENT OF CONSOLIDATED OPERATIONS DATA:

|  | NINE MONTHS<br>ENDED<br>DEC. 31, |             |             |                     |
|--|----------------------------------|-------------|-------------|---------------------|
|  | 2000 (1)                         | 2001        | 2002        | YEAR ENDED D<br>200 |
|  | (In thousands, except per        |             |             |                     |
| Israeli GAAP:  |                                  |             |             |                     |
| Revenues .....   | NIS 107,616                      | NIS 119,920 | NIS 108,035 | NIS 108             |
| Cost of revenues .....                                     | (78,173)                         | (101,335)   | (106,458)   | (102                |
| Gross profit .....   | 29,443                           | 18,585      | 1,577       | 5                   |
| Research and development income<br>(expenses), net .....   | (356)                            | (398)       | (116)       |                     |
| Selling, general and<br>administrative expenses .....      | (12,817)                         | (14,273)    | (15,152)    | (14                 |
| Amortization of goodwill .....                             | --                               | --          | (292)       |                     |
| Operating income (loss) .....                              | 16,270                           | 3,914       | (13,983)    | (9                  |
| Financial expenses, net .....                              | (1,192)                          | (1,799)     | (1,443)     | (2                  |
| Income (loss) before other income<br>(expenses), net ..... | 15,078                           | 2,115       | (15,426)    | (12                 |
| Other income (expenses),<br>net .....                      | 25                               | 718         | 290         |                     |
| Income (loss) before tax benefit<br>(expenses) .....       | 15,103                           | 2,833       | (15,136)    | (12                 |

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|  |            |           |              |          |
|--|------------|-----------|--------------|----------|
| Tax benefit (expenses) .....   | --         | --        | (380)        |          |
| Income (loss) after tax benefit (expenses) ..  | 15,103     | 2,833     | (15,516)     | (13)     |
| Minority share in subsidiary's net results ..  | --         | --        | (198)        |          |
| Net income (loss) .....  | NIS 15,103 | NIS 2,833 | NIS(15,714)  | NIS (12) |
| Basic and diluted earnings (loss) per NIS<br>1 par value of the share capital(2) .....                                   | NIS 5.08   | NIS 0.96  | NIS(5.36)    | NIS (    |
| Total par value of shares used to compute<br>basic and diluted net earnings (loss)<br>per NIS 1 par value of share ..... | 2,980      | 2,932     | 2,932        | 3        |
| U.S. GAAP:   |            |           |              |          |
| Net income (loss) .....  | NIS 15,103 | NIS 2,833 | NIS (15,422) | NIS (12) |
| Basic earnings (loss)<br>per share .....   | NIS 3.16   | NIS 0.59  | NIS (3.16)   | NIS (    |
| Weighted average number of shares<br>used in basic EPS calculation .....   | 4,778      | 4,825     | 4,886        | 4        |
| Diluted earnings (loss) per share .....  | NIS 3.08   | NIS 0.58  | NIS (3.16)   | NIS (    |
| Weighted average number of shares<br>used in diluted EPS calculation .....   | 4,903      | 4,884     | 4,886        | 4        |

(1) The company changed its fiscal year beginning in fiscal 2000 to a year ending on December 31.

(2) Ordinary shares of a par value of NIS 0.6 each

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|   | AS AT DECEMBER 31, |             |             |             |
|---|--------------------|-------------|-------------|-------------|
|   | 2000 (1)           | 2001        | 2002        | 2003        |
| CONSOLIDATED BALANCE SHEETS DATA:                           |                    |             |             |             |
| Israeli GAAP:   |                    |             |             |             |
| Working capital (deficit) .....                             | NIS 8,450          | NIS 7,712   | NIS (4,521) | NIS (10,05) |
| Total assets .....  | 95,376             | 106,570     | 105,831     | 88,62       |
| Long-term liabilities excluding<br>current maturities ..... | 11,709             | 16,016      | 21,725      | 14,63       |
| Shareholders' equity .....                                  | 42,692             | 46,094      | 30,919      | 19,39       |
| US GAAP:  |                    |             |             |             |
| Total assets .....  | NIS 95,376         | NIS 106,570 | NIS 106,123 | NIS 89,54   |
| Shareholders' equity .....                                  | 42,692             | 46,094      | 31,211      | 20,27       |

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 (1) The company changed its fiscal year beginning in fiscal 2000 to a year ending on December 31.

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### EXCHANGE RATE INFORMATION

The following tables sets forth, for the periods and dates indicated, certain information regarding the Bank of Israel representative rate of exchange for dollars, expressed in NIS per one dollar.

| PERIOD<br>-----                    | AVERAGE (1)<br>----- | HIGH<br>----- | LOW<br>----- | PERIOD END<br>----- |
|------------------------------------|----------------------|---------------|--------------|---------------------|
| Year ended December 31, 2000 ..... | 4.069                | 4.170         | 4.008        | 4.041               |
| Year ended December 31, 2001 ..... | 4.219                | 4.416         | 4.067        | 4.416               |
| Year ended December 31, 2002 ..... | 4.736                | 4.994         | 4.437        | 4.737               |
| Year ended December 31, 2003 ..... | 4.512                | 4.924         | 4.283        | 4.379               |
| Year ended December 31, 2004 ..... | 4.483                | 4.634         | 4.308        | 4.308               |

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 (1) Calculated based on the average of the representative exchange rates on the last business day of each month during the relevant period.

| PERIOD<br>-----     | HIGH<br>----- | LOW<br>----- |
|---------------------|---------------|--------------|
| December 2004 ..... | 4.374         | 4.308        |
| January 2005 .....  | 4.414         | 4.352        |
| February 2005 ..... | 4.392         | 4.357        |
| March 2005 .....    | 4.379         | 4.299        |
| April 2005 .....    | 4.395         | 4.360        |
| May 2005 .....      | 4.416         | 4.348        |

At June 28, 2005, the representative rate of exchange was NIS4.567 = \$1.00, as published by the Bank of Israel.

#### B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

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

Not applicable.

#### D. RISK FACTORS

INVESTING IN OUR ORDINARY SHARES INVOLVES A HIGH DEGREE OF RISK AND UNCERTAINTY. YOU SHOULD CAREFULLY CONSIDER THE RISKS AND UNCERTAINTIES DESCRIBED BELOW BEFORE INVESTING IN OUR ORDINARY SHARES. OUR BUSINESS, PROSPECTS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS COULD BE ADVERSELY AFFECTED DUE TO

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ANY OF THE FOLLOWING RISKS. IN THAT CASE, THE VALUE OF OUR ORDINARY SHARES COULD DECLINE, AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT.

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### RISKS RELATING TO OUR BUSINESS AND MARKET

WE HAVE A HISTORY OF OPERATING LOSSES AND WE MAY NOT BE ABLE TO RETURN TO PROFITABLE OPERATIONS.

In the year ended December 31, 2004 we recorded a net loss of NIS 5.9 million (\$1.4 million) and at December 31, 2004 our accumulated deficit was NIS 86.5 million (\$20.1 million). Although our management has adopted a plan to improve our profitability, which includes focusing on products with high margins, expanding our market to non-Israeli customers, mainly in Europe (with the support of our subsidiary in Germany) and the United States, and cost-cutting of production expenses, no assurance can be given that we will be able to return to profitability or maintain profitable operations thereafter.

RAPID CHANGES IN THE ISRAELI AND INTERNATIONAL ELECTRONICS INDUSTRIES AND RECESSIONARY PRESSURE MAY CONTINUE TO ADVERSELY AFFECT OUR BUSINESS.

Our principal customers include manufacturers of defense and aerospace equipment, medical equipment, telecom and networking equipment and industrial equipment, as well as distributors and contract electronic manufacturers. These industry segments, as well as the electronics industry as a whole, are subject to rapid technological changes and products obsolescence. Discontinuance or modification of products containing PCBs manufactured by us could have a material adverse effect on us. In addition, the electronics industry, particularly the defense and aerospace industries and the medical equipment industries, which accounted for approximately 35% and 23% respectively of our sales in the fiscal year ended December 31, 2004, is subject to sharp economic cycles. Recessionary pressures and other events leading to excess production capacity or a general downturn in the electronics industry, such as cuts in medical care expenses, as was experienced by us from 2001 until 2003, have resulted in intensified price competition, reduced margins and a decrease in unit volume. As a result, our financial condition and results of operations had been adversely affected. There can be no assurance that a weakness in the Israeli and International electronic markets will not adversely affect our operating results and financial condition.

BECAUSE COMPETITION IN THE PCB MARKET IS INTENSE, OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION MAY BE ADVERSELY AFFECTED.

The global PCB industry is highly fragmented and is intensely competitive. It is characterized by rapidly changing technology, frequent new product introductions and rapidly changing customer requirements. In the Israeli market we mainly compete with PCB Technologies Ltd., Melta Ltd. and several smaller local PCB manufacturers, as well as with major international PCB exporters, mainly from the United States, Europe and Asia. Such exporters include Ruwel Werke GmbH, HannStar Board Corp., Vertex Precision Electronics Inc., Nan-Ya PCB Corp., Unitech Printed Circuit Corp., Tyco Printed Circuit Group, Dynamic Details Inc. (prior to the dissolution of its British plant in 2005), Oriental Printed Circuits Ltd. and Dae Duck Electronics Comp. Ltd. In the European market we mainly compete with Ruwel Werke GmbH, Advanced Circuit Boards NV and Dynamic Details Inc. (prior to the dissolution of its British plant in 2005). In the United States market we mainly compete with Tyco Printed Circuit Group. Most of these competitors have significantly greater financial, technical and marketing resources than us. From the second quarter of fiscal 2001 through the 2003 fiscal year, we experienced increased price competition mainly in the rigid PCB



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segment, particularly from our local competitors and to a lesser extent from U.S., European and Asian based PCB manufacturers, due to the continued recession in the Israeli and international electronics industry, which had resulted in reduced demand for our products. During the last years PCB manufacturers in the Far-East (mainly in China) have made significant investments in their PCB production capacity, mainly for rigid PCBs. As a result of this increased production capacity, together with the recession in the international electronics industry from 2001 through 2003, many PCB manufacturers in Europe and the United States ceased their production activities and our current competition in the rigid PCB segment is mainly from PCB manufacturers based in the Far-East, that have substantially lower production costs than us. Continued competitive pressures could cause us to lose market share. During 2002 and 2003, we suffered from a significant price erosion that had had a material adverse affect on our operating results. There can be no assurance that we will be able to compete successfully against current or future competitors or that competition will not have a material adverse effect on our future revenues and, consequently, on our business, operating results and financial condition.

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### OUR OPERATING RESULTS FLUCTUATE SIGNIFICANTLY.

Our quarterly results have fluctuated significantly in the past and are likely to fluctuate significantly in the future. Our future operating results will depend on many factors, including (but not limited to) the following:

- o the size and timing of significant orders and their fulfillment;
- o demand for the products produced by our customers;
- o competition with our products;
- o plant utilization;
- o changes in currency fluctuation of the NIS against the U.S. dollar and the Euro;
- o yields in the manufacturing process;
- o timing of expenditures based on projections of future sales;
- o availability of raw materials;
- o the length of our sales cycles;
- o changes in our strategy; and
- o changes in seasonal trends and general domestic and international economic and political conditions.

Due to the foregoing factors, quarterly revenues and operating results are difficult to forecast, and it is likely that our future operating results will be adversely affected by these or other factors.

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Quarterly sales and operating results are also difficult to forecast because quarterly sales and operating results are dependent, almost exclusively,

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on the volume and timing of orders during the quarter and our customers generally operate with a short delivery cycle and expect delivery of a significant portion of our production within twenty working days. The delivery of such orders is subject to the number of available working days during the quarter, which can fluctuate significantly from quarter to quarter due to holidays and vacations. Certain prototype and pre-production runs require even shorter turn around times stemming from customers' product launches and design changes. In addition, there are often sudden increases, decreases or cancellations of orders for which there are commitments, which further characterize the electronics industry and the companies that operate in it. The industry practice is to make such changes without forfeiture, except for the time and materials expended on the order.

Our business involves highly complex manufacturing processes that are subject to periodic failure. Process failures have occurred in the past and have resulted in delays in product shipments. There is no assurance that process failures will not occur in the future. Further, our expenses are, in significant part, relatively fixed in the short-term. If revenue levels fall below expectations, our net income is likely to be disproportionately adversely affected because a proportionately smaller amount of the expenses varies with our revenues. There can be no assurance that we will be able to be profitable on a quarterly or annual basis in the future. An ongoing pattern of cancellations, reductions in orders and delays could have a material adverse effect on our results of operations. Due to all of the foregoing, we cannot predict revenues for any future quarter with any significant degree of accuracy. Accordingly, we believe that period-to-period comparisons of our operating results are not necessarily meaningful and should not be relied upon as indications of future performance. Although we have experienced revenue growth in the third and fourth quarters of 2004, we may not be able to generate increased revenues in the future.

WE MAY ENCOUNTER DIFFICULTY IN REALIZING THE POTENTIAL FINANCIAL OR STRATEGIC BENEFITS OF FUTURE BUSINESS ACQUISITIONS AND INVESTMENTS.

We believe that the acquisition of and the investment in new subsidiaries could assist us in reaching our goals of focusing on the high end of the PCB market, and in expanding our exports mainly into Europe and the United States. Any acquisition or investment would present risks commonly encountered in the acquisition of or investment in other businesses. The following are examples of such risks, one or more of which may apply to any such acquisition or investment:

- o difficulty in combining the technology, operations or work force of the acquired business;
- o adverse effects on our reported operating results under Israeli GAAP due to the amortization of goodwill associated with acquisitions;
- o diversion of management attention from running our existing business; and
- o increased expenses, including compensation expenses resulting from newly-hired employees.

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OUR RESULTS MAY BE ADVERSELY AFFECTED BY PRODUCT LIABILITY CLAIMS.

The sale and support of our products may entail the risk of product liability claims, which are likely to be substantial in light of the use of our

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products in business-critical applications. In the past we were involved in a costly litigation relating to allegedly defective products. If such suits are brought against us in the future, our business, results of operations and financial condition may be adversely affected.

TECHNOLOGICAL CHANGE MAY ADVERSELY AFFECT THE MARKET ACCEPTANCE OF OUR PRODUCTS.

Technological change in the PCB industry is rapid and continual. To satisfy customers' needs for increasingly complex products, PCB manufacturers must continue to develop improved manufacturing processes, provide innovative solutions and invest in new facilities and equipment. To the extent we determine that new technologies and equipment are required to remain competitive, the acquisition and implementation of such technologies and equipment are likely to require significant capital investment. There is no assurance that this capital will be available to us in the future for the acquisition or implementation of new technologies and equipment or that any new manufacturing processes developed by us will become or remain commercially viable. As a result, there can be no assurance we will be able to maintain our current technological position. Furthermore, the PCB industry may in the future encounter competition from new technologies that may reduce demand for PCBs or may render existing technology less competitive or obsolete. There can be no assurance our future process development efforts will be successful or that the emergence of new technologies, industry standards or customer requirements will not render our technology, equipment or processes obsolete or uncompetitive.

WE DEPEND ON OUR KEY CUSTOMERS AND THE LOSS OF ONE OR MORE OF OUR KEY CUSTOMERS WOULD RESULT IN A LOSS OF SIGNIFICANT AMOUNT OF OUR REVENUES.

Our top ten customers accounted for 40.5% and 46% of our revenues in the fiscal years ended December 31, 2003 and December 31, 2004, respectively. During the fiscal year ended December 31, 2004, our principal customer accounted for 12.3% of our total revenues. We expect that a significant portion of our future revenues will continue to be dependent on a small number of customers. There can be no assurance that our principal customers will continue to purchase products from us at current levels or that if we are unable to retain such customers we would be able to attract sufficient new business to compensate for their loss.

WE MAY REQUIRE ADDITIONAL CAPITAL IN THE FUTURE, WHICH MAY NOT BE AVAILABLE TO US.

Our working capital requirements and cash flow provided by our operating and financing activities are likely to vary greatly from quarter to quarter, depending on the following factors:

- o the timing of orders and deliveries;
- o the purchase of new equipment;
- o the build-up of inventories;
- o the payment terms offered to our customers;
- o the payment terms offered by our suppliers; and
- o approval of the current or additional lines of credit and long-term loans from our banks.

As of March 31, 2005, we had revolving lines of credit aggregating NIS

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12.9 million (\$3.0 million) with our banks, of which NIS 11.6 million (\$2.7 million) will be available to us until at least March 31, 2006, subject to certain conditions. The entire amount of our line of credit was outstanding as of March 31, 2005. As of March 31, 2005, we also had NIS 11.2 million (\$2.6 million) of long-term loans. We cannot assure you that these credit facilities will remain available to us in the future. Furthermore, under certain circumstances our banks may require us to accelerate the repayment of our credit facilities. All of our assets are pledged as security for our liabilities to our banks, whose consents are required for any future pledge of such assets. Financial covenants in respect of our credit facilities and long-term loans require us to maintain the higher of shareholders' equity of NIS 20.0 million (\$4.6 million) or 20% of our total assets according to the loan from Israel Discount Bank Ltd., or Discount Bank, and to maintain the higher of shareholders' equity of NIS 17.0 million (\$3.9 million) or 20% of our total assets, according to the loan from Bank Leumi LeIsrael Ltd., or Leumi Bank. For these purposes, shareholders' equity includes our outstanding convertible note and excludes prepaid expenses. As of December 31, 2003, we were in compliance with such covenants. However, on March 31, 2004, we were in breach of such covenants and therefore negotiated with our banks and were granted a temporary waiver, reducing our covenants to the higher of shareholders' equity of NIS 12 million (\$2.8 million) or 15% of our total assets until the release of our December 31, 2004 earnings (i.e. between March - June 2005). The waiver of Leumi Bank was subject to the repayment by us of NIS 1.5 million (\$348,000) over a 15 month period (from October 1, 2004 to December 31, 2005). In March 2005, the banks agreed to extend the temporary covenants. Leumi Bank agreed to extend the temporary covenants until the release of our June 30, 2005 earnings, following which and until the release of our December 31, 2005 earnings (i.e. between March - June 2006), Leumi Bank agreed to set the shareholders' equity threshold to not less than NIS 16 million (\$3.7 million). In accordance with the Discount Bank extension of the temporary covenants, we are required to maintain the higher of shareholders' equity of NIS 13 million (\$3 million) or 15% of our total assets until the release of our December 31, 2005 earnings. Upon the release of our December 31, 2005 earnings, we are required to comply with our original covenant terms. As of December 31, 2004 and March 31, 2005, we were in compliance with the terms of such temporary covenants. Our management has programs and projects in place in order to continue to meet these terms. We cannot assure you that we will be able to maintain compliance with such covenants in the future.

To the extent that the funds generated from our operations and from our existing capital resources are insufficient to fund our operating and financial requirements, we may be required to raise additional funds through public or private financing or other sources. There can be no assurance that such additional financing will be available or that, if available, it will be obtained on terms favorable to us. Any equity or debt financings, if available at all, may cause dilution to our then-existing shareholders. If additional funds are raised through the issuance of equity securities, the net tangible book value per share of our ordinary shares may decrease and the percentage ownership of then current shareholders may be diluted. We do not have any committed sources of additional financing, and there can be no assurance that additional financing, if necessary, will be available on commercially reasonable terms, if at all. If adequate funds are not available on terms acceptable to us, we may be required to delay, scale back or eliminate certain aspects of our operations and our business, financial condition and results of operations would be materially and adversely affected.

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Our suppliers decreased their prices in 2002, 2003 and 2004 for the principal raw materials, laminates and photo-chemical films that we use in the manufacture of PCBs. However, such decreases were partially offset by the devaluation of the NIS primarily against the dollar and the Euro. Based on the current trends of the raw materials market, we expect that our suppliers will increase their prices in 2005. Although to date our operating margins have not been significantly affected by such price changes and NIS devaluation, we cannot assure you that future price changes in raw materials will not materially affect our profitability.

WE MAY ENCOUNTER DIFFICULTIES WITH OUR INTERNATIONAL OPERATIONS AND SALES THAT MAY HAVE A MATERIAL ADVERSE EFFECT ON OUR SALES AND PROFITABILITY.

We are based in Israel and Germany and generate a large percentage of our sales in Europe. Our sales in Europe in the fiscal year ended December 31, 2004 accounted for 38.4% of our revenues, of which 42% was generated in Germany. Our sales in Europe in the fiscal years ended December 31, 2003 and December 31, 2002 accounted for 28.5% and 19.9% of our revenues, respectively. In June 2002, we entered into an agreement to acquire 76% of Kubatronik, a privately held German PCB manufacturer. Although we intend to continue to expand our international operations and commit significant management time and financial resources to developing direct and indirect international sales and support channels, we cannot be certain that we will be able to maintain or increase international market demand for our products. To the extent that we cannot do so in a timely manner, our business, operating results and financial condition may be adversely affected.

International operations are subject to inherent risks, including the following:

- o the impact of possible recessionary environments in multiple foreign markets;
- o unexpected changes in regulatory requirements and complying with a wide variety of foreign laws;
- o tariffs and other trade barriers;
- o difficulties and costs of staffing and managing foreign operations; and
- o political and economic instability.

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However, such factors have not had a material adverse effect on our business, results of operations or financial condition to date. If for any reason exchange or price controls or other restrictions on the conversion of foreign currencies were imposed, our business could be adversely affected.

We may be adversely affected by fluctuations in currency exchange rates because our revenues and expenses are incurred in various currencies, primarily the NIS, U.S. dollar and the Euro. In the fiscal year ended December 31, 2001, we engaged in currency hedging transactions, hedging the Euro against the U.S. dollar and the NIS, in an attempt to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. We did not engage in currency hedging transactions in 2002, 2003 and 2004, but have engaged a consulting company to advise us with regard to currency hedging measures. There can be no assurance that we will enter into any hedging transactions in the

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future or that such transactions, if entered into, will materially reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. In addition, if for any reason exchange or price controls or other restrictions on the conversion of foreign currencies into NIS were imposed, our business could be adversely affected. Although exposure to currency fluctuations to date has not had a material adverse effect on our business, there can be no assurance such fluctuations in the future will not have a material adverse effect on revenues from sales and, consequently our business, operating results and financial condition.

IF WE ARE FOUND TO BE IN VIOLATION OF ENVIRONMENTAL LAWS, WE COULD BE LIABLE FOR DAMAGES AND COSTS OF REMEDIAL ACTIONS, WHICH MAY AFFECT OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION.

We use certain materials in our manufacturing processes that are classified as hazardous substances. Proper waste disposal and environmental regulations are major considerations for PCB manufacturers because metals and chemicals classified as hazardous substances are used in the manufacturing process. We believe we are substantially in compliance with all material environmental laws and regulations. Since May 2003, our environmental management system has been ISO 14001 certified. This certification was based on successful implementation of environmental management requirements and includes ongoing monitoring of our processes, raw materials and products. The certification is subject to periodic compliance audits conducted by the Israeli Institute of Standards. If, in the future, we are found to be in violation of environmental laws, we could be liable for damages and costs of remedial actions and could also be subject to revocation of permits necessary to conduct our business or any part thereof. Any such revocation could require us to cease production, which could have a material adverse effect on our financial condition and results of operations. We are also subject to laws relating to the storage, use and disposal of hazardous materials, as well as air quality regulations. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with a violation. For example, environmental regulations enacted in Israel in September 2000, provide that a company that is found to have discharged water containing contaminants will be liable for quadruple the amount normally charged for its water consumption. Moreover, according to the same regulations, manufacturing plants are required to reduce the quantity of the wastewater discharged by them by 90% within four years. To be exempted from such legislation, a plant will have to show the Israeli Ministry of the Environment that a partial or complete decrease in the quantity of wastewater is not feasible. Since 1996 we have undertaken various actions to reduce the use of water in our manufacturing facilities. We believe that we have materially complied with the September 2000 regulations, but no assurance can be given that such compliance will be sufficient.

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

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission regulations and NASDAQ Stock Market rules, are creating uncertainty for companies such as ours. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we have invested and intend to further invest such resources as are reasonably necessary to comply with evolving standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities, which

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could harm our operating results and business prospects.

### RISK FACTORS RELATED TO OUR ORDINARY SHARES

OUR SHARE PRICE HAS BEEN VOLATILE IN THE PAST AND MAY CONTINUE TO BE SUSCEPTIBLE TO SIGNIFICANT MARKET PRICE AND VOLUME FLUCTUATIONS IN THE FUTURE.

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- o quarterly variations in our operating results;
- o operating results that vary from the expectations of securities analysts and investors;
- o changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- o announcements of technological innovations or new products by us or our competitors;
- o announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- o changes in the status of our intellectual property rights;
- o announcements by third parties of significant claims or proceedings against us;
- o additions or departures of key personnel;
- o future sales of our ordinary shares; and
- o stock market price and volume fluctuations.

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Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

WE MAY BE DELISTED FROM THE NASDAQ SMALLCAP MARKET IF WE FAIL TO MEET ITS MAINTENANCE REQUIREMENTS.

We must comply with certain NASDAQ SmallCap Market maintenance requirements in order to maintain the listing of our ordinary shares on the NASDAQ SmallCap Market. Currently we comply with all of the requirements but we cannot assure you that we will be able to fulfill the maintenance requirements in the future. Should we fail to fulfill such requirements, our ordinary shares will be delisted from the NASDAQ SmallCap Market and transferred to the NASDAQ Bulletin Board.

WE DO NOT INTEND TO PAY DIVIDENDS.

We have never declared or paid any cash dividends on our ordinary shares.

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We currently intend to retain any future earnings to finance operations and expand our business and, therefore, do not expect to pay any dividends in the foreseeable future.

### RISKS RELATING TO OUR OPERATIONS IN ISRAEL

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

We are incorporated under the laws of the State of Israel, and our offices and our production 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, or 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 had, and may in the future continue to have, an adverse impact on our operations, our financial results or the expansion of our business. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations.

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

We could be adversely affected by the interruption or reduction of trade between Israel and its trading partners. Some countries, companies and organizations continue to participate in a boycott of Israeli firms and others doing business with Israel or with Israeli companies. To date, these measures have not had a material adverse affect on our business. However, there can be no assurance that restrictive laws, policies or practices towards Israel or Israeli businesses will not have an adverse impact on our business.

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

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



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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 gone through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Despite positive trends in the Israeli economy in 2004, our operations in the local market, primarily in the rigid PCB segment, have continued to be adversely affected by the economic conditions in Israel and could be further affected if the economic conditions in Israel 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 our business, including our ability to deliver products to our customers and to import raw materials.

OUR RESULTS OF OPERATIONS MAY BE HARMED IF THE RATE OF INFLATION IN ISRAEL EXCEEDS THE RATE OF DEVALUATION OF THE NIS AGAINST THE U.S. DOLLAR AND THE EURO.

In the fiscal years ended December 31, 2003 and 2004 approximately 48% and 51%, respectively, of our expenses were in U.S. dollars, Euros, dollar-linked NIS or Euro-linked NIS and virtually most of the remaining expenses were in non-linked NIS. Our expenses, which are denominated in U.S. dollars and Euros or paid in Israeli currency linked to the dollar-NIS exchange rate and the Euro-NIS exchange rate, are influenced by the extent to which any inflation in Israel is not offset (or is offset on a lagging basis) by the devaluation of the NIS in relation to the dollar and the Euro. We believe that the rate of inflation in Israel has not had a material adverse effect on our business to date. However, our dollar and Euro costs in Israel will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar and the Euro, or if the timing of such devaluation lags behind inflation in Israel. Over time, the NIS has been devalued against foreign currencies, generally reflecting inflation rate differentials. Likewise, our operations could be adversely affected if we are unable to guard against currency fluctuations in the future.

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SERVICE AND ENFORCEMENT OF LEGAL PROCESS ON US AND OUR DIRECTORS AND OFFICERS MAY BE DIFFICULT TO OBTAIN.

Service of process upon our directors and officers and the Israeli experts named herein, all of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, all of our directors and officers and the Israeli experts named in this annual report are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

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.

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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.

THE RIGHTS AND RESPONSIBILITIES OF OUR SHAREHOLDERS ARE GOVERNED BY ISRAELI LAW AND DIFFER IN SOME RESPECTS FROM THE RIGHTS AND RESPONSIBILITIES OF SHAREHOLDERS UNDER U.S. LAW.

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

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### 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 January 1, 1970. We are a public limited liability company under the Israeli Companies Law 5759-1999 and operate under this law and associated legislation. Our registered offices and principal place of business are located at 4 Drezner Street, Sgoola Industrial Zone, Petach Tikva 49101, Israel, and our telephone number is 972-3-939-5025. Our address on the Internet is [www.eltekglobal.com](http://www.eltekglobal.com). The information on our website is not incorporated by reference into this annual report.

We manufacture and supply technologically advanced circuitry solutions for use in sophisticated and compact electronic products. We provide specialized services and are a solution provider in the PCB business, mainly in Israel and in Europe. PCBs are platforms that conduct an electric current among active and passive microelectronics components, microprocessors, memories, resistors and capacitors and are integral parts of the products produced by high-technology industries. Our focus is on short run quick-turnaround, prototype, pre-production and low to medium volume runs of high-end PCB products for high growth, advanced electronics applications.

We design and develop innovative manufacturing solutions pursuant to complex interconnect requirements of original equipment manufacturers, and

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provide our customers with a wide range of custom designed PCBs, including complex rigid, double-sided and multi-layer PCBs as well as flexible circuitry (flex and flex-rigid boards) made of glass epoxy and high-performance substrates. To complement our quick-turnaround, prototype, pre-production and low to medium volume production capability and provide our customers with single source service, we also act as an agent for the importation of PCBs from the Far East when customers require high volume production runs.

In July 2000, we adopted a plan for the investment of approximately \$7.0 million over a two-year period for the purchase of equipment and facilities in order to create the capacity and capability to offer our customers the new state-of-the-art PCB technology known as high density interconnect, or HDI. This technology enables manufacturers to produce PCBs with line width and spaces as narrow as 2-3 mils and hole diameters of 3 to 6 mils. As part of this investment, we have purchased and leased several key machines, including a laser drilling system for microvia holes, a laser direct imaging system for transferring conductor images as narrow as 2 mils, upgraded our plating lines for enhanced capacity and capability, and acquired a vacuum press, flying probe electrical testers, an automated optical inspection system, an exposure system, a laser plotter and an horizontal line for black oxide substitution using the Alpha Prep process. We began to supply PCBs utilizing the HDI technology to select customers in August 2000. We completed this investment plan in 2002.

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In 2004, we continued to focus on the sale of flex-rigid, high density interconnect, or HDI, and special different base materials PCBs. Such products accounted for approximately \$17.3 million or 61% of our total sales in the fiscal year ended December 31, 2004 as compared to approximately \$12.9 million or 52% of our total sales in the fiscal year ended December 31, 2003.

In June 2002, we acquired 76% of Kubatronik, a privately held German PCB manufacturer, for approximately 2.6 million Euros. The remaining 24% of Kubatronik is held by Mr. Alois Kubat, its founder. Kubatronik specializes in manufacturing short run and prototype boards, including multi-layer, flex-rigid and HDI boards. Its customers include companies engaged in the production of industrial equipment, defense and aerospace equipment, telecom and networking equipment and computer and data storage equipment as well as contract electronic manufacturers. This acquisition facilitated our entry into the German market, while complementing our existing relationships throughout the rest of Europe. We believe that this acquisition will continue to provide us additional sales and marketing channels. In July 2003 we appointed a new General Manager for Kubatronik and in October 2003, Mr. Kubat retired from Kubatronik (see Item 5B, "Operating and Financial Review and Prospects - Liquidity and Capital Resources").

### B. BUSINESS OVERVIEW

#### INDUSTRY OVERVIEW

PCBs are constructed from a variety of raw materials. PCBs can be double-sided or multi-layered and made of rigid, flexible or flex-rigid materials. In essence, they are platforms that conduct electric current among active and passive microelectronics components, microprocessors, memories, resistors and capacitors. Photographic type processes transfer the images of the electrical circuit onto the layers, and chemical processes etch these lines on the boards. There are several broad categories of PCBs:

- o RIGID PCBs. Rigid PCBs are the core product of the industry and can be found in virtually every electronics device. The layer count of these

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products generally ranges from one to thirty-two layers.

- o FLEXIBLE AND FLEX-RIGID PCBs. Flexible boards are thin, light-weight circuits used to interconnect other circuit boards and electronic devices within electronic equipment. Flex-rigid boards are composed of rigid parts and flexible layers. They generally range from two to thirty layers. Flex-rigid boards provide solutions for electronic systems that impose space and shape restrictions and for systems in which reliability of connectivity is crucial. These products are often found in military applications (primarily avionics), medical and measurement equipment and the automotive industry, among other uses.

- o BACKPLANES. Backplanes are large, high-density circuit boards with design features such as tight tolerance finished hole sizes that require precise process controls. These products are commonly known as "motherboards" on which connectors are mounted to receive and interconnect other PCBs and can be found primarily in telecommunications applications.

PCB manufacturers can generally be classified based on two parameters, product sophistication and service sophistication. Product sophistication is evident in the capability of a PCB manufacturer to offer products with higher layer counts and more complex construction, as well as in the line width and the spacing of lines on the circuit boards. The new state-of-the-art HDI technology enables manufacturers to produce PCBs with line width and spaces as narrow as 2-3 mils and hole diameters of 3 to 6 mils.

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### MANUFACTURING AND ENGINEERING PROCESSES

In the PCB industry, significant investments in equipment are necessary to maintain technological competitiveness. During the five years ended December 31, 2004, we invested approximately \$11.8 million for these purposes (not including the investments of Kubatronik).

MANUFACTURING CAPABILITIES. We have the capability to manufacture PCBs with layer counts in excess of 30 layers, blind and buried vias and designs using materials as thin as 0.002 inches. We established our HDI advanced capabilities after a two-year period of research and development, followed by a significant investment in HDI production capacity. As of August 31, 2000, we began to supply HDI products to selected customers. We are able to produce short runs of five to thirty PCBs within three to five working days, a few hundred units within ten working days and are capable of producing such number of boards within five working days when production line scheduling permits. In the fiscal year ended December 31, 2004, approximately 43% of our manufactured products were ordered for delivery in less than 20 working days, of which approximately 9% were ordered for delivery within six to ten working days and approximately 4% in less than five working days. The recent trend of short time delivery orders as compared to past years is a result of the continued change in our product mix, from rigid PCBs to flex-rigid, high density interconnect and special different base material PCBs, which involve a more complex and timely production process.

COMPUTER AIDED DESIGN/COMPUTER AIDED MANUFACTURING. We utilize a state-of-the-art computer aided design system of Frontline Ltd., an Israeli based company jointly owned by Orbotech Ltd. and Valor Ltd., and can receive computer aided design data by electronic data transmission. Our computer aided design workstations perform design rule checks on transmitted designs, incorporate any customer-specific design modifications and perform manufacturability enhancements that increase PCB quality.

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ADVANCED FINISHING CAPABILITIES FOR DENSE PACKAGING DESIGNS. We provide a wide assortment of alternative surface finishes, including hot air solder leveling, electroless gold over nickel, tin immersion, silver immersion and Entek, which is produced by Enthone-Omi Inc., for the attachment of components to PCBs.

OTHER ADVANCED PROCESS CAPABILITIES. We provide fabrication of dense multi-layer PCBs. We use advanced inner-layer production line pressing, drilling equipment and clean room environments to produce technologically advanced products.

QUALITY STANDARDS. Our quality management system has been ISO 9001:2000 certified since July 2002 (and prior to such date, was ISO 9002 certified since January 1995). This certification is based on successful implementation of quality assurance requirements and includes ongoing monitoring of our business and periodic compliance audits conducted by the Israeli Institute of Standards. We have obtained United States Department of Defense Qualified Product List, or QPL, approval (MIL-PRF-55110F and MIL-P-50884D) for our products. Since 1976 our Glass Epoxy (FR4) Boards have had UL approval.

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### SALES, CUSTOMERS AND MARKETING

SALES. In the fiscal year ended December 31, 2002, December 31, 2003 and December 31, 2004, the primary industries for which we produced PCBs were defense and aerospace equipment (42%, 41% and 35% of production, respectively), medical equipment (20%, 10% and 23% of production respectively), telecom and networking equipment (20%, 24% and 18% of production, respectively) and industrial equipment (9%, 13% and 16% of production, respectively) as well as for contract electronic manufacturers (6%, 6% and 3% of production, respectively).

CUSTOMERS. During the fiscal year ended December 31, 2004, we provided PCBs to approximately 210 customers in Israel and approximately 290 customers outside of Israel (including Kubatronik's customers). Our customers outside of Israel are located primarily in Germany and the Scandinavian countries and our principal customer is located in France. Sales to non-Israeli customers increased from \$6.1 million (24.2% of revenues) in the fiscal year ended December 31, 2002 to \$8.3 million (33% of revenues) in the fiscal year ended December 31, 2003 to \$13.3 million (45.7% of revenues) in the fiscal year ended December 31, 2004.

In the fiscal years ended December 31, 2002, 2003 and 2004, our principal customer accounted for 8.5%, 9.1% and 12.3% of our sales, respectively. Our ten largest customers accounted for 46%, 40.5% and 46% of our sales in the fiscal years ended December 31, 2002, 2003 and 2004, respectively. We expect that a significant portion of our future revenues will continue to be dependent on a small number of customers.

MARKETING. We market and sell our products primarily through our direct sales staff located in Israel, which currently consists of six sales personnel. The marketing of our products in Europe is generally performed by Kubatronik and our sales agent in Sweden. We recently initiated marketing efforts in order to expand our market share to other European countries such as France, Spain and Italy. In 2004, we continued our marketing efforts in the United States in order to increase the demand for our flex rigid and HDI PCBs. We currently market our products in the United States through a sales manger who is supported by six regional representatives. Since 2001, we market our products in India through a

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local sales agent, mainly to government bodies. We also maintain an internal sales and customer service support system that works with our outside sales personnel to initiate, promote and maintain our relationships with customers.

Our strategy is to focus on the high end of the PCB market, mainly in flex-rigid PCBs, in which margins are significantly better. We also initiated a program to upgrade our processes by implementing high-quality standards, employee training and special training activities for clients. We are continuing to expand our export marketing efforts in Europe, mainly in Germany as well as in the United States. Marketing efforts include the distribution of promotional items, seminars for engineers, technical information supplied to business publications and participation in trade shows and industry conferences.

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### MATERIALS AND SUPPLIES

The materials used in the manufacture of PCBs are primarily laminates (copper clad, with an isolating core separating them), prepregs, photo-chemical films, chemicals and inks. Most of the materials we use are manufactured in Europe. Some of the materials are purchased directly from the manufacturer, while others are purchased from local distributors.

Although we use a select group of suppliers, the materials used to manufacture PCBs generally are readily available from multiple suppliers. After an increase in prices in 2001, our suppliers decreased their prices in 2002, 2003 and 2004 for the principal raw materials we use in the manufacture of PCBs. However, in certain periods such decrease was partially offset by the devaluation of the NIS primarily against the U.S. dollar and the Euro. Based on the current trends of the raw materials market, we expect that our suppliers will increase their prices in 2005. Although to date our profitability has not been significantly affected by such price changes and NIS devaluation, we cannot assure you that future price changes in raw materials will not materially affect our profitability.

### COMPETITION

The global PCB industry is highly fragmented and intensely competitive, trends that we believe will continue. In the Israeli market we mainly compete with PCB Technologies Ltd., Melta Ltd. and several smaller local PCB manufacturers, as well as with major PCB exporters from the United States, Europe and Asia. Such exporters include Ruwel Werke GmbH (Germany), HannStar Board Corp. (Taiwan), Vertex Precision Electronics Inc. (Taiwan), Nan-Ya PCB Corp. (Taiwan), Unitech Printed Circuit Corp. (Taiwan), Tyco Printed Circuit Group (United States), Dynamic Details Inc. (United Kingdom) (prior to the dissolution of its British plant in 2005), Oriental Printed Circuits Ltd. (Hong Kong) and Dae Duck Electronics Comp. Ltd. (South Korea). In the European market we mainly compete with Ruwel Werke GmbH (Germany), Advanced Circuit Boards NV (Belgium) and Dynamic Details Inc. (United Kingdom) (prior to the dissolution of its British plant in 2005). In the United States market we mainly compete with Tyco Printed Circuit Group (United States). We compete principally in the market for complex, rigid multi-layer PCBs. Although capital requirements are a significant barrier to entry for manufacturing complex PCBs, the basic interconnect technology is generally not protected by patents or copyrights. From the second quarter of the 2001 fiscal year through the 2003 fiscal year, we experienced increased price competition mainly in the rigid PCB segment, particularly from our local competitors and to a lesser extent from U.S., European and Asian based PCB manufacturers, due to continued recession in the Israeli and international electronics industry, which had resulted in reduced demand for our products. During the last years, PCB manufacturers in the

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Far-East (mainly in China) have made significant investments in their PCB production capacity, mainly for rigid PCBs. As a result of this increased production capacity, together with the recession in the international electronics industry from 2001 through 2003, many PCB manufacturers in Europe and the United States ceased their production activities and our current competition in the rigid PCB segment is mainly from PCB manufacturers based in the Far-East, that have substantially lower production costs than us. Price competition as well as increased PCB production capacity in the Far-East, negatively affected our revenues in the two years ended December 31, 2003. Competitive pressures could cause us to lose market share. From 2002 through 2003 we suffered from price erosion, primarily in the rigid PCB segment, that had a material adverse affect on our operating results in the two years ended December 31, 2003.

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### ENVIRONMENTAL MATTERS

Since May 2003, our environmental management system has been ISO 14001 certified. This certification was based on successful implementation of environmental management requirements and includes ongoing monitoring of our processes, raw materials and products. The certification is subject to periodic compliance audits conducted by the Israeli Institute of Standards.

PCB manufacturing requires the use of metals and chemicals classified as hazardous substances. Water used in the manufacturing process must be treated to remove metal particles and other contaminants before it can be discharged into the local sewer systems. Environmental regulations enacted in Israel in September 2000 provide that a company, which is found discharging water containing contaminants, will be liable to pay quadruple the amount normally charged for its water consumption. We operate and maintain effluent water treatment systems and use approved testing procedures at our manufacturing facilities. We believe the waste treatment systems at our facilities are substantially in compliance with all material applicable environmental laws and regulations. There is no assurance, however, that violations will not occur in the future. We are also subject to environmental laws and regulations relating to the storage, use and disposal of chemicals, solid waste and other hazardous materials, as well as air quality regulations. Environmental laws and regulations could become more stringent over time, and the costs of compliance with more stringent laws could be substantial. According to the September 2000 regulations, manufacturing plants are required to reduce the quantity of the wastewater discharged by them by 90% within four years. To be exempted from such legislation, an owner of a plant would have to show the Israeli Ministry of the Environment that a partial or complete decrease in the quantity of wastewater is not feasible. Since 1996, we have undertaken various actions to reduce the use of water in our manufacturing facilities. We believe that we have materially complied with the September 2000 regulations, but no assurance can be given that such compliance will be sufficient.

### INTELLECTUAL PROPERTY RIGHTS

Our success depends in part on our proprietary techniques and manufacturing expertise, particularly in the area of complex multi-layer and flex-rigid PCBs. Like many companies in the PCB segment of the electronics industry, we do not hold any patents and rely principally on trade secret protection of our intellectual property. We believe that, because of the rapid pace of technological change in the electronics industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of support services that we provide.

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### C. ORGANIZATIONAL STRUCTURE

In June 1999, we established Eltek Europe Ltd., as a wholly owned subsidiary incorporated in the United Kingdom, to manage our marketing activities in Europe. Since July 31, 2002, Eltek Europe Ltd. is inactive and the marketing activities in Europe are currently managed from Israel and Germany.

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In May 2002, we established En-Eltek Netherlands 2002 B.V., a wholly owned subsidiary incorporated in the Netherlands, in connection with our acquisition of a 76% interest in Kubatronik. Kubatronik is a PCB manufacturer that specializes in short run and prototype boards, including multi-layer, flex-rigid and HDI boards. Its customers include companies engaged in the production of industrial equipment, defense and aerospace equipment, telecom and networking equipment and computer and data storage equipment as well as contract electronic manufacturers. Mr. Alois Kubat, Kubatronik's founder, holds the remaining 24% interest in such company. See Item 5B. "Operating and Financial Review and Prospects -Liquidity and Capital Resources."

### D. PROPERTY, PLANTS AND EQUIPMENT

#### LEASED FACILITIES

Our executive offices, as well as our design, production, storage and shipping facilities, aggregating approximately 90,000 square feet, are located in an industrial building in the Sgoola Industrial Zone of Petach Tikva, Israel. The lease for our facilities expires in December 31, 2011. A lease for an adjoining 10,000 square feet parking area expires on December 31, 2006. In the fiscal year ended December 31, 2004, we paid NIS 2.3 million (\$535,000) in rent for these premises.

Kubatronik's executive offices as well as its design, production, storage and shipping facilities, aggregating approximately 15,000 square feet, are located in an industrial building in Geislingen, Germany. The lease for their facilities expires in June 30, 2008. A lease for an adjoining 8,000 square feet parking area expires on December 31, 2010. In the fiscal year ended December 31, 2004, Kubatronik paid NIS 482,000 (\$112,000) in rent for these premises.

#### LEASED EQUIPMENT

We lease manufacturing equipment from Orbotech Ltd. under two operating lease agreements, pursuant to which as of December 31, 2004 we are obligated to pay a total amount of NIS 6.1 million (\$1.4 million), through February 2010. Our monthly lease expense under these two agreements is approximately NIS 120,000 (\$28,000), linked to the U.S. dollar.

We lease additional manufacturing equipment under two operating lease agreements, pursuant to which as of December 31, 2004 we are obligated to pay a total amount of NIS 1.5 million (\$354,000), through March 2007. Our monthly lease expense under these two agreements is approximately NIS 76,000 (\$18,000), linked to the Swiss Franc in one agreement and the Euro in the other.

Kubatronik leases manufacturing equipment under two operating lease agreements, pursuant to which as of December 31, 2004 Kubatronik is obligated to pay a total amount of 105,000 Euros (\$143,000), through January 2008. Our monthly lease expense under these two agreements is approximately 5,300 Euros (\$7,200).



INVESTMENT IN EQUIPMENT AND INFRASTRUCTURE

In 2003, we invested NIS 3.8 million (\$881,000) in capital expenditures. Almost all of our capital expenditures were allocated to the purchase of production and manufacturing equipment (mainly for Kubatronik) in the amount of NIS 3.0 million (\$693,000) and leasehold improvements in the amount of NIS 607,000 (\$141,000).

In 2004, we invested NIS 1.5 million (\$341,000) in capital expenditures. Almost all of our capital expenditures were allocated to the purchase of production and manufacturing equipment (mainly for our company) in the amount of NIS 1.1 million (\$250,000) and leasehold improvements in the amount of NIS 306,000 (\$71,000).

In 2005, we intend to invest approximately NIS 4.3 million (\$1 million) in capital expenditures, most of which we intend to allocate to the purchase of production and manufacturing equipment (mainly for our company).

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion and analysis should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this annual report. The following discussion contains forward-looking statements.

CRITICAL ACCOUNTING POLICIES

We have identified the policies below as critical to the understanding of our financial statements. The application of these policies requires management to make estimates and assumptions that affect the valuation of assets and expenses during the reporting period. There can be no assurance that actual results will not differ from these estimates.

The significant accounting policies described in Note 2 of our consolidated financial statements, which we believe to be most important to fully understand and evaluate our financial condition and results of operation under generally accepted accounting principles, are discussed below.

Our financial statements have been prepared in accordance with Israeli GAAP, which vary in certain significant respects from U.S. GAAP, as described in Note 28 to the financial statements.

INVENTORIES

Inventories are recorded at the lower of cost or market value. The cost of raw materials is determined on a moving average basis. The cost of work-in process and completed products is determined on a direct production cost, plus allocated indirect expenses, all of which are on an average basis. If actual market conditions are less favorable than those projected by us or if there is no future demand for part or all of our inventories, we will need to write-off the affected inventories. This could result in an increase of our operating expenses. At December 31, 2004, our inventories amounted to NIS 13.6 million (\$3.2 million).

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### IMPAIRMENT IN VALUE OF ASSETS

Since January 1, 2003, we have applied the Israel Accounting Standards Board, or IASB, Accounting Standard No. 15, "Impairment in Value of Assets", to ensure that our assets in the consolidated balance sheet are not stated at an amount exceeding their recoverable value, which is the higher of the net sales price and the usage value, which is the present value of the estimated future cash flows expected to derive from the use and realization of the asset. This standard which is based on International Accounting Standard No. 36, applies to all of our assets in the consolidated balance sheet, except for tax assets and monetary assets. Likewise this Standards prescribes the presentation and disclosure principles for assets that have declined in value. When the carrying value of an asset in the consolidated balance sheet exceeds its recoverable amount, we recognize an impairment loss equal to the difference between the book value of the asset and its recoverable value. A loss is recognized in this manner will be reversed only if changes have occurred in the estimates used in determining the recoverable value of the asset, from the date on which the last impairment loss was recognized.

### PROPERTY AND EQUIPMENT

Assets are recorded at cost. Depreciation on property and equipment is calculated on the straight-line method over the estimated useful lives of the assets. Annual rates of depreciation range from 3% to 33% per year. Under Israeli GAAP, in accordance with Standard No. 15, certain procedures must be applied in order ensure that our property and equipment in our consolidated balance sheet are not presented at an amount which is in excess of our recoverable value, which is the higher of the net selling price or the present value of the estimated future cash flows expected to be derived from use and disposal of our property and equipment. If in the future the carrying value of our property and equipment do not meet the requirements of Standard No. 15, we may be required to accelerate the depreciation or write-off part of our property and equipment. This could result in an increase of our operating expenses. At December 31, 2004, our property and equipment amounted to NIS 31.6 million (\$7.3 million).

### GOODWILL

Our goodwill as of December 31, 2004 is the surplus of our investment in Kubatronik over the acquired part of its net assets. Under Israeli GAAP, goodwill is amortized periodically on a straight-line basis over ten years. Under U.S. GAAP, goodwill is no longer amortized but evaluated for impairment in accordance with SFAS No. 142. If our future revenues, operating expenses or other assumptions made in order to determine fair value of goodwill are less favorable than our estimates, we may be required to accelerate the amortization or write-off the goodwill associated with the Kubatronik acquisition. At December 31, 2004, such goodwill amounted to NIS 4.7 million (\$1.1 million).

### RECENT ACCOUNTING PRONOUNCEMENTS

#### RECENT ACCOUNTING PRONOUNCEMENTS IN ISRAEL

In July 2004, the IASB published Accounting Standard No. 19, "Taxes on Income." The Standard provides that a liability for deferred taxes is to be recorded for all temporary differences subject to tax, except for a limited number of exceptions. In addition, a deferred tax asset is to be recorded for all temporary differences that may be deducted, losses for tax purposes and tax benefits not yet utilized, if it is anticipated that there will be taxable income against which they can be offset, except for a limited number of exceptions. The new Standard applies to financial statements for periods beginning on January 1, 2005. The Standard provides that it is to be implemented by means of a cumulative effect of a change in accounting method. We believe

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that the impact of the Standard on our results of operations, financial position and cash flows will not be material.

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### RECENT ACCOUNTING PRONOUNCEMENTS IN THE UNITED STATES

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

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

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

As permitted by SFAS 123, we currently account for share-based payments to employees using APB 25, the intrinsic value method, and, as such, recognize no compensation cost for employee stock options. Accordingly, the adoption of the SFAS 123(R) fair value method will have significant impact on our results of operations, although it will have no impact on our overall financial position. The impact of the adoption of SFAS 123(R) cannot be predicted at this time, as it depends on levels of share-based payments for future grant.

In June 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections", or SFAS 154. SFAS 154 replaces APB Opinion No. 20, "Accounting Changes" and SFAS 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS 154 requires that a voluntary change in an accounting principle be applied retrospectively with all prior period financial statements presented in accordance with the new accounting principle. SFAS 154 also requires that a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for prospectively as a change in estimate, and correction of errors in previously issued financial statements should be termed a "restatement". SFAS 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The implementation of SFAS 154 is not expected to have a material impact on our consolidated financial statements.

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### A. OPERATING RESULTS

The following table sets forth, for the periods indicated, selected financial information expressed as a percentage of our total revenues:

|  | FISCAL YEAR ENDED DECEMBER 31, |        |        |
|--|--------------------------------|--------|--------|
|  | 2002                           | 2003   | 2004   |
| Revenues .....                                     | 100.0%                         | 100.0% | 100.0% |
| Cost of revenues .....                             | (98.5)                         | (94.8) | (88.0) |
|  | 1.5                            | 5.2    | 12.0   |
| Gross profit .....                                 |                                |        |        |
| Research and development costs, net .....          | (0.1)                          | *      | --     |
| Selling, general and administrative expenses ..... | (14.0)                         | (13.8) | (14.6) |
| Amortization of goodwill .....                     | (0.3)                          | (0.5)  | (0.5)  |
|  | (12.9)                         | (9.1)  | (3.1)  |
| Operating loss .....                               |                                |        |        |
| Financial expenses, net .....                      | (1.4)                          | (2.8)  | (2.3)  |
| Other income (expenses), net .....                 | 0.3                            | *      | *      |
|  | (14.0)                         | (11.9) | (5.4)  |
| Loss before tax benefit (expenses) .....           |                                |        |        |
| Tax benefit (expenses) .....                       | (0.4)                          | (0.2)  | 0.6    |
|  | (14.4)                         | (12.1) | (4.8)  |
| Loss after tax benefit (expenses) .....            |                                |        |        |
| Minority share in subsidiary's net results..       | (0.2)                          | 0.1    | 0.1    |
|  | (14.6)                         | (12.0) | (4.7)  |
| Net loss .....                                     | (14.6)                         | (12.0) | (4.7)  |

\* Less than 0.1%

FISCAL YEAR ENDED DECEMBER 31, 2004 COMPARED WITH FISCAL YEAR ENDED DECEMBER 31, 2003

**REVENUES.** Revenues increased by 15.4% to NIS 125 million (\$29.0 million) in the fiscal year ended December 31, 2004 from NIS 108.3 million (\$25.1 million) in the fiscal year ended December 31, 2003. The increase in revenues primarily reflects the growth of our sales in Europe, which increase was partially offset by a decrease in our sales to local customers. We believe that our revenues will increase slightly in 2005.

**COST OF REVENUES.** Cost of revenues increased by 7.2% to NIS 110.0 million (\$25.5 million) in the fiscal year ended December 31, 2004 from NIS 102.6 million (\$23.8 million) in the fiscal year ended December 31, 2003. The decrease in cost of revenues as a percentage of revenues primarily reflects the implementation of our strategic plan to concentrate our efforts in the high-end PCB market that provides higher margins and our cost-cutting measures. We believe that our cost of revenues as a percentage of revenues will decrease slightly in 2005.

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**GROSS PROFIT.** Gross profit increased by 265% to NIS 15.0 million (\$3.5 million) in the fiscal year ended December 31, 2004 from NIS 5.7 million (\$1.3 million) in the fiscal year ended December 31, 2003. The increase in gross profits as a percentage of revenues primarily reflects increased margins as a result of the concentration of our efforts in the high-end PCB market, mainly flex-rigid PCBs. We believe that our gross profit as a percentage of revenues will increase slightly in 2005.

**RESEARCH AND DEVELOPMENT INCOME, NET.** We generally do not engage in research and developments efforts. During the years 1999 to 2001, we were a member of a consortium of companies operating in the electronic equipment industry that engaged in research and development under the supervision of the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel, or the Chief Scientist. The consortium ended its activities as of July 31, 2001. In 2003, after the consortium was discontinued, a surplus amount of money was distributed among its members. We received NIS 18,000 (\$4,000) from the distribution that was recorded as income in 2003. We did not record research and development income or expense in 2004.

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES.** Selling, general and administrative expenses increased by 21.8% to NIS 18.3 million (\$4.2 million) in the fiscal year ended December 31, 2004 from NIS 15.0 million (\$3.5 million) in the fiscal year ended December 31, 2003. The increase primarily reflects growth in payroll and related benefits expenses and costs of professional services.

**AMORTIZATION OF GOODWILL.** Amortization of goodwill was NIS 593,000 (\$138,000) in the fiscal year ended December 31, 2004 and NIS 584,000 (\$136,000) in the fiscal year ended December 31, 2003. Goodwill reflects the goodwill arising from our acquisition of Kubatronik.

**OPERATING LOSS.** As a result of the foregoing, we had an operating loss of NIS 3.9 million (\$896,000) in the fiscal year ended December 31, 2004 compared to an operating loss of NIS 9.9 million (\$2.3 million) in fiscal year ended December 31, 2003.

**FINANCIAL EXPENSES, NET.** Financial expenses, net were NIS 2.9 million (\$684,000) in the fiscal year ended December 31, 2004 and NIS 3.0 million (\$694,000) in the fiscal year ended December 31, 2003. Financial expenses, net in the fiscal year ended December 31, 2004 were primarily attributable to short-term credit and bank charges, expenses on long-term loans and exchange rate expenses net.

**OTHER INCOME (EXPENSES), NET.** We had other income, net of NIS 52,000 (\$12,000) in the fiscal year ended December 31, 2004 as compared to other expenses, net of NIS 20,000 (\$5,000) in the fiscal year ended December 31, 2003. Other income, net in the fiscal year ended December 31, 2004 was attributable to gain on disposals of fixed assets, net, which was partially offset by legal expenses that were not in the ordinary course of business.

**TAXES BENEFIT (EXPENSES).** We recorded a tax benefit of NIS 713,000 (\$166,000) in the fiscal year ended December 31, 2004 from a deferred tax asset due to carry-forward losses of Kubatronik that we expect to realize in the foreseeable future. In the fiscal year ended December 31, 2003, Kubatronik recorded taxes on income of NIS 194,000 (\$45,000).

**MINORITY SHARE IN SUBSIDIARY'S NET RESULTS.** Minority share in subsidiary's net results reflects the minority's interest of NIS 182,000 (\$42,000) in Kubatronik's net loss in the fiscal year ended December 31, 2004 as compared to

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the minority interest of NIS 118,000 (\$27,000) in Kubatronik's net loss in the fiscal year ended December 31, 2003.

NET LOSS. As a result of the foregoing, we incurred a net loss of NIS 5.9 million (\$1.4 million) in the fiscal year ended December 31, 2004 as compared to a net loss of NIS 13.0 million (\$3.0 million) in the fiscal year ended December 31, 2003

FISCAL YEAR ENDED DECEMBER 31, 2003 COMPARED WITH FISCAL YEAR ENDED DECEMBER 31, 2002

REVENUES. Revenues slightly increased to NIS 108.3 million (\$25.1 million) in the fiscal year ended December 31, 2003 from NIS 108 million (\$25.1 million) in the fiscal year ended December 31, 2002. The increase in revenues primarily reflects the inclusion of 12 months of Kubatronik's revenues in 2003 compared to approximately seven months in 2002. The increase was offset by the decrease in local market revenues.

COST OF REVENUES. Cost of revenues decreased by 3.6% to NIS 102.6 million (\$23.8 million) in the fiscal year ended December 31, 2003 from NIS 106.5 million (\$24.7 million) in the fiscal year ended December 31, 2002. The decrease in cost of revenues as a percentage of revenues primarily reflects the reduction in raw material usage, reduced payroll expenses and the influence of the high margins obtained by Kubatronik.

GROSS PROFIT. Gross profit increased by 259% to NIS 5.7 million (\$1.3 million) in the fiscal year ended December 31, 2003 from NIS 1.6 million (\$366,000) in the fiscal year ended December 31, 2002. The increase in gross profits as a percentage of revenues primarily reflects the cost-cutting actions that were undertaken to improve our profitability and the increased contribution by Kubatronik.

RESEARCH AND DEVELOPMENT INCOME (EXPENSES), NET. We generally do not engage in research and developments efforts. During the years 1999 to 2001, we were a member of a consortium of companies operating in the electronic equipment industry that engaged in research and development under the supervision of the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel, or the Chief Scientist. The consortium ended its activities as of July 31, 2001. Unapproved reimbursements from the Chief Scientist relating to our research and development expenses arising from our participation in the consortium were debited in 2001 in the amount of NIS 116,000 (\$27,000) and were included in our research development expenses in 2002. In 2003, after the consortium had been discontinued, a surplus amount of money was distributed among its members. We received NIS 18,000 (\$4,000) from the distribution that was recorded as income in 2003.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses decreased by 1.0% to NIS 15.0 million (\$3.5 million) in the fiscal year ended December 31, 2003 from NIS 15.2 million (\$3.5 million) in the fiscal year ended December 31, 2002. The decrease reflects the cost-cutting actions that were undertaken to improve our profitability. The decrease was partially offset by the inclusion of a full year of Kubatronik's expenses in 2003 compared to approximately seven months in 2002.

AMORTIZATION OF GOODWILL. Amortization of goodwill increased by 100% to NIS 584,000 million (\$136,000) in the fiscal year ended December 31, 2003 from NIS 292,000 (\$68,000) in the fiscal year ended December 31, 2002. The increase reflects 12 months of goodwill amortization in the year ended December 31, 2003

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as compared to approximately seven months in the year ended December 31, 2002.

**OPERATING LOSS.** As a result of the foregoing, we had an operating loss of NIS 9.9 million (\$2.3 million) in fiscal year ended December 31, 2003 compared to an operating loss of NIS 14.0 million (\$3.2 million) in fiscal year ended December 31, 2002.

**FINANCIAL EXPENSES, NET.** Financial expenses, net increased to NIS 3.0 million (\$694,000) in the fiscal year ended December 31, 2003 from NIS 1.4 million (\$335,000) in the fiscal year ended December 31, 2002. The increase primarily reflects the impact of the deflation in Israel during the fiscal year ended December 31, 2003 as compared to the 6.5% rate of inflation in the fiscal year ended December 31, 2002.

**OTHER INCOME (EXPENSES), NET.** We had other expenses, net of NIS 20,000 (\$5,000) in the fiscal year ended December 31, 2003 as compared to other income net of NIS 290,000 (\$67,000) in the fiscal year ended December 31, 2002. Other expenses, net in the fiscal year ended December 31, 2003 were attributable to a provision that we recorded in respect to customer indemnification and customs charges. This amount was partially offset by gain on disposals of fixed assets.

**TAX EXPENSES.** We recorded taxes on income of NIS 194,000 (\$45,000) in the fiscal year ended December 31, 2003 as compared to NIS 380,000 (\$88,000) in the fiscal year ended December 31, 2002. The decrease primarily reflects the net loss of Kubatronik in the fiscal year ended December 31, 2003, as a result of which Kubatronik recorded a tax benefit in 2003 of NIS 159,000 (\$37,000) that was partially offset by taxes incurred by En-Eltek Netherlands 2002 B.V. in 2003 on dividends distributed by Kubatronik in 2002.

**MINORITY SHARE IN SUBSIDIARY'S NET RESULTS.** Minority share in subsidiary's net results reflects the minority's interest of NIS 118,000 (\$27,000) in Kubatronik's net loss in the fiscal year ended December 31, 2003 as compared to the minority interest of NIS 198,000 (\$46,000) in Kubatronik's net income for the period beginning on the date of acquisition and ended December 31, 2002.

**NET LOSS.** As a result of the foregoing, we incurred a net loss of NIS 13.0 million (\$3.0 million) in the fiscal year ended December 31, 2003 as compared to a net loss of NIS 15.7 million (\$3.6 million) in the fiscal year ended December 31, 2002.

### QUARTERLY RESULTS OF OPERATIONS

The following table sets forth certain unaudited quarterly financial information in NIS and expressed as a percentage of revenues for each of our last eight quarters. The data has been prepared on a basis consistent with our audited consolidated financial statements included elsewhere in this annual report, consisting only of normal recurring accruals, that we consider necessary for a fair presentation. The operating results for any quarter are not necessarily indicative of results for any future periods.

| QUARTER ENDED (UNAUDITED) |         |         |         |         |
|---------------------------|---------|---------|---------|---------|
| 2003                      |         |         |         |         |
| MAR. 31                   | JUN. 30 | SEP. 30 | DEC. 31 | MAR. 31 |

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(NIS IN THOUSAND)

|  |          |          |          |          |        |
|--|----------|----------|----------|----------|--------|
| ISRAELI GAAP:                                      |          |          |          |          |        |
| Revenues .....                                     | 28,076   | 25,496   | 27,085   | 27,646   | 30,31  |
| Cost of revenues .....                             | (26,882) | (24,367) | (25,076) | (26,318) | (26,84 |
| Gross profit .....                                 | 1,194    | 1,129    | 2,009    | 1,328    | 3,46   |
| Research and development income, net .....         | 18       | -        | -        | -        |        |
| Selling, general and administrative expenses ..... | (4,088)  | (3,519)  | (3,814)  | (3,575)  | (4,62  |
| Amortization of goodwill .....                     | (127)    | (127)    | (153)    | (177)    | (14    |
| Operating income (loss) .....                      | (3,003)  | (2,517)  | (1,958)  | (2,424)  | (1,30  |
| Financial income (expenses), net .....             | (473)    | 28       | (1,429)  | (1,115)  | (1,15  |
| Other income (expenses), net .....                 | 5        | 24       | 134      | (183)    | (1     |
| Income (loss) before tax benefit (expenses).....   | (3,471)  | (2,465)  | (3,253)  | (3,722)  | (2,47  |
| Tax benefit (expenses) .....                       | (126)    | (58)     | 83       | (93)     | (5     |
| Income (loss) after tax benefit (expenses)...      | (3,597)  | (2,523)  | (3,170)  | (3,815)  | (2,53  |
| Minority share in subsidiary's net results...      | (46)     | (22)     | 31       | 155      | (3     |
| Net income (loss) .....                            | (3,643)  | (2,545)  | (3,139)  | (3,660)  | (2,56  |

QUARTER ENDED (UNAUD

|  | 2003                      |         |         |         |        |
|--|---------------------------|---------|---------|---------|--------|
|  | (AS A PERCENTAGE OF TOTAL |         |         |         |        |
|  | MAR. 31                   | JUN. 30 | SEP. 30 | DEC. 31 | MAR. 3 |
| ISRAELI GAAP:                                  |                           |         |         |         |        |
| Revenues .....                                 | 100.0%                    | 100.0%  | 100.0%  | 100.0%  | 10     |
| Cost of revenues .....                         | (95.7)                    | (95.6)  | (92.6)  | (95.2)  | (88.   |
| Gross profit .....                             | 4.3                       | 4.4     | 7.4     | 4.8     | 11.    |
| Research and development income, net .....     | *                         | -       | -       | -       |        |
| Selling, general and administrative expenses.. | (14.6)                    | (13.8)  | (14.1)  | (12.9)  | (15.)  |
| Amortization of goodwill .....                 | (0.4)                     | (0.5)   | (0.5)   | (0.6)   | (0.    |
| Operating income (loss) .....                  | (10.7)                    | (9.9)   | (7.2)   | (8.7)   | (4.    |
| Financial income (expenses), net .....         | (1.7)                     | 0.1     | (5.3)   | (4.0)   | (3.    |
| Other income (expenses), net .....             | *                         | 0.1     | 0.5     | (0.7)   | (0.    |
| Income (loss) before tax benefit (expenses)... | (12.4)                    | (9.7)   | (12.0)  | (13.4)  | (8.    |
| Tax benefit (expenses) .....                   | (0.4)                     | (0.2)   | 0.3     | (0.4)   | (0.    |
| Income (loss) after tax benefit (expenses).... | (12.8)                    | (9.9)   | (11.7)  | (13.8)  | (8.    |
| Minority share in subsidiary's net results.... | (0.2)                     | (0.1)   | 0.1     | 0.6     | (0.    |
| Net income (loss) .....                        | (13.0)                    | (10.0)  | (11.6)  | (13.2)  | (8.    |

\* Less than 0.1%



CONDITIONS IN ISRAEL

We are incorporated under the laws of the State of Israel, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. Accordingly, we are directly influenced by 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.

POLITICAL CONDITIONS

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity, 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 and with Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses had, and may in the future continue to have, an adverse impact on our operations, our financial results or the expansion of our business. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations.

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

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

ECONOMIC CONDITIONS

In recent years, the Israeli economy has gone through a period of recession in economic activity, resulting in low growth rates and growing

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unemployment. Despite positive trends in the Israeli economy in 2004, our operations in the local market, primarily in the rigid PCB segment, have continued to be adversely affected by the economic conditions in Israel and could be further affected if the economic conditions in Israel 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 our business, including our ability to deliver products to our customers and to import raw materials.

### TRADE RELATIONS

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

Israel and the European Union Community concluded a Free Trade Agreement in July 1975 which confers certain advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinition of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

### EFFECTIVE CORPORATE TAX RATE

Israeli companies are generally subject to corporate tax on taxable income at the rate of 35% for the 2004 tax year, 34% for the 2005 tax year, 32% for the 2006 tax year and 30% for the 2007 tax year and thereafter. The Israeli government recently announced a new tax reform, pursuant to which the corporate tax rate is expected to be reduced gradually during the following years up to 25% in 2010, but such tax reform has not yet been enacted. Certain of our production facilities have been granted the status of an "approved enterprise" under the Law for the Encouragement of Capital Investments, 1959, as amended. Subject to certain time limitations, income derived from such approved enterprise will be subject to corporate tax of up to 25%. For additional information see Item 10E. "Additional Information - Taxation - Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959" and Note 24 to our financial statements.

As of December 31, 2004, we had approximately NIS 68.3 million (\$15.9 million) in tax loss carry-forwards, which can be offset against future income without time limitation. We can not be reasonably assured as to our ability to utilize the tax asset attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their

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respective tax bases and our loss carry-forwards in the foreseeable future. Therefore we have not recorded a deferred tax asset in respect of these differences and loss carry-forwards. In the fiscal year ended December 31, 2004, we recorded a deferred tax asset in respect of Kubatronik's tax loss carry-forwards.

### IMPACT OF CURRENCY FLUCTUATION AND OF INFLATION

For many years prior to 1986, the Israeli economy was characterized by high rates of inflation and devaluation of the Israeli currency against the dollar and other currencies. However, since the institution of the Israeli Economic Program in 1985, inflation, while continuing, has been significantly reduced and the rate of devaluation has substantially diminished. Because governmental policies in Israel linked exchange rates to a weighted basket of foreign currencies of Israel's major trading partners, the exchange rate between the NIS and the dollar remained relatively stable during reported periods.

The following table sets forth, for the periods indicated, (i) devaluation of the NIS against the most important currencies for our business, the U.S. dollar, and the Euro, and (ii) inflation as reflected in changes in the Israeli consumer price index.

|                                    | FISCAL YEAR<br>ENDED DECEMBER 31, |      |      |        |      |
|------------------------------------|-----------------------------------|------|------|--------|------|
|                                    | 2000                              | 2001 | 2002 | 2003   | 2004 |
| U.S. dollar .....                  | (2.7)%                            | 9.3% | 7.3% | (7.6)% | 1.6% |
| Euro .....                         | (9.9)                             | 3.8  | 27.2 | 11.3   | 6.2% |
| Israeli consumer price index ..... | 0.0                               | 1.4  | 6.5  | (1.9)  | 1.2% |

Since most of our sales are quoted in U.S. dollars and in Euro and most of our expenses are incurred in NIS, our results could be adversely affected by a change in the rate of inflation in Israel when such change is not offset (or is offset on a lagging basis) by a corresponding devaluation of the NIS against the U.S. dollar and the Euro. Since 2002, we have not used any hedging instruments in order to protect ourselves from currency fluctuation and inflation risks, though we may use them in the future.

### B. LIQUIDITY AND CAPITAL RESOURCES

Historically, we have financed our operations through cash generated by operations, shareholder loans, funds generated by our initial public offering in 1997 (approximately \$5.8 million) and long-term and short-term bank loans and borrowings under available credit facilities.

Our principal commitments consist of obligations outstanding under bank loans and credit facilities, suppliers' credit, and operating leases.

We expended approximately NIS 1.5 million (\$341,000) for capital expenditures in the fiscal year ended December 31, 2004 and approximately NIS 3.8 million (\$881,000) in the fiscal year ended December 31, 2003. In the fiscal years ended December 31, 2004 and 2003, our capital expenditures were mainly

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related to our investments in production and manufacturing equipment and leasehold improvements. We do not presently have any commitments for significant capital spending expenditures or capitalized leases.

In June 2002, we acquired 76% of Kubatronik for approximately 2.6 million Euros. The remaining 24% of Kubatronik is held by Mr. Alois Kubat. Pursuant to the agreement under which we acquired our interest in Kubatronik, as amended on May 4, 2005, following the termination of Mr. Kubat's employment with Kubatronik and prior to December 31, 2007, Mr. Kubat will have the right to require us to purchase, and we will have the right to require Mr. Kubat (or his permitted transferee) to sell to us, Mr. Kubat's entire holdings in Kubatronik. The price for Mr. Kubat's entire holdings in Kubatronik will not be less than 552,000 Euros and will not exceed 920,000 Euros, subject to certain price adjustments set forth in the agreement (including, among other things, accrual of annual interest at the rate of LIBOR + 1% from December 31, 2004). Mr. Kubat retired in October 2003. Under Israeli GAAP, our right to purchase the remaining 24% of Kubatronik has no accounting consequences. Under U.S. GAAP, such an instrument should be marked to market every reporting period, in accordance with SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" (see Note 28 of our financial statements, "Effect of Significant Differences Between Generally Accepted Principles in Israel and the United States").

Net cash provided by operating activities was NIS 7.9 million (\$1.8 million) for the fiscal year ended December 31, 2004. This amount was primarily attributable to fixed assets depreciation of NIS 13.4 million (\$3.1 million), an increase in other liabilities and accrued expenses of NIS 2.5 million (\$569,000), a decrease in other receivables and prepaid expenses of NIS 1.3 million (\$294,000), an increase in trade payables of NIS 1.2 million (\$277,000) and amortization of goodwill of NIS 593,000 (\$138,000). This amount was partially offset by our net loss of NIS 5.9 million (\$1.4 million), an increase in trade receivables of NIS 4.0 million (\$926,000), a deferred tax asset that we recorded in the amount of NIS 753,000 (\$175,000) and an increase in inventories of NIS 379,000 (\$88,000). Net cash provided by operating activities was NIS 6.6 million (\$1.5 million) for the fiscal year ended December 31, 2003. This amount was primarily attributable to fixed assets depreciation of NIS 14.9 million (\$3.5 million), a decrease in trade receivables of NIS 5.7 million (\$1.3 million), amortization of goodwill of NIS 584,000 (\$136,000) and an increase in other liabilities and accrued expenses of NIS 391,000 (\$91,000). This amount was partially offset by our net loss of NIS 13.0 million (\$3.0 million), the inflationary impact on long-term debt of NIS 706,000 (\$164,000), an increase in inventories of NIS 632,000 (\$147,000) and a decrease in trade payables of NIS 503,000 (\$117,000).

Net cash used in investing activities was NIS 1.3 million (\$297,000) in the fiscal year ended December 31, 2004 and NIS 3.5 million (\$811,000) in the fiscal year ended December 31, 2003. The decrease in investing activities in the fiscal year ended December 31, 2004 was primarily attributable to a decrease of NIS 2.3 million (\$540,000) in fixed assets acquisitions.

Net cash used in financing activities was NIS 6.9 million (\$1.6 million) in the fiscal year ended December 31, 2004, which was primarily attributable to a net decrease of NIS 6.9 million (\$1.6 million) in long-term and short-term credit from our banks. Net cash used in financing activities was NIS 5.3 million (\$1.2 million) in the fiscal year ended December 31, 2003, which was primarily attributable to a net decrease of NIS 7.5 million (\$1.7 million) in long-term and short-term credit from our banks which was partially offset by the issuance of convertible note in the amount of NIS 2.2 million (\$503,000).

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As of December 31, 2004, we had NIS 4.3 million (\$992,000) in cash and cash equivalents and working deficit of NIS 10.8 million (\$2.5 million), as compared to NIS 4.4 million (\$1.0 million) in cash and cash equivalents and working deficit of NIS 10.1 million (\$2.3 million) at December 31, 2003.

As of December 31, 2004, the following revolving lines of credit (all of which will be available to us until at least March 31, 2006, subject to certain conditions, unless otherwise indicated) and long-term loans were outstanding.

- o a revolving line of credit of approximately NIS 4.6 million (\$1.1 million) with Bank Hapoalim B.M. Of such amount, NIS 474,000 (\$110,000) was linked to the dollar and NIS 4.1 million (\$952,000) was not linked.
- o long-term loans from Bank Hapoalim B.M. aggregating NIS 4.1 million (\$951,000). Of such amount, NIS 1.8 million (\$412,000) was linked to the Israeli consumer price index, NIS 1.3 million (\$296,000) was linked to the dollar and NIS 1.0 million (\$243,000) was not linked.
- o a revolving line of credit of approximately NIS 3.6 million (\$826,000) with Israel Discount Bank Ltd. Of such amount NIS 560,000 (\$130,000) was linked to the dollar and NIS 3.0 million (\$696,000) was not linked.
- o long-term loans from Israel Discount Bank Ltd. in the aggregate amount of NIS 7.4 million (\$1.7 million). Of such amount, NIS 1.5 million (\$345,000) was linked to the Israeli consumer price index, NIS 4.5 million (\$1.0 million) was linked to the dollar and NIS 1.4 million (\$323,000) was not linked.
- o a revolving line of credit of approximately NIS 5.0 million (\$1.2 million) with Bank Leumi LeIsrael Ltd. Of such amount NIS 491,000 (\$114,000) was linked to the dollar and NIS 4.5 million (\$1.0 million) was not linked. In accordance with agreements with Bank Leumi LeIsrael Ltd., the dollar linked credit line will be repaid in six equal monthly payments during the six months period ending June 30, 2005, and an additional NIS 1.0 million (\$232,000) will be repaid in six equal monthly payments during the six months period ending December 31, 2005.
- o long-term loans from Bank Leumi LeIsrael Ltd. in the aggregate amount of NIS 1.5 million (\$355,000). Of such amount, NIS 902,000 (\$209,000) was linked to the Israeli consumer price index and NIS 628,000 (\$146,000) was linked to the dollar.

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Our credit lines bear annual interest ranging from 6.15% to 6.7% for non-linked credit and 3.9% to 5.15% for credit which was linked to the dollar. Our long-term loans bear annual interest ranging from 5.95% to 7.05% for long-term loans which were linked to the Israeli consumer price index, 3.90% to 4.55% for long-term loans which were linked to the dollar and 6.45% to 6.7% for non-linked long-term loans.

The borrowings from our banks are secured by specific liens on certain assets, by a first priority floating charge on the rest of our assets and by a fixed lien on goodwill (intangible assets) and insurance rights (rights to proceeds on insured assets in the event of damage). In addition, the agreements with our banks prohibit us from selling or otherwise transferring any assets except in the ordinary course of business or from placing a lien on our assets

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without the banks' consent. Financial covenants in respect of our credit facilities and long-term loans require us to maintain the higher of shareholders' equity of NIS 20.0 million (\$4.6 million) or 20% of our total assets according to the loan from Israel Discount Bank Ltd., or Discount Bank, and to maintain the higher of shareholders' equity of NIS 17.0 million (\$3.9 million) or 20% of our total assets, according to the loan from Bank Leumi LeIsrael Ltd., or Leumi Bank. For these purposes, shareholders' equity includes our outstanding convertible note and excludes prepaid expenses. As of December 31, 2003, we were in compliance with such covenants. However, on March 31, 2004 we were in breach of such covenants and therefore negotiated with our banks and were granted a temporary waiver, reducing our covenants to the higher of shareholders' equity of NIS 12 million (\$2.8 million) or 15% of our total assets until the release of our December 31, 2004 earnings (i.e. between March - June 2005). The waiver of Leumi Bank was subject to the repayment by us of NIS 1.5 million (\$348,000) over a 15 month period (from October 1, 2004 to December 31, 2005). In March 2005, the banks agreed to extend the temporary covenants. Leumi Bank agreed to extend the temporary covenants until the release of our June 30, 2005 earnings, following which and until the release of our December 31, 2005 earnings (i.e. between March - June 2006), Leumi Bank agreed to set the shareholders' equity threshold to not less than NIS 16 million (\$3.7 million). In accordance with the Discount Bank extension of the temporary covenants, we are required to maintain the higher of shareholders' equity of NIS 13 million (\$3 million) or 15% of our total assets until the release of our December 31, 2005 earnings. Upon the release of our December 31, 2005 earnings, we are required to comply with our original covenant terms. As of December 31, 2004 and March 31, 2005, we were in compliance with the terms of such temporary covenants. Our management has programs and projects in place in order to continue to meet these terms. We cannot assure you that we will be able to maintain compliance with such covenants in the future.

In June 2004, although not achieving the work plan goals for 2003, the banks agreed to extend our revolving credit until June 30, 2005, and in March 2005, the banks agreed to further extend our revolving credit until March 31, 2006.

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In 2003, we negotiated a new financing plan with our banks and controlling shareholder. Pursuant to this financing plan the banks agreed to postpone 60% of our current outstanding repayments, in the amount of NIS 3.4 million (\$800,000) for ten months with Discount Bank (from June 1, 2003 to March 31, 2004) and for 12 months with Bank Hapoalim B.M., or Hapoalim Bank, and Leumi Bank (from July 1, 2003 to June 30, 2004). Hapoalim Bank and Discount Bank agreed that their share in the aggregate outstanding amount equal to NIS 2.6 million (\$611,000) will be paid in 33 installments beginning on July 1, 2004 and Leumi Bank agreed that the repayment of its share in the aggregate outstanding amount equal to NIS 814,000 (\$189,000) will be required on or after July 1, 2004. In 2004, Leumi Bank agreed that such outstanding amount owed to it will also be paid in 36 installments beginning on July 14, 2004. As part of this financing plan, we signed a factoring agreement with U Bank Ltd. (formerly Investec Bank (Israel) Ltd.), or U Bank, pursuant to which we are entitled to \$1.0 million factoring facilities, in consideration for the assignment to U Bank of an equal amount of our accounts receivable. The use of these factoring facilities by us is subject to the consent of our banks, which initially was provided until June 30, 2004, and following two extensions, our banks have provided their consent until March 31, 2006. Also see Item 7.B., "Major Shareholders and Related Party Transactions - Related Party Transactions."

We expect to finance our entire capital budget from operational cash flow, revolving bank credit lines and long-term bank loans, supplier financing

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and capital contribution from our controlling shareholder. We believe that the availability of our revolving lines of credit, long-term bank loans and cash flow from operations will provide us with sufficient working capital to fund our operational and capital requirements through December 31, 2005.

### C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

We generally do not engage in research and development.

However, in the past we participated as a member of a consortium of companies operating in the electronic equipment industry in a research and development project under the supervision of the Office of the Chief Scientist of the Israeli Ministry of Industry & Trade, or the Office of the Chief Scientist. The consortium ended its activities as of July 31, 2001.

Additionally, in 2005, we were granted membership in OptiPac, a consortium within the framework of the MAGNET program of the Office of the Chief Scientist. The OptiPac mission is to develop generic electro-optical packaging technologies that are critically important in optical fiber based telecommunication systems, and to wide array of industries and applications. Under the terms of the consortium, each member of the consortium will be provided with an advance for its research and development costs for a specific research and development project assigned to it by the consortium. The Office of the Chief Scientist reimburses 66% of such approved research and development expenses. These reimbursements are contingent upon our submitting periodic reports prepared in accordance with the requirements of the Office of the Chief Scientist, but are not contingent upon royalties or any future payments being made by us.

### D. TREND INFORMATION

From the second quarter of 2001 through the second quarter of 2004, we experienced a downturn in the demand for our PCB products as a result of a slowdown in technology spending, price competition and increased PCB production capacity in the Far-East. The downturn in the demand for our products during this period was particularly among our customers from the telecom and networking industries. Customers from these industries accounted for approximately 20% of our revenues in the last four fiscal years, as compared to approximately 40% of our revenues in the preceding fiscal years. The period of downturn was characterized by demand for our special products and prototypes, while demand for recurring orders decreased due to the continued slowdown in technology expenditures.

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From the third quarter of the fiscal year ended December 31, 2002 through the second quarter of 2004, we suffered a further decline in our activities as a result of the termination of three projects that we were involved in. Since we had not engaged in any major new projects, we were forced to compete for market share, particularly in the local market. This competition caused significant price erosion that has negatively affected us.

Since the third quarter of 2004, we have experienced growth in our revenues, primarily as a result of the implementation of our new strategy to focus our marketing efforts in the high end of the PCB market, mainly in the flex-rigid PCB market. In addition, we have been engaged in a new project with our major customer and are developing new business relationships with customers from abroad.

Our backlog at December 31, 2004 was approximately \$5.2 million compared to a backlog of approximately \$3.2 million at December 31, 2003. We include in

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our backlog all purchase orders scheduled for delivery within the next 12 months, although the majority of the backlog typically is scheduled for delivery within 45 days. The majority of the backlog at December 31, 2004 was delivered by March 31, 2005, at which time our backlog was approximately \$3.0 million. For a variety of reasons, including the timing of orders, delivery intervals, customer and product mix and the possibility of customer changes in delivery schedules, backlog as of any particular date may not be a reliable measure of sales for any succeeding period. Cancellation charges generally vary depending upon the time of cancellation and, therefore, substantially all of our backlog may be subject to cancellation without penalty.

### E. OFF-BALANCE SHEET ARRANGEMENTS

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

### F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our minimum contractual obligations and commercial commitments, as of December 31, 2004 and the effect we expect them to have on our liquidity and cash flow in future periods.

| CONTRACTUAL OBLIGATIONS  | PAYMENTS DUE BY PERIOD<br>NIS (IN THOUSANDS) |                     |           |           |
|--|--|---------------------|-----------|-----------|
|  | TOTAL  | LESS THAN 1<br>YEAR | 1-3 YEARS | 3-5 YEARS |
| Short-term bank credit .....   | 12,925                                       | 12,925              | --        | --        |
| Long-term debt obligations .....   | 14,547                                       | 6,664               | 7,883     | --        |
| Capital lease obligations .....  | 648  | 278                 | 370       | --        |
| Operating lease obligations .....  | 32,461                                       | 6,781               | 11,777    | 7,758     |
| Other contractual obligations .....  | 1,226  | 427                 | 388       | 388       |
| Purchase obligations .....   | 3,335  | 3,335               | --        | --        |
| Other long-term liabilities reflected on the<br>company's balance sheet under Israeli GAAP.. | 1,048  | --                  | --        | --        |
| Total .....  | 66,190                                       | 30,410              | 20,418    | 8,146     |

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### A. DIRECTORS AND SENIOR MANAGEMENT

Our articles of association provide for a board of directors consisting of no less than three and no more than nine members or such other number as may be determined from time to time at a general meeting of shareholders, and the number of directors must be odd. Our board of directors is currently composed of seven directors.

Our executive officers are responsible for our day-to-day management. The executive officers have individual responsibilities established by our chief executive officer and by the board of directors.



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

| NAME                    | AGE | POSITION  |
|-------------------------|-----|---|
| ----                    | --- | -----   |
| Nissim Gilam.....       | 66  | Chairman of the Board of Directors                  |
| Arieh Reichart.....     | 51  | President and Chief Executive Officer               |
| Amnon Shemer.....       | 46  | Vice President, Finance and Chief Financial Officer |
| Dan Eshed.....          | 54  | Senior Vice President, Subsidiaries                 |
| Moshe Leibovich.....    | 48  | Vice President, Marketing and Sales                 |
| Eli Dvora.....          | 49  | Vice President, Operations                          |
| David Banitt.....       | 53  | Independent Director                                |
| Jack Bigio.....         | 41  | Director  |
| Revital Degani.....     | 49  | Outside Director                                    |
| Joseph Maiman.....      | 59  | Director  |
| Eliyaho Tov.....        | 61  | Outside Director                                    |
| Joseph Yerushalmi ..... | 67  | Director  |

Messrs. Joseph A. Maiman and Nissim Gilam, Class III directors, will serve as directors until our 2005 general annual meeting of shareholders. Mr. Joseph Yerushalmi, a Class I director, will serve as a director until our 2006 general annual meeting of shareholders. Messrs. David Banitt and Jack Bigio, Class II directors, will serve as directors until our 2007 annual general meeting of shareholders. Ms. Revital Degani and Mr. Eliyaho Tov will serve as outside directors pursuant to the provisions of the Israeli Companies Law for a three-year term until our 2006 annual general meeting of shareholders, following which the service of Ms. Degani as an outside director may not be extended and service of Mr. Tov as an outside director may be renewed for only one additional three-year term.

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NISSIM GILAM has served as chairman of our board of directors since December 1, 1998, he has served as a director since January 1996 and previously held office as a director and our chief executive officer during the period January 1990 through March 1991. Since April 2002, Mr. Gilam is self-employed. From September 1993 until March 2002, Mr. Gilam served as managing director of Ney Agencies Ltd., an Israeli company engaged as a sales agent of raw materials and machinery sold by trading companies. From September 1987 through September 1993, Mr. Gilam served as vice president-finance of Merhav M.N.F. Ltd., an Israeli company that constructs turnkey projects in, among other fields, refineries, energy and agriculture.

ARIEH REICHART joined us in September 1984 and assumed the position of president and chief executive officer in May 1991. Mr. Reichart holds a B.A. degree in Economics and an M.B.A. from Bar-Ilan University.

AMNON SHEMER joined us in March 2004 as vice president-finance and chief financial officer. Prior to joining us and since January 2003, Mr. Shemer was managing director of Mea Control Transfer Ltd., a company that provides investment banking services. From June 1995 until August 2002, Mr. Shemer was vice president of finance for Mentergy Ltd., a publicly-traded company that provides e-learning solutions and satellite communications services. Mr. Shemer holds a B.A. in Economics and Business Administration from Bar-Ilan University and an M.A. degree in Economics from Bar-Ilan University.

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DAN ESHED joined us in April 1987 as a production manager. During his employment Mr. Eshed served as operation manager, senior vice president - technology and infrastructure and was appointed senior vice president - subsidiaries in February 2005. Mr. Eshed holds a B.Sc. degree in Management and Industrial Engineering from Ben Gurion University.

MOSHE LEIBOVICH joined us in November 2003 as vice president marketing and sales. From February 1996 until November 2003, Mr. Leibovich served as marketing and sales manager of Ophir Optronics Ltd., an Israeli company engaged in infra red optical components and subassemblies. Prior to joining Ophir Optronics Ltd. and since January 1994, Mr. Leibovich served as technical marketing and sales manager of A.I. Gil Import Ltd., an Israeli company engaged as the representative of Eveready Battery Company, Inc. in Israel.

ELI DVORA joined us in 1993 after our merger with TPC Ltd. and served as our Comptroller until August 1997. From September 1997 until February 1998, Mr. Dvora was self-employed. In March 1998, Mr. Dvora rejoined us and was appointed our vice president - operations in August 1999. Mr. Dvora holds a B.A. degree in Economics and an M.B.A. degree, both from Bar Ilan University.

DAVID BANITT, an independent director, has served as a director since March 1997. From August 2001 until May 2005, Mr. Banitt served as chief executive officer of Nano-OR Ltd. an Israeli start-up company engaged in the development of electro-optics systems. Prior to joining Nano-OR Ltd. and since January 2001, Mr. Banitt was self-employed. From September 1997 until January 2001, Mr. Banitt served as President of Exsight Electro Optical Systems Ltd., an Israeli start-up company engaged in the development of electro-optics systems for the printed circuit boards industry. From 1993 until 1997, Mr. Banitt served as general manager of Nitzanim Initiative Center. Prior thereto, Mr. Banitt served as Vice President of Marketing of Optrotech Ltd., an Israeli company that provides optical inspection systems to the printed circuit boards industry. Mr. Banitt holds a B.Sc. degree in Electronics Engineering from Tel Aviv University.

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JACK BIGIO has served as a director since May 2000. Since May 2002, Mr. Bigio has served as the president and chief executive officer of Ampal American - Israel Corporation. From July 1995 until April 2002, Mr. Bigio served as vice president-operations and finance of Merhav M.N.F. Ltd., an Israeli company that constructs turnkey projects in, among other fields, refineries, energy and agriculture. Prior thereto he served as an economist and executive assistant to the president of Merhav M.N.F. Ltd. for five years. Mr. Bigio holds a B.A. degree in Economics and Business Administration and an M.B.A. degree, both from The Hebrew University of Jerusalem.

REVITAL DEGANI has served as an outside director since December 2000. Since January 2003, Ms. Degani has served as the CEO of Bakara Handasit Ltd, an Israeli company engaged in engineering control and building inspection and surveying. Ms. Degani was an attorney for 19 years. From January 2000 until December 2002, Ms. Degani was self-employed. From April 1995 until December 1999, Ms. Degani was in-house counsel of Reved Ltd., an Israeli company whose shares trade on the Tel Aviv Stock Exchange, that is engaged in engineering and construction of residential and commercial buildings. Ms. Degani received her qualification as a lawyer and has been a member of the Israel Bar since 1981. Ms. Degani holds a B.A. degree in Law from Tel Aviv University.

JOSEPH MAIMAN has served as a director since July 1988. Mr. Maiman has served as president of Merhav M.N.F. Ltd. since August 1972. Since January 2002, Mr. Maiman has served as the chairman of the board of directors of Israel 10 Channel Ltd. and since April 2002 Mr. Maiman has served as the chairman of the

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board of directors of Ampal American - Israel Corporation, a public holding company that trades on the NASDAQ Stock Market. Mr. Maiman holds a B.A. degree in Economics from University of Texas and an M.A. degree in Economics from Cornell University.

ELIYAHU TOV was appointed as an outside director in December 2003. Since November 1999, Mr. Tov has been a freelance consultant as an economic advisor and management advisor. Mr. Tov serves as a director of several other companies. From 1973 to September 1999, Mr. Tov served as a senior economist of The Israel Corporation Ltd. and during such period served as a director of several companies within The Israel Corporation Ltd. group. Mr. Tov holds a B.A. degree in Economics and Political Science and an M.A. degree in Business Management from the Hebrew University in Jerusalem.

JOSEPH YERUSHALMI has served as a director since December 2003. Since January 1996, Mr. Yerushalmi has served as a senior vice president in charge of the projects of Merhav M.N.F Ltd. From 1992 to 1996, Mr. Yerushalmi served as vice president for projects of Israel Chemicals Ltd. During such time he also served as chairman and director for several of Israel Chemicals Ltd.'s subsidiaries. From 1989 to 1992, Mr. Yerushalmi was a visiting Professor at the University of Pittsburgh and a consultant to industry in energy related projects. Mr. Yerushalmi holds a Ph.D. in Chemical Engineering from the City University of New York. From 1969 to 1977, he was a member of the Faculty of Chemical Engineering of the City College of New York rising to the rank of Full Professor in 1976.

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### B. COMPENSATION

The following table sets forth all compensation we paid with respect to all of our directors and executive officers as a group for the fiscal year ended December 31, 2004.

|  | SALARIES, FEES,<br>COMMISSIONS AND<br>BONUSES | PENSION,<br>RETIREMENT<br>AND SIMILAR<br>BENEFITS |
|--|---|---|
|  | -----   | -----   |
| All directors and executive officers<br>as a group, consisting of twelve persons | \$889,000                                     | \$137,000   |

During the fiscal year ended December 31, 2004, we paid each of our outside and independent directors an annual fee of NIS 15,760 (\$3,658) and a per meeting attendance fee of NIS 1,000 (\$232). During such period we paid Nissim Gilam, chairman of our board of directors, a management fee ranging of \$3,500 per month, and reimbursed him for various expenses that he incurred in connection with his service as chairman of the board of directors in an annual amount of NIS 13,800 (\$3,200).

As of December 31, 2004, our directors and executive officers as a group, consisting of twelve persons, held options to purchase an aggregate of 128,000 ordinary shares. Of such options, options to purchase 108,000 ordinary shares have an exercise price of \$4.375 and will expire in July 2005, and options to purchase 20,000 ordinary shares have an exercise price of \$1.14 and will expire in November 2009. The options vest over a three-year period. All of the options

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were issued under our 2000 Stock Option Plan. See - "Share Ownership - Stock Option Plans."

### C. BOARD PRACTICES

#### ELECTION OF DIRECTORS

Pursuant to our articles of association, the board of directors is divided into three classes (other than outside directors). Generally, at each annual meeting of shareholders one class of directors is elected for a term of three years by a vote of the holders of a majority of the voting power represented and voting at such meeting. All the members of our board of directors (except the outside directors as detailed below) may be reelected upon completion of their term of office.

We do not follow the requirements of the NASDAQ Marketplace Rules with regard to the nomination process of directors, and instead, we follow Israeli law and practice, in accordance with which our directors are recommended by our board of directors for election by our shareholders. See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices."

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#### INDEPENDENT AND OUTSIDE DIRECTORS

The Israeli Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint at least two outside directors. Outside directors must be Israeli residents, unless the company's shares have been offered to the public outside of Israel or have been listed on a stock exchange outside of Israel. No person may be appointed as an outside director if, at the time of the appointment or during the two years that preceded the appointment, the person or the person's relative, partner, employer or a entity of which he is a controlling shareholder had an interest in the company, in a person who was a controlling shareholder of the company at the time of the appointment, or in another entity. The term "interest" includes an employment relationship; a business or professional relationship maintained on a regular basis; control; and service as an officer, excluding service as an outside director of a company that is offering its shares to the public for the first time.

A director of one company may not be appointed as an outside director of another company if, at the time of the appointment, a director of the other company serves as an outside director of the first company. Furthermore, no person may be appointed as an outside director if he is an employee of the Israeli Securities Authority or a stock exchange in Israel.

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

According to the recent amendment to the Israeli Companies Law, at least one of the outside directors must be an accounting and financial expert, and the others must be professional experts, as such terms will be defined in the future by the Minister of Justice, at which time this requirement will become effective.

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

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

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In addition, the NASDAQ Marketplace Rules currently require us to have at least two independent directors on our board of directors and to establish an audit committee. In general, under new NASDAQ Marketplace Rules promulgated pursuant to the Sarbanes-Oxley Act of 2002, effective as of July 31, 2005, a majority of our board of directors must qualify as independent directors within the meaning of the NASDAQ Marketplace Rules and our audit committee must have at least three members and be comprised only of independent directors each of whom satisfies the respective "independence" requirements of the Securities and Exchange Commission and NASDAQ. However, we do not follow the requirements of the NASDAQ Marketplace Rules with regard the NASDAQ requirement to maintain a majority of independent directors (as defined under the NASDAQ Marketplace Rules). Instead, we follow Israeli law and practice, in accordance with which we are required to appoint two outside directors (within the meaning of the Israeli Companies Law) to our board of directors. In addition, we have the mandated three independent directors, within the meaning of the Securities and Exchange Commission, on our audit committee. See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices."

Our board of director has determined that Ms. Degani and Mr. Tov qualify both as independent directors under the Securities and Exchange Commission and NASDAQ requirements and as outside directors under the Israeli Companies Law requirements. Our board of director has further determined that Mr. Banitt qualifies as an independent director under the Securities and Exchange Commission and NASDAQ requirements.

### APPROVAL OF RELATED PARTY TRANSACTIONS UNDER ISRAELI LAW

The Israeli Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. The duty of care requires an office holder to act at a level of competence at which a reasonable office holder in the same position would employ under the same circumstances. The duty of loyalty requires an officer holder to act in good faith and in the company's interest, including, avoiding any act that involves a conflict of interest between the office holder's position in the company and any other position or his personal affairs; avoiding any act that involves competition with the company's business; avoiding exploiting a business opportunity of the company in order to obtain personal gain for the office holder or another person; and disclose to the company any information and

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

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The Israeli Companies Law requires that an office holder promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by us. In addition, if the transaction is an extraordinary transaction, that is, a transaction other than in the ordinary course of business, other than on market terms, or likely to have a material impact on the company's profitability, assets or liabilities, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder or a relative is a 5% or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager. Some transactions, actions and arrangements involving an office holder (or a third party in which an office holder has an interest) must be approved by the board of directors or as otherwise provided for in a company's articles of association, as not being adverse to the company's interest. In some cases, including in the case of an extraordinary transaction, such a transaction, action and arrangement must be approved by the audit committee and by the board of directors itself, and further shareholder approval is required to approve the terms of compensation of an office holder who is a director. An office holder who has a personal interest in a matter, which is considered at a meeting of the board of directors or the audit committee, may not be present during the board of directors or audit committee discussions and may not vote on this matter, unless the majority of the members of the board or the audit committee have a personal interest, as the case may be.

The Israeli Companies Law also provides that an extraordinary transaction with a controlling shareholder or in which a controlling shareholder of the company has a personal interest (including private offerings in which a controlling shareholder has a personal interest) and a transaction with a controlling shareholder or his relative regarding terms of service and employment, must be approved by the audit committee, the board of directors and shareholders. The shareholder approval for such transactions must include at least one-third of the shareholders who have no personal interest in the transaction who voted on the matter. The transaction can be approved by shareholders without this one-third approval, if the total shareholdings of those shareholders who have no personal interest and voted against the transaction do not represent more than one percent of the voting rights in the company.

However, under the Companies Regulations (Relief From Related Party Transactions), 5760-2000, promulgated under the Israeli Companies Law and amended in January 2002, certain transactions between a company and its controlling shareholder(s) and certain transaction with its director(s) regarding terms of compensation do not require shareholder approval.

In addition, directors' compensation and employment arrangements do not require the approval of the shareholders if both the audit committee and the board of directors agree that such arrangements are for the benefit of the

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company. If the director or the office holder is a controlling shareholder of the company then, the employment and compensation arrangements of such director or office holder do not require the approval of the shareholders providing certain criteria is met.

The above relief will not apply if one or more shareholder, holding at least 1% of the issued and outstanding share capital of the company or of the company's voting rights, objects to the grant of such relief, provided that such objection is submitted to the company in writing not later than seven (7) days from the date of the filing of a report regarding the adoption of such resolution by the company pursuant to the requirements of the Israeli Securities Law. If such objection is duly and timely submitted, then the compensation arrangement of the directors will require shareholders' approval as detailed above.

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

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a company's outstanding shares, the acquisition must be made by means of a tender offer for all of the outstanding shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to the acquirer. The Israeli Companies Law provides for appraisal rights if any shareholder files a request in court within three months following the consummation of a full tender offer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquiror may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares

Regulations under the Israeli Companies Law provide that the Israeli Companies Law's tender offer rules do not apply to a company whose shares are publicly traded outside of Israel, if pursuant to the applicable foreign securities laws and stock exchange rules there is a restriction on the acquisition of any level of control of the company, or if the acquisition of any level of control of the company requires the purchaser to make a tender offer to the public shareholders.

### EXCULPATION, INDEMNIFICATION AND INSURANCE OF DIRECTORS AND OFFICERS

The Israeli Companies Law provides that an Israeli company cannot exculpate an office holder from liability with respect to a breach of his duty of loyalty, but may, if permitted by its articles of association, exculpate in

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advance an office holder from his liability to the company, in whole or in part, with respect to a breach of his duty of care. However, a company may not exculpate in advance a director from his liability to the company with respect to a breach of his duty of care in the event of distributions. Our articles of association allow us to exculpate any office holder from his or her liability to us for breach of duty of care, to the maximum extent permitted by law, before or after the occurrence giving rise to such liability.

Additionally, the Israeli Companies Law provides that a company may, if permitted by its articles of association, enter into a contract for the insurance of the liability of any of its office holders with respect to an act performed by him in his capacity as an office holder, for: a breach of his duty of care to us or to another person; breach of his duty of loyalty to us, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice our interests; or a financial liability imposed upon him in favor of another person. Our articles of association provide that, subject to any restrictions imposed by applicable law, we may procure, and/or undertake to procure, insurance covering any past or present or future office holder against any liability which he or she may incur in such capacity, including insurance covering us for indemnifying such office holder, to the maximum extent permitted by law.

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Further, the Israeli Companies Law permits a company, if its articles of association so provide, to indemnify an office holder for acts or omissions committed in his or her capacity as an office holder of the company for:

- o a financial obligation imposed on the office holder in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court;
- o reasonable litigation expenses, including attorney's fees, incurred by the office holder as a result of an investigation or proceeding instituted against him by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against him or the imposition of any financial liability in lieu of criminal proceedings, or concluded without the filing of an indictment against him and a financial liability was imposed on him in lieu of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and
- o reasonable litigation expenses, including attorney's fees, expended by such office holder or charged to him or her by a court: (a) in a proceeding instituted against him or her by or on behalf of the company or by another person, (b) in a criminal charge from which he or she was acquitted, or (c) in criminal proceedings in which he or she was convicted of a crime which does not require proof of criminal intent.

The Israeli Companies Law provides that a company's articles of association may permit the company to indemnify an office holder following a determination to this effect made by the company after the occurrence of the event in respect of which the office holder will be indemnified. It also provides that a company's articles of association may permit the company to undertake in advance to indemnify an office holder, provided that the undertaking is limited to types of events, which, in the opinion of the company's board of directors, are, at the time of giving the undertaking, foreseeable due to our company's activities and to an amount or standard that the board of directors has determined is reasonable under the circumstances. Our



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articles of association provide that we may undertake to indemnify in advance an office holder, in accordance with the conditions set under applicable law, against any liabilities he or she may incur in such capacity, provided that such undertaking is limited with respect to categories of events that can be expected as determined by our board of directors when authorizing such undertaking, and with respect to such amounts determined by our board of directors as reasonable in the circumstances. Furthermore, under our articles of association, we may indemnify any past or present office holder, in accordance with the conditions set under any law, with respect to any past occurrence, whether or not we are obligated under any agreement to indemnify such office holder in respect of such occurrence.

These provisions are specifically limited in their scope by the Israeli Companies Law, which provides that a company may not indemnify an office holder, nor exculpate an office holder, nor enter into an insurance contract which would provide coverage for any monetary liability of an office holder, incurred as a result of certain improper actions.

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

We have agreed to indemnify our office holders to the fullest extent permitted by law. We currently maintain directors and officers liability insurance with a per claim and aggregate coverage limit of \$7.5 million, and in accordance with the approval of our shareholders at our 2004 annual general meeting, we may increase such policy to provide coverage of \$10.0 million. Under our current directors and officers liability insurance policy, losses will be paid in accordance with the following order of priority: first, on behalf of officers and directors, for all loss that they will be obligated to pay as a result of a claim made against them; thereafter, on our behalf, for all loss that an officer or director will be obligated to pay as a result of a claim made against them, to the extent that we are required or permitted by law to indemnify our officers and directors; and thereafter, on our behalf, for all loss that we will be obligated to pay as a result of a securities claim made against us.

### DIRECTORS' SERVICE CONTRACTS

Except for a monthly fee of \$3,500 that we pay to the chairman of our board of directors and his reimbursement for various expenses incurred by him in connection with his service as chairman of the board of directors in an annual amount of up to NIS 18,000 (\$4,200), we do not have any service contracts with our directors. Our directors are not entitled to any benefits upon termination of their service as our directors.

### AUDIT COMMITTEE

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

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committee may consult with our independent auditors and internal auditor, proposing to the board of directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our board of directors.

Our audit committee consists of three board members who satisfy the respective "independence" requirements of the Securities and Exchange Commission, NASDAQ and Israeli Law for audit committee members. Our audit committee is currently composed of Ms. Revital Degani and Messrs. David Banitt and Eliyaho Tov. The audit committee meets at least once each quarter.

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

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### COMPENSATION COMMITTEE

Our board of directors established a compensation committee, which is responsible for the administration of our: (i) 1996 Stock Option Plan; and (ii) 2000 Stock Option Plan (see Item 6.E., "Directors, Senior Management and Employees - Share Ownership - Stock Option Plans"). Messrs. Tov and Gilam are the current members of our compensation committee. Under the Israeli Companies Law, the compensation committee may advise our board of directors with regard to the grant of options, however the actual grant of options must be approved by our board of directors. The grant of options to our office holders requires the approval of our audit committee and board of directors, and, if the office holder is a director, also by our shareholders.

### EXECUTIVE COMMITTEE

Our board of directors established an executive committee, which is responsible for monitoring the implementation of the plan to improve our profitability that was adopted by our management, and recommending to our board of directors future strategies for our company and monitoring their implementation. Messrs. Gilam, Banitt, Tov and Degani are the current members of our executive committee. Our executive committee meets approximately once a month with our Chief Executive Officer.

### INTERNAL AUDIT

The Israeli Companies Law also requires the board of directors of a public company to appoint an internal auditor nominated by the audit committee. A person who does not satisfy the Israeli Companies Law's independence requirements may not be appointed as an internal auditor. The role of the internal auditor is to examine, among other things, the compliance of the company's conduct with applicable law and orderly business practice. Mr. Daniel Shapira serves as our internal auditor.

### NASDAQ MARKETPLACE RULES AND HOME COUNTRY PRACTICES

NASDAQ Marketplace Rule 4350, or Rule 4350, was recently amended to permit foreign private issuers, such as our company, to follow certain home country corporate governance practices without the need to seek individual exemptions from NASDAQ. Instead, a foreign private issuer must provide NASDAQ with a letter

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from outside counsel in its home country certifying that the issuer's corporate governance practices are not prohibited by home country law. On June 9, 2005, we provided NASDAQ with a notice of non-compliance with Rule 4350. We do not comply with the following requirements of Rule 4350, and instead follow Israeli law and practice in respect of such requirements:

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

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- o The requirements regarding the directors nominations process. Instead, we follow Israeli law and practice in accordance with which our directors are recommended by our board of directors for election by our shareholders. See above in this Item 6C. "Directors, Senior Management and Employees - Board Practices- Election of Directors."
- o The requirement regarding the quorum for any meeting of the holders of common stock. Instead, we follow Israeli law and practice which provides that, unless otherwise provided by a company's articles of association, the quorum required for a general meeting of shareholders is at least two shareholders present who hold, in the aggregate, 25% of the company's voting rights. Our articles of association provide that the quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least 40% of the voting rights of the issued share capital. See Item 10A. "Additional Information - Share Capital - Annual and Extraordinary Meetings of Shareholders."

### D. EMPLOYEES

As of December 31, 2004, we employed 261 full-time employees in Israel, of which 150 were employed in manufacturing services, 34 in process and product engineering, 30 in quality assurance and control, 12 in marketing and sales and 35 in finance, accounting, information service and administration.

As of December 31, 2003, we employed 244 full-time employees in Israel, of which 135 were employed in manufacturing services, 35 in process and product engineering, 31 in quality assurance and control, 10 in marketing and sales and 33 in finance, accounting, information service and administration. On May 1, 2003 we laid off about 15% of our employees at such time, mainly from our production lines.

As of December 31, 2002, we employed 294 full-time employees in Israel, of which 158 were employed in manufacturing services, 49 in process and product engineering, 38 in quality assurance and control, 12 in marketing and sales and 37 in finance, accounting, information service and administration.

In addition, as of December 31, 2004, our German subsidiary employed 32 full-time employees and nine part-time employees, 32 full-time employees and two part-time employees at December 31, 2003 and 33 full-time employees and three part-time employees at December 31, 2002.

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We are subject to various Israeli labor laws, general collective bargaining agreements entered into, from time to time, between the Histadrut (General Federation of Labor in Israel) and the Manufacturers Association, as well as specific and local agreements and arrangements. Such laws, agreements, and arrangements cover the wages and employment conditions of our employees, including length of the workday, minimum daily wages for professional workers, contribution to pension fund, insurance for work related accidents, procedures for dismissing employees, determination of severance pay, benefit programs and annual leave. We generally provide our employees with benefits and working conditions beyond the required minimums.

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Some of our officers, key employees and certain of our other employees are party to individual employment agreements. We have entered into a non-disclosure and non-competition agreement with some of our executive officers. All of our officers and employees are subject to confidential and proprietary information provisions set forth in our Code of Business Conduct and Ethics.

Pursuant to Israeli law, we are legally required to pay severance benefits upon certain circumstances, including the retirement or death of an employee or the termination of employment of an employee without due cause. Some of our employees are covered by life and pension insurance policies providing customary benefits to employees, including retirement and severance benefits. Most of our employees are covered by pension funds providing similar benefits. We contribute between 12.0% and 13.3% of base wages to such plans and employees contribute between 5.0% to 5.5% of base wages. We also contribute between 5.0% and 7.5% of base wages to certain "professional advancement" funds for managers, engineers and others and such employees contribute 2.5% of base wages. Our contribution and employee contributions are not limited, however, a company's contribution above certain specified maximum amounts are taxable income to the employee. Israeli employers and employees are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. In the fiscal year ended December 31, 2004, the aggregate payments to the National Insurance Institute amounted to approximately 13.56% of wages (limited to a maximum wage of NIS 34,820 (\$8,083)), with the employee contributing on average 7.84 % (of which approximately 4.01% relates to payments for national health insurance) and the employer contributing the remainder. All such contributions to the National Insurance Institute are subject to minimum amount.

### E. SHARE OWNERSHIP

#### BENEFICIAL OWNERSHIP OF EXECUTIVE OFFICERS AND DIRECTORS

The following table sets forth certain information as of June 20, 2005 regarding the beneficial ownership by each of our directors and executive officers:

| Name<br>-----        | Number of Ordinary<br>Shares<br>Beneficially Owned (1)<br>----- | Percentage of<br>Ownership (2)<br>----- |
|----------------------|---|---|
| Joseph Maiman .....  | 1,736,547 (3)   | 25.8%                                   |
| Arieh Reichart ..... | 115,515 (4)   | 2.1%                                    |
| Nissim Gilam .....   | 30,000 (4)  | *                                       |

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|                         |            |    |
|-------------------------|------------|----|
| Eli Dvora .....         | 23,500 (5) | *  |
| Dan Eshed.....          | --         | -- |
| Moshe Leibovich.....    | --         | -- |
| Amnon Shemer .....      | --         | -- |
| David Banitt.....       | --         | -- |
| Jack Bigio.....         | --         | -- |
| Revital Degani.....     | --         | -- |
| Eliyaho Tov.....        | --         | -- |
| Joseph Yerushalmi ..... | --         | -- |

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 \* Less than 1%

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- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible note currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
- (2) The percentages shown are based on 5,602,511 ordinary shares issued and outstanding as of June 20, 2005.
- (3) Includes 1,136,803 ordinary shares currently issuable upon exercise of a convertible note at \$0.33 per share, by Merhav M.N.F. Ltd., an Israeli private company controlled by Mr. Maiman. Also includes 571,993 ordinary shares held of record by Integral International Inc., a Panama corporation and 27,751 ordinary shares held of record by Integral International Inc.'s wholly owned subsidiary, A. Sariel Ltd. Mr. Maiman, a director, is the controlling shareholder of Integral International Inc. and its wholly owned subsidiary, A. Sariel Ltd. Mr. Maiman may be deemed to be the beneficial owner of the aggregate 599,744 ordinary shares held directly by Integral International Inc. and A. Sariel Ltd.
- (4) Includes 30,000 ordinary shares subject to currently exercisable options granted under our 2000 Stock Option Plan, having an exercise price of \$4.375 per share, which options expire in July 2005.
- (5) Subject to currently exercisable options granted under our 2000 Employee Stock Option Plan, having an exercise price of \$4.375 per share, which options expire in July 2005.

### STOCK OPTION PLANS

#### 1996 STOCK OPTION PLAN

Under our 1996 Stock Option Plan, or the 1996 Plan, options to purchase an aggregate of 474,000 ordinary shares may be granted to our directors and employees. Ordinary shares underlying any options, which terminate, expire or otherwise cease to exist, will become available for future grants under the 1996 Plan.

The 1996 Plan is currently administered by our compensation committee. The compensation committee is authorized to determine, among other things, to whom options may be granted, the number of ordinary shares to which an option may relate, the exercise price for each share, the vesting period of the option, and the terms, conditions and restrictions thereof; to construe and interpret the 1996 Plan and any options; to prescribe, amend and rescind rules and regulations relating to the 1996 Plan; and to make all other determinations deemed necessary or advisable for the administration of the 1996 Plan, all subject to the terms of the 1996 Plan and applicable law.

The exercise price of options granted under the 1996 Plan may not be less than 85% of the fair market value of our ordinary share on the date of grant and the options will expire on the fifth anniversary of the day of grant. Generally, the options will vest ratably over a three-year period and may not be exercised for a period of one year from the date of grant. The exercise price for the options is payable in NIS at the representative exchange rate as published on the date of payment, subject to certain adjustments for mergers, recapitalizations, stock splits and similar transactions.

Upon the occurrence of any ordinary shares split, reverse ordinary shares split, distribution of bonus shares, recapitalization or rights offerings or other substantially similar corporate transaction or event, we will make such equitable changes or adjustments necessary to the number of shares subject to each outstanding option in order to prevent dilution or enlargement of the optionee's rights.

As of June 20, 2005, options for the purchase of 107,999 ordinary shares had been granted under the 1996 Plan (excluding options that expired without being exercised) and were exercised, of which, options to purchase 104,666 ordinary shares at an exercise price of \$1.375 per share and options to purchase 3,333 ordinary shares at an exercise price of \$1.75 per share. There are no options currently outstanding under the 1996 Plan. Options for the purchase of 366,001 ordinary shares are available for future grant under the 1996 Plan. Of the options granted under the 1996 Plan (excluding options that expired without being exercised), options for the purchase of 14,000 ordinary shares were granted to our officers, all of which have been exercised.

#### 2000 STOCK OPTION PLAN

Our 2000 Stock Option Plan, or the 2000 Plan, authorizes the grant of options to purchase up to 750,000 ordinary shares. Employees, officers, directors and consultants of our company and its subsidiaries are eligible to participate in the 2000 Plan. Awards under the 2000 Plan may be granted in the forms of incentive stock options as provided in Section 422 of the U.S. Internal Revenue Code of 1986, as amended, non-qualified stock options, options granted pursuant to Section 102 of the Israeli Tax Ordinance and options granted pursuant to Section 3.9 of the Israeli Tax Ordinance. The 2000 Plan has a term of ten years and will terminate on July 31, 2010. No award of options may be made after such date.

The compensation committee administers the 2000 Plan. Subject to the provisions of the 2000 Plan and applicable law, the compensation committee has the authority, in its sole discretion, to:

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- o propose to grant awards under the 2000 Plan and recommend to the board of directors the persons to whom such awards be granted;
- o determine the form, terms and conditions of the written stock option agreement evidencing the option, including the type of option and the number of shares to which it pertains, the option price, the option period and its vesting schedule, and exercisability of the option in special cases (such as death, retirement, disability and change of control);
- o prescribe the form and provisions of the notice of exercise and payment of the option;
- o nominate a trustee for options issued under Section 102 of the Israeli Tax Ordinance;
- o adjust any or all of the number and type of shares that thereafter may be made the subject of options, the number and type of shares subject to outstanding options, and the grant or exercise price with respect to any option, or, if deemed appropriate, make provision for a cash payment to the holder of any outstanding option in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the 2000 Plan in the event of any dividend or other distribution, recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase, or exchange of shares or other securities;
- o interpret the provisions of the 2000 Plan; and
- o prescribe, amend, and rescind rules and regulations relating to the 2000 Plan or any award thereunder as it may deem necessary or advisable.

Neither the board of directors nor the compensation committee may, without the consent of the optionee, alter or in any way impair the rights of optionee under any award previously granted. Neither the termination of the 2000 Plan nor the change of control of our company (except to the extent provided in the 2000 Plan) will affect any option previously granted.

The option price per share may not be less than 100% of the fair market value of such share on the date of the grant; provided, however, that in the case of an award of an incentive stock option made to a 10% owner, the option price per share may not be less than 110% of the fair market value (as such term is defined in the 2000 Plan) of such share on the date of the award. Generally the options vest ratably over a three-year period.

An option may not be exercisable after the expiration of five (5) years from the date of its award. No option may be exercised after the expiration of its term.

Options are not assignable or transferable by the optionee, other than by will or the laws of descent and distribution, and may be exercised during the lifetime of the optionee only by the optionee or his or her guardian or legal representative; provided, however, that during the optionee's lifetime, the optionee may, with the consent of the compensation committee transfer without consideration all or any portion of his options to members of the optionee's immediate family (as defined in the 2000 Plan), a trust established for the exclusive benefit of members of the optionee's immediate family, or a limited liability company in which all members are members of the optionee's immediate family.

As of June 20, 2005, options for the purchase of 412,933 ordinary shares had been granted under the 2000 Plan (excluding options that expired without being exercised), of which, options to purchase 392,933 ordinary shares have an exercise price of \$4.375 per share and options to purchase 20,000 ordinary shares have an exercise price of \$1.14 per share. Of such options, options to purchase 110,800 ordinary shares have been exercised at an exercise price of \$4.375 per share. Options to purchase 274,033 ordinary shares will expire in July 2005, options to purchase 8,100 ordinary shares will expire in May 2006 and options to purchase 20,000 ordinary shares will expire in November 2009. Options to purchase 282,133 ordinary shares are currently exercisable. Options for the purchase of 337,067 ordinary shares are available for future grant under the 2000 Plan. Of the options granted under the 2000 Plan (excluding options that expired without being exercised), options to purchase 128,000 ordinary shares were granted to our executive officers and the chairman of our board of directors, of which options to purchase 83,500 ordinary shares are currently exercisable and options to purchase 24,500 ordinary shares have been exercised.

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

##### A. MAJOR SHAREHOLDERS

The following table sets forth certain information as of June 20, 2005 regarding the beneficial ownership by all shareholders known to us to own beneficially 5% or more of our ordinary shares:

| Name<br>-----                   | Number of Ordinary<br>Shares<br>Beneficially Owned (1)<br>----- | Percentage of<br>Ownership (2)<br>----- |
|---------------------------------|---|---|
| Joseph Maiman .....             | 1,736,547 (3)   | 25.8%                                   |
| Merhav M.N.F. Ltd.....          | 1,136,803 (4)   | 16.9%                                   |
| Integral International Inc..... | 599,744 (5)   | 10.7%                                   |

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- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
- (2) The percentages shown are based on 5,602,511 ordinary shares issued and outstanding as of June 20, 2005.
- (3) Includes 1,136,803 ordinary shares currently issuable upon exercise of a convertible note at \$0.33 per share, by Merhav M.N.F. Ltd., an Israeli private company controlled by Mr. Maiman. Also includes 571,993 ordinary shares held of record by Integral International Inc., a Panama



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corporation, and 27,751 ordinary shares held of record by Integral International Inc.'s wholly owned subsidiary, A. Sariel Ltd. Mr. Maiman, a director, is the controlling shareholder of Integral International Inc. and its wholly owned subsidiary, A. Sariel Ltd. Mr. Maiman may be deemed to be the beneficial owner of the aggregate 599,744 ordinary shares held directly by Integral International Inc. and A. Sariel Ltd.

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- (4) Issuable upon exercise of a currently convertible note at \$0.33 per share, by Merhav M.N.F. Ltd., an Israeli private company controlled by Mr. Maiman.
- (5) Includes 571,993 ordinary shares held of record by Integral International Inc., a Panama corporation, and 27,751 ordinary shares held of record by Integral International Inc.'s wholly owned subsidiary, A. Sariel Ltd. Mr. Maiman, a director, is the controlling shareholder of Integral International Inc. and its wholly owned subsidiary, A. Sariel Ltd. Mr. Maiman may be deemed to be the beneficial owner of the aggregate 599,744 ordinary shares held directly by Integral International Inc. and A. Sariel Ltd.

### SIGNIFICANT CHANGES IN THE OWNERSHIP OF MAJOR SHAREHOLDERS

Our principal shareholders do not have different voting rights attached to their ordinary shares. As at December 31, 2002, 2003 and 2004, Mr. Joseph Maiman beneficially held 1,395,496, 1,409,896 and 2,015,956 ordinary shares, respectively, representing approximately 28.6%, 28.9% and 36.7 % of our then outstanding ordinary shares, respectively. As at December 31, 2002, 2003 and 2004, Integral International Inc. beneficially held 1,068,396, ordinary shares, representing approximately 21.9%, 21.9% and 19.5% of our then outstanding shares, respectively.

During the period of March 24, 2005 through April 6, 2005, Mr. Joseph Maiman sold 1,416,212 ordinary shares that were beneficially held by him, of which 606,060 ordinary shares were held of record by Menhav M.N.F. Ltd. an Israeli private company controlled by him, 468,652 ordinary shares were held of record by Integral International Inc., a Panama corporation controlled by him, and 341,500 were held directly by Mr. Maiman. As a result, Mr. Maiman's ownership interest decreased to 10.7% (excluding 1,136,803 ordinary shares currently issuable upon exercise of a convertible note).

### RECORD HOLDERS

Based on a review of the information provided to us by our transfer agent, as of June 27, 2004, there were 26 holders of record of our ordinary shares, of which 16 record holders holding approximately 87.75% of our ordinary shares had registered addresses in the United States and eight record holders holding approximately 30.77% of our ordinary shares had registered addresses in Israel. These numbers are not representative of the number of beneficial holders of our shares nor are they representative of where such beneficial holders reside, since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 86.00% of our outstanding ordinary shares as of such date).

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### B. RELATED PARTY TRANSACTIONS

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In 2003, we negotiated a new financing plan with our banks and controlling shareholder. As part of this financing plan, we issued a convertible note in the principal amount of \$500,000 to Merhav M.N.F. Ltd., or Merhav, an Israeli private company controlled by our controlling shareholder, Mr. Joseph A. Maiman. In January 2004, pursuant to the terms of the note, Merhav converted \$200,000 of the amounts due and payable under the note into 606,060 ordinary shares of our company, and we issued a replacement convertible note to Merhav for the amount that remained outstanding under the original note at such date, in the principal amount of \$325,312.5. This note will become due on May 15, 2007. The note bears interest at the rate of 10% per year, compounded on a quarterly basis. Under the terms of the note, Merhav has the right, at any time, to convert the note and any accrued interest thereon into ordinary shares of our company at a price of \$0.33 per ordinary share. We may at our sole discretion repay the accrued interest on the principal amount of the convertible note to Merhav. During 2004, we recorded interest and exchange rate expenses of NIS 150,000 (\$35,000) on the convertible note.

### C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

## ITEM 8. FINANCIAL INFORMATION

### A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

See the consolidated financial statements, including the notes thereto, and the exhibits listed in Item 17 hereof and incorporated herein by this reference.

### LEGAL PROCEEDINGS

In June 2002, an action was initiated by a former employee, citing an alleged breach of an agreement for the payment of royalties in exchange for the use of his invention. The plaintiff is seeking damages of NIS 1.0 million. We intend to deny liability and to assert that no agreement was entered into between the parties, no compensation was agreed upon and that the amount of the claim is baseless. On April 2005, the court referred the parties to mediation proceedings.

During the year 2002, one of our customers demanded that we pay compensation of approximately \$250,000 with respect to damages claimed to have been incurred as a result of the use of defective PCBs that were manufactured and supplied by us. Although we disagreed with the customer's claim we have recorded a provision in respect of our deductible amount that is not covered by our insurance. In the meantime, the claim is being litigated by our insurance company.

In February 2004, the Environment Quality Services Company Ltd. in Ramat-Hovav advised us that it would cease the reception and treatment of certain liquid waste from our company. As a result, we began legal proceedings against the Environment Quality Services Company Ltd., the Ministry of Environment and the Industrial Municipality of Ramat-Hovav. During such proceedings, the parties reached a temporary agreement that allows us to continue to send the waste to Ramat-Hovav. Our lawsuit is still pending at court. Since the claim is still in its early stages, there is no assurance that the temporary solution will become permanent, nor is it possible to assess the success of such legal proceedings.

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From time to time, claims arising in the ordinary course of our business are brought against us. In the opinion of management, no currently existing claims will have a material adverse effect on our financial position, liquidity or results of operations.

### DIVIDEND DISTRIBUTIONS POLICY

We have never paid cash dividends to our shareholders. We intend to retain future earnings for use in our business and do not anticipate paying cash dividends on our ordinary shares in the foreseeable future. Any future dividend policy will be determined by our board of directors and will be based upon conditions then existing, including our results of operations, financial condition, current and anticipated cash needs, contractual restrictions and other conditions as the board of directors may deem relevant.

According to the Israeli Companies Law, a company may distribute dividends out of its profits, so long as the company reasonably believes that such dividend distribution will not prevent the company from paying all its current and future debts. Profits, for purposes of the Israeli Companies Law, means the greater of retained earnings or earnings accumulated during the preceding two years, after deducting previous distributions that were not deducted from the surpluses. In the event cash dividends are declared, such dividends will be paid in NIS.

### B. SIGNIFICANT CHANGES

In March 2005, subsequent to the release of our results of operations for the fiscal year ended December 31, 2004 and the fourth quarter then ended, options to purchase 110,800 ordinary shares were exercised by our employees, resulting in a capital contribution of \$485,000, which we received at the beginning of April 2005.

## ITEM 9. THE OFFER AND LISTING

### A. OFFER AND LISTING DETAILS

#### ANNUAL STOCK INFORMATION

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

| YEAR<br>---- | HIGH<br>----- | LOW<br>----- |
|--------------|---------------|--------------|
| 2000.....    | \$ 8.9688     | \$ 2.2500    |
| 2001.....    | \$ 4.6400     | \$ 1.5000    |
| 2002.....    | \$ 1.9100     | \$ 0.2800    |
| 2003.....    | \$ 1.8400     | \$ 0.3100    |
| 2004.....    | \$ 2.8400     | \$ 0.8200    |

#### QUARTERLY STOCK INFORMATION

The following table sets forth, for each of the full financial quarters in

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the years indicated, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Stock Market:

|                     | HIGH<br>----- | LOW<br>----- |
|---------------------|---------------|--------------|
| 2003                |               |              |
| ----                |               |              |
| First Quarter.....  | \$ 0.430      | \$ 0.310     |
| Second Quarter..... | \$ 0.790      | \$ 0.310     |
| Third Quarter.....  | \$ 0.990      | \$ 0.500     |
| Fourth Quarter..... | \$ 1.840      | \$ 0.620     |
| 2004                |               |              |
| ----                |               |              |
| First Quarter.....  | \$ 2.840      | \$ 1.190     |
| Second Quarter..... | \$ 2.300      | \$ 1.320     |
| Third Quarter.....  | \$ 1.800      | \$ 0.950     |
| Fourth Quarter..... | \$ 1.710      | \$ 0.820     |

### MONTHLY STOCK INFORMATION

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

| MONTH<br>-----     | HIGH<br>----- | LOW<br>----- |
|--------------------|---------------|--------------|
| December 2004..... | \$ 1.330      | \$ 1.120     |
| January 2005.....  | \$ 1.590      | \$ 1.210     |
| February 2005..... | \$ 1.750      | \$ 1.270     |
| March 2005.....    | \$ 6.400      | \$ 1.500     |
| April 2005.....    | \$ 4.500      | \$ 2.120     |
| May 2005.....      | \$ 3.380      | \$ 1.900     |

#### B. PLAN OF DISTRIBUTION

Not applicable.

#### C. MARKETS

Our ordinary shares were listed on the NASDAQ National Market from our initial public offering on January 22, 1997 until May 19, 1999, at which date the listing of our ordinary shares was transferred to the NASDAQ SmallCap Market (symbol: ELTK).

#### D. SELLING SHAREHOLDERS

Not applicable.

#### E. DILUTION

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Not applicable.

### F. EXPENSE OF THE ISSUE

Not applicable.

## ITEM 10. ADDITIONAL INFORMATION

### A. SHARE CAPITAL

Not applicable.

### B. MEMORANDUM AND ARTICLES OF ASSOCIATION

We are registered with the Israeli Registrar of Companies and have been assigned company number 52-004295-3. Section 2 of our memorandum of association provides that we were established for the purpose of engaging in the business of developing, manufacturing, producing, vending, importing, exporting, supplying, distributing and dealing in printed, multi-layer, flexible, semiconductors integrated, thick film and hybrid circuits related products, any components or portions thereof and processors for making same. In addition, the purpose of our company is to perform various corporate activities permissible under Israeli law.

### THE POWERS OF THE DIRECTORS

Under the provisions of the Israel Companies Law and our articles of association, a director cannot participate in a meeting nor vote on a proposal, arrangement or contract in which he or she is materially interested. In addition, our directors cannot vote compensation to themselves or any members of their body without the approval of our audit committee and our shareholders at a general meeting. See "Item 6C. Directors, Senior Management and Employees - Board Practices - Approval of Related Party Transactions Under Israeli Law."

The authority of our directors to enter into borrowing arrangements on our behalf is not limited, except in the same manner as any other transaction by us.

Under our articles of association, the service of directors in office is not subject to any age limitation and our directors are not required to own shares in our company in order to qualify to serve as directors.

### RIGHTS ATTACHED TO SHARES

Our authorized share capital consists of NIS 30,000,000 divided into 50,000,000 ordinary shares of a nominal value of NIS 0.6 each. All outstanding ordinary shares are validly issued, fully paid and non-assessable. The rights attached to the ordinary shares are as follows:

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**DIVIDEND RIGHTS.** Holders of our ordinary shares are entitled to the full amount of any cash or share dividend subsequently declared. The board of directors may declare interim dividends and propose the final dividend with respect to any fiscal year only out of the retained earnings, in accordance with the provisions of the Israeli Companies Law. See "Item 8A. Financial Information - Consolidated and Other Financial Information - Dividend Distribution." If after 30 days a dividend has been declared and it is still unclaimed, the dividend may be invested or otherwise used by us for our own account, as we deem fit, until such dividend is claimed; and we will not be deemed a trustee in

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respect thereof. We are not obliged to pay, and may not pay interest on declared but unpaid dividends if the shareholders entitled to such dividends fails to collect the same or to provide us the necessary information for the payment thereof, or if we are for any other reason unable to pay the dividend to such shareholder.

VOTING RIGHTS. Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

An ordinary resolution requires approval by the holders of a majority of the voting rights represented at the meeting, in person, by proxy or by voting card and voting thereon. As permitted under the Israeli Companies Law, our amended and restated articles of association requires only a simple majority of shareholders present and voting at any shareholders meeting for approval of actions such as increases in the share capital of the company, share splits and other recapitalizations. Nevertheless, approval of a special majority, representing the holders of no less than 75% of the voting rights represented at the meeting in person, by proxy or by voting card, and voting thereon is required in order to amend the articles of association.

Pursuant to our articles of association, our directors are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting. See Item 6C. "Directors, Senior Management and Employees - Board Practices - Election of Directors."

RIGHTS TO SHARE IN OUR PROFITS. Our shareholders have the right to share in our profits distributed as a dividend and any other permitted distribution. See this Item 10B. "Additional Information - Memorandum and Articles of Association - Rights Attached to Shares - Dividend Rights."

RIGHTS TO SHARE IN SURPLUS IN THE EVENT OF LIQUIDATION. In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the nominal value of their holdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

LIMITATIONS ON ANY EXISTING OR PROSPECTIVE MAJOR SHAREHOLDER. See Item 6C. "Directors and Senior Management - Board Practices - Approval of Related Party Transactions Under Israeli Law."

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### CHANGING RIGHTS ATTACHED TO SHARES

According to our articles of association, in order to change the rights attached to any class of shares, such change must be adopted by a resolution in writing by the holders of the majority of the issued shares of such class or by an ordinary resolution at a separate general meeting of the holders of the affected class.

### ANNUAL AND EXTRAORDINARY MEETINGS OF SHAREHOLDERS

The board of directors must convene an annual meeting of shareholders at least once every calendar year, within fifteen months of the last annual meeting. An extraordinary meeting may be convened by the board of directors, as

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it decides or upon a demand of one or more shareholders holding in the aggregate at least 5.0% of our issued capital. The Israeli Companies Law provides that a company whose shares are traded on a stock exchange must give notice of a general meeting of shareholders to its record shareholders at least twenty-one days prior to the meeting. A shareholder present, in person or by proxy, at the commencement of a general meeting of shareholders may not seek the cancellation of any proceedings or resolutions adopted at such meeting on account of any defect in the notice of such meeting relating to the time or the place thereof. Shareholders who are registered in our register of shareholders at the record date may vote at the general meeting of shareholders. The record date is set in the resolution to convene the general meeting of shareholders, provided that such date is set between four to twenty-one (4-21) days or, in the event of a vote by ballots, between four to forty (4-40) days before the date the general meeting is held.

The quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least 40% of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the directors unanimously designate in a notice to the shareholders. The requisite quorum at an adjourned general meeting will be: (i) if the original meeting was convened upon requisition by shareholders pursuant to the Israeli Companies Law - the number of shareholders holding the minimum number of voting shares necessary to make such requisition, present in person or by proxy; and (ii) in any other case - one or more shareholders, present in person or by proxy, holding at least one share.

### LIMITATIONS ON THE RIGHTS TO OWN SECURITIES IN OUR COMPANY

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

### PROVISIONS RESTRICTING CHANGE IN CONTROL OF OUR COMPANY

The Israeli Companies Law requires that mergers between Israeli companies be approved by the board of directors and general meeting of shareholders of both parties to the transaction. The approval of the board of directors of both companies is subject to such boards' confirmation that there is no reasonable doubt that after the merger the surviving company will be able to fulfill its obligations towards its creditors. Each company must notify its creditors about the contemplated merger. Our articles of association provide that such merger be approved by an ordinary resolution of the shareholders, as explained above. The approval of the merger by the general meetings of shareholders of the companies is also subject to additional approval requirements as specified in the Israeli Companies Law and regulations promulgated thereunder. See also Item 6C. "Directors, Senior Management and Employees - Board Practices - Approval of Related Party Transactions Under Israeli Law."

### DISCLOSURE OF SHAREHOLDERS OWNERSHIP

The Israeli Securities Law and regulations promulgated thereunder do not require a company whose shares are publicly traded solely on a stock exchange outside of Israel, as in the case of our company, to disclose its share ownership.

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### CHANGES IN OUR CAPITAL

Changes in our capital are subject to the approval of a simple majority of shareholders present and voting at any shareholders meeting.

#### C. MATERIAL CONTRACTS

None.

#### D. EXCHANGE CONTROLS

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

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

#### E. TAXATION

##### GENERAL CORPORATE TAX STRUCTURE

Israeli companies are subject to "Corporate Tax" at a rate of 35% of taxable income. However, the effective rate of tax payable by a company which is qualified under Israeli law as an "Industrial Company" and/or which derives income from an "approved enterprise" (as further discussed below) may be considerably lower. See this Item 10E." Additional Information - Taxation - Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959."

Israeli companies are generally subject to corporate tax on taxable income at the rate of 35% for the 2004 tax year, 34% for the 2005 tax year, 32% for the 2006 tax year and 30% for the 2007 tax year and thereafter. The Israeli government recently announced an additional new tax reform pursuant to which corporate tax rate is expected to be reduced gradually during the following years up to 25% in 2010, however this tax reform has not yet been enacted. Such tax reform might be modified prior to enactment or might not be enacted at all. Accordingly, we cannot predict the consequences of such expected new tax reform applicable to our company.

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As of December 31, 2004, we had tax loss carry forwards of approximately NIS 67.2 million (\$15.6 million). Such amount can be offset against future income without time limitation.

##### TAX BENEFITS UNDER THE LAW FOR THE ENCOURAGEMENT OF INDUSTRY (TAXES) 1969

Pursuant to the Law for the Encouragement of Industry (Taxes), 1969, or the Industry Law, a company qualifies as an "Industrial Company" if it is resident in Israel and at least 90% of its income in any tax year, determined in Israeli currency (exclusive of income from defense loans, capital gains, interest and dividends) is derived from an "Industrial Enterprise" it owns. An



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"Industrial Enterprise" is defined for purposes of the Industry Law as an enterprise whose majority activity in a given tax year is industrial production.

We believe that we are currently an Industrial Company. An Industrial Company is entitled to certain tax benefits, including a deduction of the purchase price of patents or certain other intangible property rights at the rate of 12.5% per annum.

The tax laws and regulations dealing with the adjustment of taxable income for local inflation provide that Industrial Enterprises, such as us, are eligible for special rates of depreciation deductions. These rates vary in the case of plant and machinery according to the number of shifts in which the equipment is being operated and generally range from 20% to 40% on a straight-line basis, a 30% to 50% on a declining balance basis for equipment first put into operation on or after June 1, 1989 (instead of the regular rates which are applied on a straight-line basis).

Moreover, Industrial Enterprises which are approved enterprises (see below) can choose between (a) the special depreciation rates referred to above or (b) accelerated regular rates of depreciation applied on a straight-line basis in respect of property and equipment, generally ranging from 200% (in respect of equipment) to 400% (in respect of buildings) of the ordinary depreciation rates during the first five years of service of these assets, provided that the depreciation on a building may not exceed 20% per annum.

Eligibility for benefits under the Industry Law is not contingent upon the approval of any Government agency. There can be no assurance that we will continue to so qualify, or will be able to avail ourselves of any benefits under the Industry Law in the future.

### TAX BENEFITS UNDER THE LAW FOR THE ENCOURAGEMENT OF CAPITAL INVESTMENTS, 1959

#### GENERAL

Certain of our production facilities have been granted approved enterprise status pursuant to the Law for the Encouragement of Capital Investments, 1959, as amended, or the Investment Law, which provides certain tax and financial benefits to investment programs that have been granted such status.

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The Israeli Investment Center has the discretion, within the funding limits set by the Government budget, to grant the status of an "approved enterprise" to projects submitted to it if such projects may promote the objectives of the Investment Law and it is desirable to encourage the implementation of the project by the grant of the approval.

The Investment Law provides that capital investments in production facilities (or other eligible facilities) may, upon application to the Israeli Investment Center, be designated as an approved enterprise. Each instrument of approval for an approved enterprise relates to a specific investment program, delineated both by the financial scope of the investment, including sources of funds, and by the physical characteristics of the facility or other assets. The tax benefits available under any instrument of approval relate only to taxable profits attributable to the specific program and are contingent upon meeting the criteria set out in the instrument of approval.

If, as in our case, (i) only a part of a company's taxable income is derived from an approved enterprise or (ii) a company owns more than one approved enterprise, the resulting effective corporate tax rate of the company

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represents the weighted combination of the various applicable rates. A company owning a "mixed enterprise" (i.e., a company the income of which is derived from both an approved enterprise and other sources) generally may not distribute a dividend that is attributable only to the approved enterprise.

Subject to certain provisions concerning income subject to the alternative package of tax benefits (see below), any distributed dividends are deemed attributable to the entire enterprise, and the effective tax rate represents the weighted combination of the various applicable tax rates. A company may elect to attribute dividends distributed by it only to income not subject to the alternative package of tax benefits.

As of December 31, 2004, two approved investment programs are applicable to us. These investments programs are based on the alternative package of tax benefits track and provide for tax exemption on undistributed earnings derived from the programs for two years and a reduced tax rate for the remainder of the benefit period. The benefit period with respect to such programs have not yet commenced, and will expire no later than 2005 for one of the programs and 2016 for the other. However, the tax benefits with respect to income derived out of the programs, if any, may not be available to us due to our noncompliance with a condition prescribed in the certificate of approval. See Note 24 to our financial statements.

In March 2005, the government of Israel passed an amendment to the Investment Law in which it revised the criteria for investments qualified to receive tax benefits as an approved enterprise. No assurance can be given that we will, in the future, be eligible to receive additional tax benefits under this law.

### TAX BENEFITS

Income derived from an approved enterprise is subject to corporate tax at the reduced rate of 25% (or lower in the case of a qualified "foreign investor's company" which is at least 49% owned by non-Israeli residents) until the earlier of (i) seven (or ten in the case of a foreign investor's company) consecutive years, commencing in the year in which the specific approved enterprise first generates taxable income (which income is not offset by deductions attributable to other sources), (ii) 12 years from the year of commencement of production or (iii) 14 years from the year of approval of the approved enterprise status. Income derived from an approved enterprise in Zone A, which is approved after January 1, 1997, is exempt from corporate tax for a period of two years and is subject to the above rates for the balance of the benefit period.

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A company owning an approved enterprise, which was approved after April 1, 1986, may elect to forego the entitlement to grants and to certain tax benefits otherwise available under the Investment Law, and apply for an alternative package of tax benefits. Under the alternative package of tax benefits, undistributed income from the approved enterprise is fully tax-exempt for a defined period. The tax exemption for approval granted prior to August 6, 1996 range between 2 and 10 years, depending principally upon the geographic location within Israel and the type of the approved enterprise. If the certificate of approval was granted after August 6, 1996, the tax exemption will be based upon the geographic location of the approved enterprise in Israel. On expiration of the tax exemption, the approved enterprise is eligible for the beneficial tax rate (25% or less in the case of a qualified foreign investor's company which is at least 49% owned by non-Israeli residents) for the remainder of the applicable period of benefits, as described above.

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Dividends paid out of income derived by an approved enterprise (or out of dividends received from a company whose income is derived by an approved enterprise) are generally subject to withholding tax at the rate of 15% (deductible at source). The rate of 15% is limited to dividends and distributions out of income derived during the benefits period and actually paid at any time up to 12 years thereafter. A company which elects the alternative package of tax benefits will be subject to corporate tax at the otherwise applicable rate of 25% (or lower in the case of a qualified foreign investor's company which is at least 49% owned by non Israeli residents) in respect of the gross amount of the dividend if it pays a dividend out of income derived by its approved enterprise during the tax exemption period.

The tax benefits available to an approved enterprise relate only to taxable income attributable to that specific enterprise and are contingent upon the fulfillment of the conditions stipulated by the Investment Law, the regulations published thereunder and the instruments of approval for the specific investments in the approved enterprises. In the event of our failure to comply with these conditions, the tax and other benefits could be rescinded, in whole or in part, and we might be required to refund the amount of the canceled benefits (including the grants), with the addition of the Israeli consumer price index linkage differences and interest.

A company that qualifies as a foreign investor's company is entitled to further tax benefits relating to its approved enterprises. Subject to certain conditions, a foreign investor company is a company more than 25% of whose share capital (in terms of shares, rights to profits, voting and appointment of directors), and of whose combined share and loan capital, is owned, directly or indirectly, by persons who are not residents of Israel. Such a company with a foreign investment of over 25% will be eligible for an extension of the period of tax benefits for its approved enterprises (up to ten years) and further tax benefits (a reduced corporate tax rate of 10%-20%) should the foreign investment reach or exceed 49%. The rate of 15% applicable to dividends is effective for an unlimited period. No assurance can be given that we currently qualify or will qualify in the future as a foreign investor's company.

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### FINANCIAL BENEFITS

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

The termination or substantial reduction of any of the benefits available under the Investment Law could have a material adverse effect on our future investments in Israel.

### TAXATION UNDER INFLATIONARY CONDITIONS

The Income Tax (Inflationary Adjustments) Law, 1985, or the Inflationary Adjustments Law, is intended to neutralize the erosion of capital investments in business and to prevent tax benefits resulting from deduction of inflationary expenses. This law applies a supplementary set of inflationary adjustments to the nominal taxable profits computed under regular historical cost principles.

The Inflationary Adjustments Law introduced a special tax adjustment for

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the preservation of equity based on changes in the Israeli consumer price index, whereby certain corporate assets are classified broadly into fixed (inflation-resistant) assets and non-fixed assets. Where shareholders' equity, as defined in the Inflationary Adjustments Law, exceeds the depreciated cost of fixed assets (as defined in the Inflationary Adjustment Law), a tax deduction which takes into account the effect of the annual rate of inflation on such excess is allowed (up to a ceiling of 70% of taxable income for companies in any single year, with the unused portion carried forward on a linked basis, without limit). If the depreciated cost of such fixed assets exceeds shareholders' equity, then such excess, multiplied by the annual inflation rate, is added to taxable income. In addition, subject to certain limitations, depreciation of fixed assets and losses carried forward are adjusted for inflation on the basis of changes in the Israeli consumer price index.

PURSUANT TO THE INFLATIONARY ADJUSTMENTS LAW TO WHICH WE ARE SUBJECT, RESULTS FOR TAX PURPOSES ARE MEASURED IN REAL TERMS IN ACCORDANCE WITH THE CHANGES IN THE ISRAELI CONSUMER PRICE INDEX.

### TAX REFORM

On July 24, 2002, Amendment 132 to the Israeli Tax Ordinance was approved by the Israeli parliament and came into effect on January 1, 2003. The principal objectives of the amendment were to broaden the categories of taxable income and to reduce the tax rates imposed on employee income.

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The material consequences of the amendment applicable to our company include, among other things, imposing a tax upon all income of Israeli residents, individuals and corporations, regardless of the territorial source of the income and certain modifications in the qualified taxation tracks of employee stock options. Moreover, companies tax at the rate of 25% will be imposed on dividends that generated from income produced or accrued abroad and also from dividends generated from abroad.

The Israeli government recently announced an additional new tax reform to encourage investments in Israel pursuant to which tax rates on interest, dividends and capital gain, including capital gain from the sale of securities listed on a stock exchange, shall be at equable tax rate of 20% for individuals and 25% for corporate bodies. Likewise, the marginal tax rate on ordinary income of individuals shall be reduced gradually during the following years from 49% to 44% in 2010. Non-Israeli residents will be tax exempt on capital gain derived from investment in Israeli companies within the period commencing July 1, 2005 through December 31, 2007, even if the capital gain was derived after such period and without derogating from any other capital gain tax exemption applying to non-Israeli resident under Israeli law or under any applicable double tax treaty. The new tax reform might be modified prior to enactment or might not be enacted at all. Accordingly, we cannot predict the consequences of such expected tax reform applicable to our company.

### CAPITAL GAINS TAX AND TAXATION OF DIVIDENDS

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain that is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index between the date of purchase and the date of sale. Foreign residents who purchased an asset in foreign currency may request that the inflationary surplus will be computed on the basis of the devaluation of the New Israeli Shekel against such foreign currency. The real

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gain is the excess of the total capital gain over the inflationary surplus. The inflationary surplus accumulated from and after December 31, 1993, is exempt from any capital gains tax in Israel while the real gain is taxed at the applicable rate discussed below.

Dealers in securities in Israel are taxed at regular tax rates applicable to business income.

Under the convention between the United States and Israel concerning taxes on income, Israeli capital gains tax will not apply to the sale, exchange or disposition of ordinary shares by a person:

- o who qualifies as a resident of the United States within the meaning of the U.S.-Israel tax treaty; and
- o who is entitled to claim the benefits available under the U.S.-Israel tax treaty.

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However, this exemption will not apply, among other cases, if the gain is attributable to a permanent establishment of such person in Israel, or if the treaty U.S. resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding the sale, exchange or disposition, subject to specified conditions. In this case, the sale, exchange or disposition would be subject to Israeli tax, to the extent applicable. However, under the U.S.-Israel tax treaty, a U.S. resident generally would be permitted to claim a credit for the taxes against the U.S. federal income tax imposed on the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel tax treaty does not relate to U.S. state or local taxes.

For residents of other countries, the purchaser of the shares may be required to withhold capital gains tax on all amounts received for the sale of our ordinary shares, for so long as the capital gain from such a sale is not exempt from Israeli capital gains tax, and unless a different rate is provided in a treaty between Israel and the stockholder's country of residence.

Under new legislation, which became effective on January 1, 2003, the capital gain from the sale of shares by non-Israeli residents would be tax exempt as long as our shares are listed on the NASDAQ SmallCap Market or any other stock exchange recognized by the Israeli Ministry of Finance, and provided certain other conditions are met, the most relevant of which are: (A) the capital gain is not attributed to the foreign resident's permanent establishment in Israel, and (B) the shares were acquired by the foreign resident after the company's shares had been listed for trading on the foreign Exchange.

If the shares were sold by Israeli residents, then (A) for the period ending December 31, 2002 their sale would be tax exempt so long as (1) the shares are listed on a stock exchange, such as, in our case, the NASDAQ SmallCap Market, which is recognized by the Israeli Ministry of Finance, and (2) we qualified as an industrial company or industrial holding company under the law for Encouragement of Industry (Taxes) 1969 and (B) for the period commencing January 1, 2003, the sale of the shares would be subject to a 15% tax if the shares are listed on a stock exchange recognized by the Israeli Ministry of Finance. We believe that in 2004, we qualified as an Industrial Company under the law for Encouragement of Industry (Taxes) 1969. We cannot provide any assurance that the Israeli tax authorities will agree with the determination that we qualified as an industrial company in the past or that we will maintain this qualification or our status as an industrial company.

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If we are delisted, gains from the sale of our ordinary shares will be subject to capital gains tax at a rate of 25% unless an exemption or other tax rate applies in accordance with a tax treaty between Israel and the shareholder's country of residence.

Under an amendment to the Inflationary Adjustments Law, non-Israeli corporations might be subject to Israeli taxes on the sale of shares in an Israeli company which are traded on certain stock markets, including the NASDAQ SmallCap Market, subject to the provisions of any applicable double taxation treaty.

On the distribution of dividends other than bonus shares (stock dividends), income tax is generally withheld at source at the rate of 25% (or the lower rate payable with respect to dividends received out of income derived from approved enterprises; (see "Law for the Encouragement of Capital Investments, 1959"), unless a double taxation treaty is in effect between Israel and the shareholder's country of residence which provides for a lower tax rate in Israel on dividends. The Convention between the State of Israel and the Government of the United States relating to relief from double taxation, or the Treaty, provides for a maximum tax of 25% on dividends paid to a resident of the United States. Dividends paid to an Israeli company by another Israeli company are not subject to corporate tax, unless received out of income derived from approved enterprises or unless the dividend stems from income produced or accrued abroad.

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### TAXATION OF NON-RESIDENT HOLDERS OF SHARES

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares or stock dividends, income tax at the rate of 25% (12.5% for dividends not generated by an approved enterprise if the non-resident is a U.S. corporation and holds 10% of our voting power, and 15% for dividends generated by an approved enterprise) is withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident will be 25%. However, under the Investment Law, dividends generated by an approved enterprise are taxed at the rate of 15%.

### FOREIGN EXCHANGE REGULATION

Non-residents of Israel who purchase ordinary shares and receive dividends, if any are declared, or any amounts payable upon the dissolution, liquidation or winding up of our affairs will be able to freely repatriate such amounts in non-Israeli currencies, pursuant to the general permit issued by the Controller of Foreign Currency at the Bank of Israel under the Currency Control Law, 1978, provided that we have withheld Israeli income tax with respect to such amounts.

Under the general permit issued by the Controller of Foreign Currency, Israeli residents, including corporations, may generally purchase securities, including the ordinary shares, outside of Israel.

### STAMP DUTY

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Stamp duty applies in Israel to various types of documents at various rates, depending primarily on the type of the document and the amount specified therein. In June 2003, the statute imposing stamp duty was amended. Following this amendment, the Israeli Tax Authority has increased enforcement of this statute. The amendment to the statute and the enforcement actions taken by the Israeli Tax Authority are in legal dispute before the Israeli Supreme Court, which has not yet ruled on this matter. The outcome of the Supreme Court ruling is uncertain. In addition, under current legislation the stamp duty statute is expected to be gradually abolished until its complete cancellation in 2008. To date, we have not received a demand for payment of stamp duty following this amendment. Based on advise from our Israeli counsel, we believe that our exposure to probable costs arising from this law are not material and therefore no provision related to this law has been included in our financial statements as of December 31, 2004.

### UNITED STATES FEDERAL INCOME TAX CONSEQUENCES

The following is a summary of certain material U.S. federal income tax consequences that apply to U.S. Holders who hold ordinary shares as capital assets. This summary is based on the United States Internal Revenue Code of 1986, as amended, or the Code, Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. This summary does not address all tax considerations that may be relevant with respect to an investment in ordinary shares. This summary does not account for the specific circumstances of any particular investor, such as:

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- o broker-dealers,
- o financial institutions,
- o certain insurance companies,
- o regulated investment companies,
- o investors liable for alternative minimum tax,
- o tax-exempt organizations,
- o non-resident aliens of the U.S. or taxpayers whose functional currency is not the U.S. dollar,
- o persons who hold the ordinary shares through partnerships or other pass-through entities,
- o investors that actually or constructively own, or have owned, 10 percent or more of our voting shares, and
- o investors holding ordinary shares as part of a straddle or appreciated financial position or a hedging or conversion transaction.

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

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about the U.S. federal income tax consequences of holding and disposing of ordinary shares.

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

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

For purposes of this summary, a U.S. Holder is:

- o an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;
- o a corporation or other entity created or organized in or under the laws of the United States or any political subdivision thereof;

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- o an estate whose income is subject to U.S. federal income tax regardless of its source; or
- o a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

### TAXATION OF DIVIDENDS

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

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

Subject to complex limitations, any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability, subject to certain limitations set out in the Code (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with



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respect to each such class of income. Dividends generally will be treated as foreign-source passive income or financial services income for United States foreign tax credit purposes. U.S. Holders should note that recently enacted legislation eliminates the "financial services income" category with respect to taxable years beginning after December 31, 2006. Under this legislation, the foreign tax credit limitation categories will be limited to "passive category income" and "general category income." A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 30-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

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Subject to certain limitations, "qualified dividend income" received by a noncorporate U.S. Holder in tax years beginning on or before December 31, 2008 will be subject to tax at a reduced maximum tax rate of 15 percent. Distributions taxable as dividends paid on the ordinary shares should qualify for the 15 percent rate provided that either: (i) we are entitled to benefits under the income tax treaty between the United States and Israel (the "Treaty") or (ii) the ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that the ordinary shares currently are readily tradable on an established securities market in the United States. However, no assurance can be given that the ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied. With respect to the ordinary shares, the U.S. Holder must have held such shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. The rate reduction also does not apply to dividends received from passive foreign investment companies, see discussion below, or in respect of certain hedged positions or in certain other situations. The legislation enacting the reduced tax rate contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

### DISPOSITION OF ORDINARY SHARES

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

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

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

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### PASSIVE FOREIGN INVESTMENT COMPANIES

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

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

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

- o you would be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over the holding period for such ordinary shares,
- o the amount allocated to each year during which we are considered a PFIC other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax

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rate, as the case may be, in effect for that year and an interest charge would be imposed with respect to the resulting tax liability allocated to each such year,

- o the amount allocated to the current taxable year and any taxable year before we became a PFIC would be taxable as ordinary income in the current year, and
- o you would be required to make an annual return on IRS Form 8621 regarding distributions received with respect to ordinary shares and any gain realized on your ordinary shares.

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

Alternatively, if the ordinary shares are considered "marketable stock" and if you elect to "mark-to-market" your ordinary shares, you will generally include in income any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions generally would be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss on the disposition of ordinary shares with respect to which the mark-to-market election is made, is treated as ordinary income or loss.

### BACKUP WITHHOLDING AND INFORMATION REPORTING

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

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

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

### U.S. GIFT AND ESTATE TAX

An individual U.S. Holder of ordinary shares will be subject to U.S. gift

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and estate taxes with respect to ordinary shares in the same manner and to the same extent as with respect to other types of personal property.

### F. DIVIDEND AND PAYING AGENTS

Not applicable.

### G. STATEMENT BY EXPERTS

Not applicable.

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### H. DOCUMENTS ON DISPLAY

We are subject to the reporting requirements of the United States Securities Exchange Act of 1934, as amended, as applicable to "foreign private issuers" as defined in Rule 3b-4 under the Exchange Act, and in accordance therewith, we file annual and interim reports and other information with the Securities and Exchange Commission.

As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, transactions in our equity securities by our officers and directors are exempt from reporting and the "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we distribute annually to our shareholders an annual report containing financial statements that have been examined and reported on, with an opinion expressed by, an independent registered public accounting firm, and we file reports with the Securities and Exchange Commission on Form 6-K containing (among other things) press releases and unaudited financial information.

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the following Securities and Exchange Commission public reference rooms at 450 Fifth Street, N.W., Judiciary Plaza, Room 1024, Washington, D.C. 20549 and on the Securities and Exchange Commission Internet site (<http://www.sec.gov>) and on our website [www.eltekglobal.com](http://www.eltekglobal.com). You may obtain information on the operation of the Securities and Exchange Commission's public reference room in Washington, D.C. by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Exchange Act file number for our Securities and Exchange Commission filings is 0-28884.

The documents concerning our company which are referred to in this annual report may also be inspected at our offices located at Sgoola Industrial Zone, Petach Tikva 49101, Israel.

### I. SUBSIDIARY INFORMATION

Not applicable.

### ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISKS

We are exposed to a variety of risks, including foreign currency fluctuations and changes in interest rates affecting primarily the interest on short-term credit lines, long-term loans and our factoring agreement.

## FOREIGN CURRENCY EXCHANGE RISK

Our financial currency is the NIS and our revenues from sales in Israel are usually linked to the U.S. dollar. We also incur expenses primarily in U.S. dollars and Euros. While in former years we entered into certain foreign exchange contracts and we intend to enter into foreign exchange contracts in 2005, in the fiscal year ended December 31, 2004 we did not enter into any such contracts. We do not expect to use forward contracts for trading purposes in the future. An increase in foreign currency rates (the U.S. dollar and the Euro) as against the NIS will generally result in increased revenues and net income. Similarly, a decrease in foreign currency rates (the U.S. dollar and the Euro) as against the NIS will generally result in decreased revenues and may have a negative impact on our net income.

## INTEREST RATE RISK

Our exposure to market risk for changes in interest rates relates primarily to our short-term credit lines, our non-linked and U.S. dollar linked long-term loans and our factoring agreement. These are principally denominated in (i) NIS and bear annual interest ranging from 6.15% to 6.7% as of December 31, 2004; and (ii) U.S. dollars and bear interest ranging from 3.9% to 5.15% as of December 31, 2004. For purposes of specific risk analysis, we use sensitivity analysis to determine the impact that market risk exposure may have on the financial expenses derived from our short-term credit lines, long-term loans and factoring agreement. Our potential loss over one year that would result from a hypothetical change of 1% in the interest rate would be approximately \$58,000.

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

Not applicable.

## PART II

## ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

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

None.

## ITEM 15. CONTROLS AND PROCEDURES

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

There were no changes to our internal control over financial reporting

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that occurred during the period covered by this annual report on Form 20-F that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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All internal control systems no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Board of Directors has determined that Mr. Eliyaho Tov, who serves on our audit committee, meets the definition of an audit committee financial expert, as defined in Item 401 of Regulation S-K.

ITEM 16B. CODE OF ETHICS

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

ITEM 16C. PRINCIPAL ACCOUNTING FEES AND SERVICES

FEES PAID TO INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS

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

| Services Rendered       | Year Ended December 31, |             |             |             |
|-------------------------|-------------------------|-------------|-------------|-------------|
|                         | 2003                    |             | 2004        |             |
|                         | Fees                    | Percentages | Fees        | Percentages |
| (In thousands)          |                         |             |             |             |
| Audit (1) .....         | NIS 331,000             | 90.9%       | NIS 302,000 | 95.9%       |
| Audit-related (2) ..... | 20,000                  | 5.5%        | --          | --          |
| Tax (3) .....           | 13,000                  | 3.6%        | 13,000      | 4.1%        |
| Other (4) .....         | --                      | --          | --          | --          |
| Total .....             | NIS 364,000             | 100%        | NIS 315,000 | 100%        |

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

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services that generally only the independent accountant can reasonably provide.

- (2) Audit-related fees relate to assurance and associated services that traditionally are performed by the independent accountant, including: attest services that are not required by statute or regulation; accounting consultation and audits in connection with mergers, acquisitions and divestitures; employee benefit plans audits; and consultation concerning financial accounting and reporting standards.

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- (3) Tax fees relate to services performed by the tax division for tax compliance, planning, and advice.

### PRE-APPROVAL POLICIES AND PROCEDURES

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

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

Not applicable.

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

#### ISSUER PURCHASE OF EQUITY SECURITIES

Neither we, nor any affiliated purchaser of our company, have purchased any of our securities during 2004.

## PART III

### ITEM 17. FINANCIAL STATEMENTS

#### CONSOLIDATED FINANCIAL STATEMENTS.

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## ITEM 18. FINANCIAL STATEMENTS

Not applicable.

## ITEM 19. EXHIBITS

Index to Exhibits

| Exhibit | Description   |
|---------|---|
| -----   | -----   |
| 1.1     | Memorandum of Association of the Registrant (1)   |
| 1.2     | Articles of Association of the Registrant, as amended (4)   |
| 2.1     | Specimen of Share Certificate (1)   |
| 4.1     | Indemnity Agreement provided to Arieh Reichart dated December 5, 1996 and a schedule of agreements provided by the Registrant to its officers and directors (1) |
| 4.2     | 1996 Employee Stock Option Plan (1)   |
| 4.3     | 2000 Stock Option Plan (2)  |
| 4.4     | Services Factoring Agreement dated July 8, 2003 (3)   |
| 4.5     | Share Purchase Agreement between En-Eltek Netherlands 2000 B.V., Kubatronik-Leiterplat Mr. Thomas Kubat and Ms. Heike Heidenreich dated June 10, 2002           |
| 4.6     | Extension of Put/Call Option Agreement among En-Eltek Netherlands 2000 B.V. and Mr. AL  |
| 8.1     | List of Subsidiaries of the Registrant  |
| 10.1    | Consent of Somekh Chaikin, a member firm of KPMG International  |
| 12.1    | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) Act, as amended  |
| 12.2    | Certification by Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) Act, as amended  |
| 13.1    | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted the Sarbanes-Oxley Act of 2002  |
| 13.2    | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted the Sarbanes-Oxley Act of 2002  |

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- (1) Filed as an exhibit to our registration statement on Form F-1, registration number 333-5770, as amended, filed with the Securities and Exchange Commission and incorporated herein by reference.
- (2) Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2000 and incorporated herein by reference.
- (3) Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2002 and incorporated herein by reference.
- (4) Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2003 and incorporated herein by reference.

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S I G N A T U R E S

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

ELTEK LTD.

By: /s/ Arie Reichart

-----  
Name: Arie Reichart

Title: President and Chief Executive Officer

By: /s/ Amnon Shemer

-----  
Name: Amnon Shemer

Title: Chief Financial Officer

Dated: June 30, 2005

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ELTEK LTD.

CONSOLIDATED AND COMPANY

FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2004

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Eltek Ltd.

CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS AS OF DECEMBER 31, 2004

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| Consolidated and Company Statements of Changes in Shareholders' Equity for each of the years ended December 31, 2004, 2003 and 2002 | F-5 |
| Consolidated and Company Statements of Cash Flows for each of the years ended December 31, 2004, 2003 and 2002                      | F-6 |
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### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

#### BOARD OF DIRECTORS AND SHAREHOLDERS OF ELTEK LTD.

We have audited the accompanying consolidated and Company balance sheets of Eltek Ltd. (the "Company") and its subsidiaries as of December 31, 2004 and 2003 and the related consolidated and Company statements of operations, changes in shareholders' equity, and cash flows, for each of the years in the three years period ended December 31, 2004. These consolidated and Company financial statements are the responsibility of the Company's Board of Directors and of its Management. Our responsibility is to express an opinion on these consolidated and Company financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and Management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated and Company financial statements, referred to above present fairly, in all material respects, the consolidated and Company financial position as of December 31, 2004 and 2003 and the consolidated results of their operations, changes in their shareholders' equity and their cash flows for each of the years in the three years period ended December 31, 2004, in conformity with accounting principles generally accepted in Israel.

As discussed in Note 2B, the financial statements for dates and reporting periods subsequent to December 31, 2003 are stated in reported amounts, in accordance with the accounting standards of the Israel Accounting Standards Board. The financial statements for dates and reporting periods that ended up to the aforementioned date are stated in values that were adjusted to that date according to the changes in the general purchasing power of the Israeli currency, in accordance with Opinions of the Institute of Certified Public Accountants in Israel.

Accounting principles generally accepted in Israel vary in certain significant respects from U.S. generally accepted accounting principles. Information relating to the nature and effect of such differences is summarized in Note 28 to the consolidated and Company financial statements. As described in Note 28(G)(2) the Company has restated its statements of other comprehensive income

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for the year ended December 31, 2003.

Somekh Chaikin  
 Certified Public Accountants (Isr.)  
 Member Firm of KPMG International

Tel Aviv, Israel, March 14, 2005, except for Note 30, as to which the date is  
 April 5, 2005

BALANCE SHEETS - CONSOLIDATED AND COMPANY

|                                | NOTE | CONSOLIDATED          |                      | COMPANY               |
|--------------------------------|------|-----------------------|----------------------|-----------------------|
|                                |      | DECEMBER 31<br>2003   | DECEMBER 31<br>2004  | DECEMBER 31<br>2003   |
|                                |      | ADJUSTED<br>AMOUNTS** | REPORTED<br>AMOUNTS* | ADJUSTED<br>AMOUNTS** |
| NIS IN THOUSANDS               |      |                       |                      |                       |
| ASSETS                         |      |                       |                      |                       |
| CURRENT ASSETS                 |      |                       |                      |                       |
| Cash and cash equivalents      | 3    | 4,371                 | 4,274                | 1,248                 |
| Receivables:                   |      |                       |                      |                       |
| Trade                          | 4    | 19,787                | 23,835               | 18,820                |
| Other                          | 5    | 2,262                 | 1,158                | 2,405***              |
| Inventories                    | 6    | 13,158                | 13,633               | 11,618                |
| Prepaid expenses               |      | 693                   | 563                  | 648                   |
| Total current assets           |      | 40,271                | 43,463               | 34,739                |
| DEFERRED TAXES                 | 24   | -                     | 753                  | -                     |
| LONG-TERM INVESTMENTS          | 7    | -                     | -                    | 11,267***             |
| PROPERTY AND<br>EQUIPMENT, NET | 8    | 43,381                | 31,569               | 38,162                |
| GOODWILL                       | 1;9  | 4,972                 | 4,656                | -                     |
| Total assets                   |      | 88,624                | 80,441               | 84,168                |

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- \* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2B)
- \*\* Amounts adjusted to reflect inflation in terms of NIS of December 31, 2003.
- \*\*\* Reclassified

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

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Eltek Ltd.

BALANCE SHEETS - CONSOLIDATED AND COMPANY

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|  | NOTE | CONSOLIDATED     |             | COMPANY     |
|--|------|------------------|-------------|-------------|
|  |      | DECEMBER 31      | DECEMBER 31 | DECEMBER 31 |
|  |      | 2003             | 2004        | 2003        |
|  |      | ADJUSTED         | REPORTED    | ADJUSTED    |
|  |      | AMOUNTS**        | AMOUNTS*    | AMOUNTS**   |
|  |      | -----            | -----       | -----       |
|  |      | NIS IN THOUSANDS |             |             |
|  |      | -----            | -----       | -----       |
| LIABILITIES AND SHAREHOLDERS' EQUITY         |      |                  |             |             |
| CURRENT LIABILITIES                          |      |                  |             |             |
| Short-term credit and current maturities     |      |                  |             |             |
| of long-term debts                           | 10   | 19,461           | 19,589      | 19,461      |
| Trade payables                               | 11   | 22,314           | 23,577      | 21,146      |
| Other liabilities and accrued expenses       | 12   | 8,555            | 11,083      | 7,313       |
| Total current liabilities                    |      | 50,330           | 54,249      | 47,920      |
| LONG-TERM LIABILITIES                        |      |                  |             |             |
| Long-term debt, excluding current maturities | 13   | 13,692           | 6,687       | 13,692      |
| Employee severance benefits, net             | 14   | 940              | 1,048       | 864         |
| Total long-term liabilities                  |      | 14,632           | 7,735       | 14,556      |
| Minority interests                           |      | 1,970            | 1,900       | -           |
| CONVERTIBLE NOTE                             | 16   | 2,295            | 1,566       | 2,295       |
| COMMITMENTS AND CONTINGENT LIABILITIES       | 15   |                  |             |             |
| SHAREHOLDERS' EQUITY                         | 17   |                  |             |             |



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|   |    |          |          |
|---|----|----------|----------|
| Operating loss  |    | (13,983) | (9,902)  |
| Financial expenses, net   | 22 | (1,443)  | (2,989)  |
|   |    | -----    | -----    |
| Loss before other income (expenses), net  |    | (15,426) | (12,891) |
| Other income (expenses), net  | 23 | 290      | (20)     |
|   |    | -----    | -----    |
| Loss before tax benefit (expenses)  |    | (15,136) | (12,911) |
| Tax benefit (expenses)  | 24 | (380)    | (194)    |
|   |    | -----    | -----    |
| Loss after tax benefit (expenses)   |    | (15,516) | (13,105) |
| Company's share in losses of subsidiaries, net  | 7  | -        | -        |
| Minority share in subsidiary's net results  |    | (198)    | 118      |
|   |    | -----    | -----    |
| Net loss  |    | (15,714) | (12,987) |
|   |    | =====    | =====    |
| Basic and diluted net loss per NIS 1 par value of the share capital***                            |    | (5.36)   | (3.61)   |
|   |    | =====    | =====    |
| Total par value of shares used to compute basic and diluted net loss per NIS 1 par value of share |    | 2,932    | 3,569    |
|   |    | =====    | =====    |

|   | COMPANY  |                                   |                                   |
|---|--|-----------------------------------|-----------------------------------|
|   | YEAR ENDED<br>DECEMBER 31<br>2002              | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 |
|   | ADJUSTED<br>AMOUNTS**                          | ADJUSTED<br>AMOUNTS**             | REPORTED<br>AMOUNTS*              |
|   | NIS IN THOUSANDS, (EXCEPT LOSS PER SHARE DATA) |                                   |                                   |
| Revenues  | 100,545  | 93,817                            | 108,785                           |
| Cost of revenues                                | (100,978)                                      | (90,803)                          | (95,331)                          |
|   | -----  | -----                             | -----                             |
| Gross profit (loss)                             | (433)  | 3,014                             | 13,454                            |
| Research and development income (expenses), net | (116)  | 18                                | -                                 |
| Selling, general and administrative expenses    | (13,405)                                       | (11,687)                          | (15,054)                          |
| Amortization of goodwill                        | -  | -                                 | -                                 |
|   | -----  | -----                             | -----                             |
| Operating loss                                  | (13,954)                                       | (8,655)                           | (1,600)                           |
| Financial expenses, net                         | (1,081)  | (2,226)                           | (2,281)                           |
|   | -----  | -----                             | -----                             |
| Loss before other income (expenses), net        | (15,035)                                       | (10,881)                          | (3,881)                           |
| Other income (expenses), net                    | (108)  | (108)                             | 43                                |
|   | -----  | -----                             | -----                             |

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|   |          |          |         |
|---|----------|----------|---------|
| Loss before tax benefit (expenses)  | (15,143) | (10,989) | (3,838) |
| Tax benefit (expenses)  | (94)     | 96       | -       |
|   | -----    | -----    | -----   |
| Loss after tax benefit (expenses)   | (15,237) | (10,893) | (3,838) |
| Company's share in losses of subsidiaries, net  | (477)    | (2,094)  | (2,017) |
| Minority share in subsidiary's net results  | -        | -        | -       |
|   | -----    | -----    | -----   |
| Net loss  | (15,714) | (12,987) | (5,855) |
|   | =====    | =====    | =====   |
| Basic and diluted net loss per NIS 1 par value of the share capital***                            | (5.36)   | (3.61)   | (1.36)  |
|   | =====    | =====    | =====   |
| Total par value of shares used to compute basic and diluted net loss per NIS 1 par value of share | 2,932    | 3,569    | 4,131   |
|   | =====    | =====    | =====   |

\* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2B)

\*\* Amounts adjusted to reflect inflation in terms of NIS of December 31, 2003.

\*\*\* Ordinary shares of a par value of NIS 0.6 each.

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

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Eltek Ltd.

STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (CONSOLIDATED AND COMPANY)

|   | NUMBER OF<br>ORDINARY<br>SHARES | ORDINARY<br>SHARES | ADDITIONAL<br>PAID-IN<br>CAPITAL | CAPITAL<br>RESERVES<br>RELATED TO<br>LOANS FROM<br>CONTROLLING<br>SHAREHOLDERS | CUMULATIVE<br>FOREIGN<br>CURRENCY<br>TRANSLATION<br>ADJUSTMENTS | CAPITAL<br>RESERVE |
|---|---------------------------------|--------------------|----------------------------------|--|---|--------------------|
|   | -----                           | -----              | -----                            | -----  | -----   | -----              |
|   | NIS                             | NIS                | NIS                              | NIS  | NIS   | NIS                |
|   | -----                           |                    |                                  |  |   |                    |
|   | (IN THOUSANDS, EXCEPT NUMBER    |                    |                                  |  |   |                    |
|   | -----                           |                    |                                  |  |   |                    |
|   | ADJUSTED AMOUNTS**              |                    |                                  |  |   |                    |
|   | -----                           |                    |                                  |  |   |                    |
| BALANCE AS OF DECEMBER 31, 2001                     | 4,885,651                       | 29,334             | 51,985                           | 10,010   | -   | 6,6                |
| CHANGES DURING THE YEAR                             |                                 |                    |                                  |  |   |                    |
| Cumulative foreign currency translation adjustments | -                               | -                  | -                                | -  | 539   |                    |
| Net loss  | -                               | -                  | -                                | -  | -   |                    |
|   | -----                           | -----              | -----                            | -----  | -----   | -----              |





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|   |          |          |
|---|----------|----------|
| Net loss  | (15,714) | (12,987) |
| ADJUSTMENTS TO RECONCILE NET LOSS TO NET                                  |          |          |
| CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:                              |          |          |
| Inflationary and exchange rate impact on long- term debts                 | (609)    | (706)    |
| Depreciation  | 13,904   | 14,938   |
| Amortization of goodwill  | 292      | 584      |
| Write-off of other assets   | 26       | -        |
| Gain on disposal of properties  | (415)    | (200)    |
| Company's share in losses of subsidiaries, net                            | -        | -        |
| Minority share in subsidiary's net results                                | 198      | (118)    |
| Increase (decrease) in employee severance benefits, net                   | 110      | (62)     |
| Decrease (increase) in trade receivables                                  | 4,052    | 5,721    |
| Decrease (increase) in other receivables<br>and prepaid expenses          | 20       | 20       |
| Decrease (increase) in inventories  | 3,343    | (632)    |
| Increase (decrease) in trade payables                                     | 3,071    | (503)    |
| Increase (decrease) in other liabilities and accrued expenses             | (2,102)  | 391      |
| Accrued interest on convertible note                                      | -        | 105      |
| Interest and exchange rate differentials relating to subsidiaries,<br>net | -        | -        |
| Deferred taxes  | -        | -        |
| Net cash provided by operating activities                                 | 6,176    | 6,551    |

|  | COMPANY                           |                                   |
|--|-----------------------------------|-----------------------------------|
|  | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 |
|  | ADJUSTED<br>AMOUNTS**             | ADJUSTED<br>AMOUNTS**             |
|  | NIS THOUSANDS                     |                                   |
| Net loss   | (15,714)                          | (12,987)                          |
| ADJUSTMENTS TO RECONCILE NET LOSS TO NET                         |                                   |                                   |
| CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:                     |                                   |                                   |
| Inflationary and exchange rate impact on long- term debts        | (609)                             | (706)                             |
| Depreciation   | 12,941                            | 12,993                            |
| Amortization of goodwill   | -                                 | -                                 |
| Write-off of other assets  | 26                                | -                                 |
| Gain on disposal of properties                                   | (8)                               | (112)                             |
| Company's share in losses of subsidiaries, net                   | 477                               | 2,094                             |
| Minority share in subsidiary's net results                       | -                                 | -                                 |
| Increase (decrease) in employee severance benefits, net          | 99                                | (69)                              |
| Decrease (increase) in trade receivables                         | 3,919                             | 5,557                             |
| Decrease (increase) in other receivables<br>and prepaid expenses | 62***                             | (682)***                          |
| Decrease (increase) in inventories                               | 3,111                             | (222)                             |
| Increase (decrease) in trade payables                            | 3,189                             | (1,381)                           |
| Increase (decrease) in other liabilities and accrued expenses    | (746)                             | 423                               |

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|   |         |          |
|---|---------|----------|
| Accrued interest on convertible note                                      | -       | 105      |
| Interest and exchange rate differentials relating to subsidiaries,<br>net | (88)*** | (548)*** |
| Deferred taxes  | -       | -        |
| Net cash provided by operating activities                                 | 6,659   | 4,465    |

\* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2B)

\*\* Amounts adjusted to reflect inflation in terms of NIS of December 31, 2003.

\*\*\* Reclassified

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Eletek Ltd.

STATEMENT OF CASH FLOWS - CONSOLIDATED AND COMPANY (CONT'D)

|   | CONSOLIDATED                      |                                   |                                   |                                   | C        |
|---|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|----------|
|   | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 |          |
|   | ADJUSTED<br>AMOUNTS**             | ADJUSTED<br>AMOUNTS**             | REPORTED<br>AMOUNTS*              | ADJUSTED<br>AMOUNTS**             | AD<br>AM |
| NIS THOUSANDS   |                                   |                                   |                                   |                                   |          |
| CASH FLOWS USED IN INVESTING ACTIVITIES:                                    |                                   |                                   |                                   |                                   |          |
| Investment in subsidiary  | -                                 | -                                 | -                                 | (11,890)                          |          |
| Repayment of loan to subsidiary   | -                                 | -                                 | -                                 | 1,133                             |          |
| Acquisition of newly - consolidated<br>subsidiary (Annex A)                 | (4,259)                           | -                                 | -                                 | -                                 |          |
| Purchase of fixed assets  | (7,963)                           | (3,797)                           | (1,470)                           | (6,959)                           |          |
| Dividends declared prior to the<br>acquisition and paid to the shareholders | (2,644)                           | -                                 | -                                 | -                                 |          |
| Proceeds from sale of fixed assets  | 453                               | 304                               | 188                               | 15                                |          |
| Net cash used in investing activities                                       | (14,413)                          | (3,493)                           | (1,282)                           | (17,701)                          |          |
| CASH FLOWS PROVIDED BY (USED IN)  |                                   |                                   |                                   |                                   |          |
| FINANCING ACTIVITIES:   |                                   |                                   |                                   |                                   |          |
| Increase (decrease) in short- term credit                                   | 4,884                             | (1,388)                           | (726)                             | 4,841                             |          |
| Repayment of long-term loans  | (8,614)                           | (6,116)                           | (6,164)                           | (8,614)                           |          |
| Long-term loans received  | 11,948                            | -                                 | -                                 | 11,948                            |          |
| Dividend distributions of subsidiary  | (625)                             | -                                 | -                                 | -                                 |          |
| Issue of convertible note   | -                                 | 2,166                             | -                                 | -                                 |          |
| Net cash provided by (used in) financing                                    |                                   |                                   |                                   |                                   |          |

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|  |       |         |         |         |
|--|-------|---------|---------|---------|
| activities   | 7,593 | (5,338) | (6,890) | 8,175   |
|  | ----- | -----   | -----   | -----   |
| ADJUSTMENTS FROM TRANSLATION OF FINANCIAL STATEMENTS OF AUTONOMOUS UNITS | 309   | 414     | 126     | -       |
|  | ----- | -----   | -----   | -----   |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS                     | (335) | (1,866) | (97)    | (2,867) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD                         | 6,572 | 6,237   | 4,371   | 6,358   |
|  | ----- | -----   | -----   | -----   |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD                               | 6,237 | 4,371   | 4,274   | 3,491   |
|  | ===== | =====   | =====   | =====   |

\* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2B)

\*\* Amounts adjusted to reflect inflation in terms of NIS of December 31, 2003.

\*\*\* Reclassified

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

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Eltek Ltd.

STATEMENTS OF CASH FLOWS - CONSOLIDATED AND COMPANY (CONT'D)

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CONSOLIDATED  
-----  
YEAR ENDED  
DECEMBER 31  
2002  
-----  
ADJUSTED  
AMOUNTS\*  
-----  
NIS THOUSANDS  
-----

ANNEX A - ACQUISITION OF NEWLY CONSOLIDATED SUBSIDIARY

Assets and liabilities of subsidiary at date of acquisition

|                                   |         |
|-----------------------------------|---------|
| Working capital (other than cash) | 2,694   |
| Property and equipment            | (4,154) |
| Goodwill                          | (4,998) |
| Minority interests                | 2,152   |
| Employees severance benefits      | 47      |
|                                   | -----   |
|                                   | (4,259) |
|                                   | =====   |

ANNEX B - NON CASH INVESTING ACTIVITIES

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In May 2002, the Company purchased a computer system for the price of NIS 1,262 thousand by means of a five year long-term loan. The loan is being repaid in 48 monthly installments beginning in May 2003.

Conversion of convertible note into share capital in the amount of NIS 879.

\* Amounts adjusted to reflect inflation in terms of NIS of December 31, 2003.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 1 - GENERAL

Eltek Ltd. ("the Company") was incorporated in Israel in 1970. The Company manufactures and supplies advanced printed circuit boards ("PCB"), complex multi-layer back-panels and flex rigid circuit boards for sophisticated electronic equipment. The principal markets of the Company are in Israel and Europe.

In June 2002, the Company established a wholly-owned subsidiary, EN-Eltek Netherlands 2002 B.V. ("EN-Eltek"), for the purpose of the acquisition of Kubatronik Leiterplatten GmbH (see below). All of the excess of the consideration over the fair value of Kubatronik's assets and liabilities was attributed to goodwill. The Company has two other subsidiaries (Eltek Europe and Eltek International), which have been inactive for several years.

The Company incurred losses of approximately NIS 5.9 million in 2004 and has a working capital deficit of approximately NIS 14 million as at December 31, 2004. Management has taken a series of measures since 2003 that are intended to put the Company on a positive track, such as a reduction in workforce and new finance arrangements with the banks as described hereafter.

In July 2003, the Company finalized a process of restructuring its long-term loans and reached a new settlement with its banks: The restructuring included the postponement of the repayment of 60% of the Company's current maturities of long-term loans for ten months with Israel Discount Bank Ltd. ("Discount Bank") (from June 1, 2003 to March 31, 2004) and for one year with Bank Hapoalim B.M. ("Bank Hapoalim") and Bank Leumi Le-Israel Ltd. ("Leumi Bank") (from July 1, 2003 to June 30, 2004). - The postponed repayments recommenced in July 2004. The remaining 40% and the interest on the entire principal had been repaid monthly as scheduled.

In June 2004, the Company, although not achieving the work plan goals for 2003, was provided an extension of its revolving credit until June 30, 2005, and in March 2005 the banks agreed to further extend the Company's revolving credit until March 31, 2006.

In June 2003, the Company signed a factoring agreement with U Bank Ltd. (formerly Investec Bank (Israel) Ltd.) ("U Bank"), pursuant to which the Company is entitled to \$ 1.0 million factoring facilities, in consideration for the assignment to U Bank of an equal amount of the Company's accounts

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receivable. The use of these factoring facilities by the Company is subject to the consent of Discount Bank, Bank Hapoalim and Leumi Bank, which initially was provided until June 30, 2004, and following two extensions, the banks have provided their consent until March 31, 2006.

Financial covenants in respect of the Company's credit facilities and long-term loans require the Company to maintain the higher of shareholders' equity of NIS 20.0 million or 20% of the Company's total assets according to the loan from Discount Bank, and to maintain the higher of shareholders' equity of NIS 17.0 million or 20% of the Company's total assets, according to the loan from Leumi Bank. For these purposes, shareholders' equity includes the Company's outstanding convertible note and excludes prepaid expenses. As of December 31, 2003, the Company was in compliance with such covenants. However, on March 31 2004, the Company was in breach of such covenants and therefore negotiated with its banks and was granted a temporary waiver, reducing the Company's covenants to the higher of shareholders' equity of NIS 12 million or 15% of its total assets until the release of the Company's December 31, 2004 earnings (i.e. between March - June 2005). The waiver of Leumi Bank was subject to the repayment by the Company of NIS 1.5 million over a 15 month period (from October 1, 2004 to December 31, 2005). In March 2005, the banks agreed to extend the temporary covenants. Leumi Bank agreed to extend the temporary covenants until the release of the Company's June 30, 2005 earnings, following which and until the release of the Company's December 31, 2005 earnings (i.e. between March - June 2006), Leumi Bank agreed to set the shareholders' equity threshold to not less than NIS 16 million. In accordance with the Discount Bank extension of the temporary covenants, the Company is required to maintain the higher of shareholders' equity of NIS 13 million or 15% of its total assets until the release of the Company's December 31, 2005 earnings. Upon the release of the Company's December 31, 2005 earnings, it is required to comply with its original covenant terms. As of December 31, 2004, the Company was in compliance with the terms of such temporary covenants. The Company's management has programs and projects in place in order to continue to meet these terms.

The Company received an infusion of US\$500,000 by means of issuance of a convertible note in July 2003, out of which US\$ 200,000 was converted into ordinary shares during the reporting period (see Note 16).

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 1 - GENERAL (CONT'D)

##### ACQUISITION OF KUBATRONIK LEITERPLATTEN GMBH

On June 10, 2002, the Company signed a Share Purchase Agreement ("SPA") for the purchase of 76% of the shares of Kubatronik - Leiterplatten GmbH ("Kubatronik"). The purchase price was (euro) 2.6 million (NIS 11.8 million as of the date of acquisition).

Pursuant to the agreement, the seller has the right to require the Company to purchase ("Put option"), and the Company has the right to require the seller to sell to the Company ("Call option"), the seller's remaining 24%

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interest in Kubatronik. The price for the option is based on the value of the acquisition subject to certain price adjustments set forth below, but not less than (euro) 552,000 and not to exceed (euro) 920,000. The option period was extended until December 31, 2007, (the minimum and the maximum amounts of the option price shall increase by the addition of interest at the rate of LIBOR + 1% from December 31, 2004). The price adjustment mechanism for the Put option is that if the ratio of earnings before tax from the revenue ("the Ratio") increases over 23% - for every 1% increase the price will increase by 1%. If the Ratio decreases below 23% - for every 1% decrease the price will decrease by 1.25%.

The price adjustment mechanism for the Call option is that if the Ratio increases over 23% - for every 1% increase the price will increase by 1.5%. If the Ratio decreases below 23% - for every 1% decrease the price will decrease by 1%.

All of the above is based on the last audited financial statements of Kubatronik as of the date of the seller's termination of employment with Kubatronik. The seller terminated his employment in October 2003 and through the date of these financial statements did not approach the Company to exercise his option.

The Company has been consolidating the accounts of Kubatronik since June 10, 2002. The acquisition made by EN-Eltek resulted in the recognition of goodwill in the amount of (euro)1.1 million (NIS5 million as of the date of acquisition) - see Note 9.

### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared in accordance with generally accepted accounting principles in Israel ("Israeli GAAP"), which vary in certain significant respects from generally accepted accounting principles in the United States ("U.S GAAP") as described in Note 28.

#### A. DEFINITIONS

Certain terms used in these financial statements are defined as follows:

1. RELATED PARTIES - as defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel ("ICPAI") are:
  - (a) Parties, one of which directly or indirectly -
    - (1) owns 10% or more of the issued share capital of the other party, or of its voting rights or of the rights to appoint its directors, or
    - (2) has the right to appoint its Chief Executive Officer ("CEO"), or
    - (3) acts as its director or CEO.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)

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- A. DEFINITIONS (CONT'D)
1. RELATED PARTIES - (cont'd)
- (b) Any corporate body in which a party mentioned in (a) above owns 25% or more of its issued share capital or of its voting rights or of the rights to appoint its directors.
- (c) Spouses and minor children of the parties mentioned in (a) above.
2. INTERESTED PARTIES - as defined in Section 1 of the Israeli Securities Law:
- (a) The holder of five percent or more of the issued share capital or voting rights of a company, a person who has the right to appoint one or more directors of a company or its CEO, a person serving as the CEO or as a director, an entity in which a person as described above holds twenty five percent or more of its issued share capital or of its voting rights, or has the right to appoint twenty five percent or more of its directors.
- (b) A subsidiary of a company, other than a nominee company.
- As applicable to the Company, related parties and interested parties as described above would all constitute related parties under U.S. GAAP as well.
3. SUBSIDIARIES - companies whose financial statements are fully consolidated with those of the Company, whether directly or indirectly.
4. CPI - Israeli consumer price index as published by the Israeli Central Bureau of Statistics.
5. NIS - New Israeli Shekels.
6. ADJUSTED AMOUNT - the nominal historical amount adjusted in accordance with the provisions of Opinions 23 and 34 and Opinions 36 and 37.
7. REPORTED AMOUNT - The adjusted amount as at the transition date (December 31, 2003), with the addition of amounts in nominal values that were added after the transition date and less amounts eliminated after the transition date.
8. ADJUSTED FINANCIAL REPORTING - Financial reporting based on the provisions of Opinions 23, 34, 36, 37 and 50.
9. NOMINAL FINANCIAL REPORTING - Financial reporting based on reported amounts.

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Elttek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)

#### B. FINANCIAL STATEMENTS REPORTED NEW ISRAELI SHEKELS (NIS)

In October 2001, the Israel Accounting Standards Board ("IASB") published Accounting Standard No. 12, "Discontinuance of Adjustment of Financial Statements". Pursuant to this standard and in accordance with Accounting Standard No. 17 that was published in December 2002, the adjustment of financial statements was discontinued as of January 1, 2004. Up to December 31, 2003, the Company continued to prepare adjusted financial statements in accordance with Opinion No. 36 of the Institute of Certified Public Accountants in Israel. The adjusted amounts included in the financial statements as at December 31, 2003 constitute the starting point for the nominal financial report as of January 1, 2004. The Company has implemented the provisions of the standard and has accordingly discontinued the adjustments as of January 1, 2004.

1. In the past the Company prepared its financial statements on the basis of historical cost adjusted for the changes in the CPI. The adjusted amounts that are included in the financial statements as at December 31, 2003 constitute the starting point for the nominal financial report as of January 1, 2004. Any additions made during the period are included according to their nominal values.
2. Amounts of non-monetary assets do not necessarily reflect their realizable value or updated economic value, but only the reported amounts of such assets.
3. The term "cost" in these financial statements means the reported amount of cost.
4. All the comparative data for prior periods is stated adjusted to the CPI at December 31, 2003.

#### Balance sheets:

- a. Non-monetary items are stated at reported amounts.
- b. Monetary items are stated in the balance sheet at their nominal historical values as at balance sheet date.

#### Statement of operations:

Income and expenses derived from non-monetary items from provisions included in the balance sheet are derived from the difference between the reported amounts of the opening balance and the reported amounts of the closing balance.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)



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### C. KUBATRONIK - AUTONOMOUS FOREIGN COMPANY

As of January 1, 2004 the Company implemented Accounting Standard No. 13, "Effect of Changes in Exchange Rates of Foreign Currency". The standard discusses the translation of transactions in foreign currency and the translation of financial statements of foreign operations for the purpose of including them in the financial statements of the reporting entity. The standard provides rules for classifying foreign operations as an autonomous foreign investee or as an integrated investee, on the basis of the indications described in the standard and the use of discretion, and it provides the method for translating the financial statements of autonomous foreign investees.

### TRANSACTIONS IN FOREIGN CURRENCY

Transactions denominated in foreign currency are recorded upon their initial recognition according to the exchange rate in effect on the date of the transaction. Exchange rate differences arising upon the settlement of monetary items or upon reporting the Company's monetary items at exchange rates that are different than those by which they were initially recorded during the period, or reported in previous financial statements, are charged to income or expenses.

### KUBATRONIK -FOREIGN OPERATIONS CLASSIFIED AS AN AUTONOMOUS INVESTEE

The financial statements of Kubatronik were translated into Israeli currency as follows:

- (1) The assets and liabilities, both monetary and non-monetary, of Kubatronik were translated according to the closing exchange rate. The goodwill arising upon the acquisition of Kubatronik is treated as an asset of Kubatronik, and it is translated according to the closing exchange rate.
- (2) Income and expense items were translated according to the exchange rate as at the date of the transaction.
- (3) All the resulting exchange rate differences are classified as a separate item of shareholders' equity until the disposal of the net investment.

### D. PRINCIPLES OF CONSOLIDATION

1. The consolidated financial statements include the accounts of the Company and its subsidiaries (EN-Eltek, Kubatronik, Eltek International and Eltek Europe).
2. All intercompany transactions and balances were eliminated in consolidation.

### E. RATE OF EXCHANGE AND LINKAGE BASES

1. Assets and liabilities denominated in, or linked to, foreign currencies have been recorded based on the representative exchange rate prevailing at balance sheet date as published by the Bank of Israel.
2. Balances linked to the CPI are recorded pursuant to contractual linkage terms of the specific assets and liabilities.

Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)

E. RATE OF EXCHANGE AND LINKAGE BASES (CONT'D)

3. Details of the CPI and the representative exchange rates are as follows:

|                                | ISRAELI<br>CPI | EXCHANGE RATE<br>OF ONE DOLLAR | EXCHANGE RATE<br>OF ONE EURO |
|--------------------------------|----------------|--------------------------------|------------------------------|
|                                | POINTS         | NIS                            | NIS                          |
| For the period ended:          |                |                                |                              |
| December 31, 2002              | 182.01         | 4.737                          | 4.970                        |
| December 31, 2003              | 178.58         | 4.379                          | 5.533                        |
| DECEMBER 31, 2004              | 180.74         | 4.308                          | 5.877                        |
|                                | %              | %                              | %                            |
| Changes during the year ended: |                |                                |                              |
| December 31, 2002              | 6.50           | 7.27                           | 27.18                        |
| December 31, 2003              | (1.89)         | (7.56)                         | 11.33                        |
| DECEMBER 31, 2004              | 1.21           | (1.62)                         | 6.22                         |

F. PRESENTATION IN U.S. DOLLARS FOR CONVENIENCE OF THE READER

For the convenience of the reader, the consolidated financial statements as of December 31, 2004 and for the year then ended have been translated into U.S. dollars, using the representative exchange rate as of December 31, 2004 (U.S. \$1 = NIS 4.308). The U.S. dollar amounts presented in these financial statements should not be construed as representing amounts receivable or payable in dollars or convertible into dollars, unless otherwise indicated.

G. USE OF ESTIMATES

The financial statements which were prepared in accordance with generally accepted accounting principles, require the Company's management to make estimates and assumptions. Actual results may differ from such estimates.

H. CASH AND CASH EQUIVALENTS

Cash equivalents are considered by the Company to be highly-liquid investments which include short-term bank deposits with an original maturity of three months or less from deposit date and which are not encumbered by a lien.

I. ALLOWANCE FOR DOUBTFUL ACCOUNTS

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The allowance has been determined specifically for debts the collection of which, in Management's opinion, is doubtful.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)

##### J. INVENTORIES

Inventories are recorded at the lower of cost or market value. Cost is determined as follows:

|  |  |
|--|--|
| Raw materials                          | - Moving average basis   |
| Work-in-process and completed products | - Direct production cost, plus allocated indirect expenses, all of which are on an average basis |

##### K. PROPERTY AND EQUIPMENT

1. Assets are recorded at cost.
2. Depreciation on property and equipment is calculated on the straight-line method over the estimated useful lives of the assets.

Annual rates of depreciation are as follows:

|                                | MOSTLY | RANGE |
|--------------------------------|--------|-------|
|                                | -----  | ----- |
|                                | %      | %     |
|                                | -----  | ----- |
| Machinery and equipment        | 15     | 5-33  |
| Office furniture and equipment | 6      | 5-33  |
| Motor vehicles                 | 15     | 15-30 |
| Leasehold improvements         | 10     | 3-25  |

##### L. INVESTMENTS IN INVESTEE COMPANIES

The investments in investee companies are presented using the equity method.

The excess of the cost of the investment over the fair value of identified assets net of the fair value of identified liabilities (after allocation of taxes resulting from temporary differences) as at the date of acquisition is recorded as goodwill.

The Company applies Accounting Standard No. 20 regarding the amortization

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period of Goodwill. Goodwill is systematically amortized over the period of its useful life. The amortization period is for 10 years and reflects the best possible estimate of the period over which the Company anticipates to obtain future economic benefits from the Goodwill.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)

##### M. DEFERRED TAXES

Income taxes are provided on the basis of the liability method of accounting. Under the liability method, deferred tax assets and liabilities are recognized for the future tax consequences of differences between the carrying amounts of existing assets and liabilities and their respective tax bases, as well as tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years when these temporary differences are expected to be recovered or settled.

The Company's management cannot be reasonably assured as to the Company's ability to utilize the tax asset attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and net operating loss carryforwards in the foreseeable future. Therefore, the Company did not record any deferred tax asset.

The Company believes that its subsidiary, Kubatronik will utilize its carryforward tax losses and therefore a deferred tax asset has been recorded (see Note 1, 24H).

##### N. IMPAIRMENT OF ASSETS

In February 2002, the IASB published Accounting Standard ("IASB") No. 15 - "Impairment in Value of Assets". The Standard provides procedures which a company must apply in order to ensure that its assets in the consolidated balance sheet, are not presented at an amount which is in excess of their recoverable value, which is the higher of the net selling price or the present value of the estimated future cash flows expected to be derived from use and disposal of the asset. In addition, the Standard provides rules for presentation and disclosure with respect to assets whose value has declined.

##### O. FACTORING OF FINANCIAL ASSETS

In June 2003, the Company entered into an accounts receivable factoring agreement with U Bank. Under the terms of the agreement, the Company has the option to factor receivables, with U Bank on a non-recourse basis, provided that U Bank approve the receivables in advance. In some cases, the Company continues to be obligated in the event of commercial disputes, (such as product defects) unrelated to the credit worthiness of the customer. The Company accounts for the factoring of its financial assets in accordance with the provisions of SFAS No. 140.

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Since the Company started to enter into such factoring agreements, there were no cases in which the Company had to reimburse the bank for accounts receivables following business commercial disputes. The Company does not expect any reimbursements to take place in the foreseeable future.

As at December 31, 2004, net trade receivables amounting to NIS 4,200 thousand were factored (as at December 31, 2003 - NIS 4,318 thousand).

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT'D)

##### P. REVENUE RECOGNITION

The Company recognizes revenues from sales of products upon delivery. Commission income is accounted for on the accrual basis.

##### Q. RESEARCH AND DEVELOPMENT

Research and development costs, net of grants from the Office of the Chief Scientist in the Ministry of Industry and Trade of the Government of Israel (OCS), are expensed as incurred.

##### R. LOSS PER SHARE

Loss per share are computed based on the weighted average number of shares and share equivalents outstanding during each period, in accordance with Opinion No. 55 of the ICPAI.

##### S. EMPLOYEE STOCK OPTION EXPENSES

The Company applies the intrinsic-value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations including FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25, to account for its stock options. Under this method for fixed-plans, compensation expenses are recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. Therefore, the accounting, under Israeli GAAP and under U.S. GAAP is identical.

##### T. SEGMENT REPORTING

Segment reporting is represented according to Accounting Standard No. 11 of the IASB.

##### U. EFFECTS OF NEW ACCOUNTING STANDARDS PRIOR TO THEIR APPLICATION

In July 2004, the IASB published Accounting Standard No. 19, "Taxes on Income". The Standard provides that a liability for deferred taxes is to be recorded for all temporary differences subject to tax, except for a limited number of exceptions. In addition, a deferred tax asset is to be

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recorded for all temporary differences that may be deducted, losses for tax purposes and tax benefits not yet utilized, if it is anticipated that there will be taxable income against which these can be offset, except for a limited number of exceptions. The new Standard applies to financial statements for periods beginning on January 1, 2005. The Standard provides that it is to be implemented by means of a cumulative effect of a change in accounting method. In the Company's estimation, the impact of the Standard on its results of operations, financial position and cash flows will not be material.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 3 - CASH AND CASH EQUIVALENTS

|              | CONSOLIDATED        |                     | COMPANY             |                     |
|--------------|---------------------|---------------------|---------------------|---------------------|
|              | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| NIS          | 537                 | 260                 | 537                 |                     |
| U.S. dollars | 693                 | 1,906               | 636                 |                     |
| Euro         | 3,055               | 2,105               | 16                  |                     |
| Others       | 86                  | 3                   | 59                  |                     |
|              | 4,371               | 4,274               | 1,248               |                     |
|              | 4,371               | 4,274               | 1,248               |                     |

As for pledges on assets, see Note 15A.

#### NOTE 4 - TRADE RECEIVABLES

|                                 | CONSOLIDATED        |                     | COMPANY             |                     |
|---------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| Israeli customers               | 15,993              | 10,895              | 15,993              |                     |
| Foreign customers               | 4,607               | 13,502              | 3,574               |                     |
| Checks receivable               | 403                 | 1,068               | 403                 |                     |
|                                 | 21,003              | 25,465              | 19,970              |                     |
| Allowance for doubtful accounts | (1,216)             | (1,630)             | (1,150)             |                     |
|                                 | 19,787              | 23,835              | 18,820              |                     |
|                                 | 19,787              | 23,835              | 18,820              |                     |

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As at December 31, 2004 one customer accounted for NIS 6,766 thousand of receivables (28.4% of the total consolidated trade receivables balance) (Company - 30.7%).

As at December 31, 2003 one customer accounted for NIS 2,792 thousand of receivables (14.1% of total consolidated trade receivables balance) (Company - 14.8%).

As for pledges on assets, see Note 15A.

### NOTE 5 - OTHER RECEIVABLES

|   | CONSOLIDATED        |                     | COMPANY             |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| Employees                                   | 162                 | 131                 | 157                 |                     |
| Subsidiaries                                | -                   | -                   | 597*                |                     |
| Commissions and other receivables           | 296                 | 120                 | 295                 |                     |
| Suppliers                                   | 503                 | 334                 | 495                 |                     |
| Government of Israel and other institutions | 12                  | 209                 | 11                  |                     |
| Government of Germany                       | 483                 | 364                 | 44                  |                     |
| Insurance companies                         | 806                 | -                   | 806                 |                     |
|   | 2,262               | 1,158               | 2,405               |                     |
|   | 2,262               | 1,158               | 2,405               |                     |

\* Reclassified

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

### NOTE 6 - INVENTORIES

|                    | CONSOLIDATED        |                     | COMPANY             |                     |
|--------------------|---------------------|---------------------|---------------------|---------------------|
|                    | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| Raw materials:     |                     |                     |                     |                     |
| On hand            | 7,522               | 7,477               | 6,541               | 6,530               |
| In transit         | 423                 | 451                 | 423                 | 451                 |
| Work-in-process    | 3,640               | 4,232               | 3,300               | 3,823               |
| Completed products | 1,573               | 1,473               | 1,354               | 1,104               |

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|        |        |        |        |
|--------|--------|--------|--------|
| -----  | -----  | -----  | -----  |
| 13,158 | 13,633 | 11,618 | 11,908 |
| =====  | =====  | =====  | =====  |

NOTE 7 - LONG-TERM INVESTMENTS

|   | COMPANY             |                     |
|---|---------------------|---------------------|
|   | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|   | -----               | -----               |
| A. INVESTMENTS IN SUBSIDIARIES:                         |                     |                     |
| Cost of shares and long-term loan (1)                   | 10,757              | 10,757              |
| Loans to the subsidiaries                               | 2,704*              | 3,558               |
| Accumulated losses                                      | (4,198)*            | (6,215)             |
| Adjustments from translation of<br>financial statements | 2,004               | 2,574               |
|   | -----               | -----               |
|   | 11,267              | 10,674              |
|   | =====               | =====               |

(1) Includes long-term loan in the amount of NIS 10,678 thousand for the purchase of Kubatronik shares.

\* Reclassified

|   | COMPANY             |                     |
|---|---------------------|---------------------|
|   | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|   | -----               | -----               |
| B. CHANGES IN THE INVESTMENTS IN SUBSIDIARIES                 |                     |                     |
| Balance at the beginning of the year                          | 11,343              | 11,267              |
| Changes during the year:                                      |                     |                     |
| Share in losses   | (2,094)             | (2,017)             |
| Accrued loan interest and investments<br>made during the year | 553                 | 854                 |
| Adjustments from the translation of<br>financial statements   | 1,465               | 570                 |
|   | -----               | -----               |
| Balance at the end of the year                                | 11,267              | 10,674              |
|   | =====               | =====               |



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NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 8 - PROPERTY AND EQUIPMENT, NET

A. CONSOLIDATED

|  | DECEMBER 31, 2004          |                           |                   |                                   |         |
|--|----------------------------|---------------------------|-------------------|-----------------------------------|---------|
|  | MACHINERY AND<br>EQUIPMENT | LEASEHOLD<br>IMPROVEMENTS | MOTOR<br>VEHICLES | OFFICE FURNITURE<br>AND EQUIPMENT | TOTAL   |
| COST                                   |                            |                           |                   |                                   |         |
| Balance as of<br>December 31, 2003     | 133,900                    | 27,496                    | 1,474             | 7,018                             | 169,888 |
| Translation<br>adjustments             | 955                        | 140                       | 33                | 290                               | 1,418   |
| Additions                              | 1,075                      | 306                       | -                 | 89                                | 1,470   |
| Disposals                              | (1,255)                    | -                         | (546)             | (456)                             | (2,257) |
| Balance as of<br>December 31, 2004     | 134,675                    | 27,942                    | 961               | 6,941                             | 170,519 |
| ACCUMULATED<br>DEPRECIATION            |                            |                           |                   |                                   |         |
| Balance as of<br>December 31, 2003     | 100,760                    | 18,216                    | 1,065             | 6,466                             | 126,507 |
| Translation<br>adjustments             | 767                        | 94                        | 28                | 281                               | 1,170   |
| Depreciation<br>during the year        | 10,998                     | 2,025                     | 157               | 248                               | 13,428  |
| Disposals                              | (1,255)                    | -                         | (446)             | (454)                             | (2,155) |
| Balance as of<br>December 31, 2004     | 111,270                    | 20,335                    | 804               | 6,541                             | 138,950 |
| NET BALANCE AS OF<br>DECEMBER 31, 2004 | 23,405                     | 7,607                     | 157               | 400                               | 31,569  |
| NET BALANCE AS OF<br>DECEMBER 31, 2003 | 33,140                     | 9,280                     | 409               | 552                               | 43,381  |

As for pledges on assets, see Note 15A.

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 8 - PROPERTY AND EQUIPMENT, NET (CONT'D)

B. COMPANY

|  | DECEMBER 31, 2004          |                           |                   |                                   |         |
|--|----------------------------|---------------------------|-------------------|-----------------------------------|---------|
|  | MACHINERY AND<br>EQUIPMENT | LEASEHOLD<br>IMPROVEMENTS | MOTOR<br>VEHICLES | OFFICE FURNITURE<br>AND EQUIPMENT | TOTAL   |
| COST                                   |                            |                           |                   |                                   |         |
| Balance as of<br>December 31, 2003     | 117,255                    | 25,265                    | 862               | 2,088                             | 145,470 |
| Additions                              | 888                        | 296                       | -                 | 5                                 | 1,189   |
| Disposals                              | -                          | -                         | (477)             | -                                 | (477)   |
| Balance as of<br>December 31, 2004     | 118,143                    | 25,561                    | 385               | 2,093                             | 146,182 |
| ACCUMULATED<br>DEPRECIATION            |                            |                           |                   |                                   |         |
| Balance as of<br>December 31, 2003     | 88,183                     | 16,738                    | 657               | 1,730                             | 107,308 |
| Depreciation<br>during the year        | 9,614                      | 1,948                     | 82                | 122                               | 11,766  |
| Disposals                              | -                          | -                         | (377)             | -                                 | (377)   |
| Balance as of<br>December 31, 2004     | 97,797                     | 18,686                    | 362               | 1,852                             | 118,697 |
| NET BALANCE AS OF<br>DECEMBER 31, 2004 | 20,346                     | 6,875                     | 23                | 241                               | 27,485  |
| NET BALANCE AS OF<br>DECEMBER 31, 2003 | 29,072                     | 8,527                     | 205               | 358                               | 38,162  |

As for pledges on assets, see Note 15A.

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 9 - GOODWILL

|                                      | CONSOLIDATED        |                     |
|--------------------------------------|---------------------|---------------------|
|                                      | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| Balance at the beginning of the year | 4,973               | 4,972               |
| Goodwill amortization                | (584)               | (593)               |
| Translation adjustments              | 583                 | 277                 |
|                                      | 4,972               | 4,656               |

NOTE 10 - SHORT-TERM CREDIT AND CURRENT MATURITIES OF LONG-TERM DEBTS

|   | ANNUAL<br>INTEREST RATE<br>31/12/2004<br>% | CONSOLIDATED AND COMPANY |                     |
|---|--|--------------------------|---------------------|
|   |  | DECEMBER 31<br>2003      | DECEMBER 31<br>2004 |
| In NIS (unlinked)   | 6.15-6.70                                  | 12,100                   | 11,400              |
| In U.S. dollars   | 3.90-5.15                                  | 1,551                    | 1,525               |
| Current maturities<br>of long-term liabilities to<br>Banks (Note 13A) |  | 5,810                    | 6,664               |
|   |  | 19,461                   | 19,589              |

As to pledges securing the credit, see Note 15A.

NOTE 11 - TRADE PAYABLES

|                   | CONSOLIDATED        |                     | COMPANY             |                     |
|-------------------|---------------------|---------------------|---------------------|---------------------|
|                   | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| Israeli suppliers | 12,054              | 15,516              | 12,054              | 15,516              |
| Foreign suppliers | 5,927               | 4,733               | 4,759               | 3,789               |
| Checks payable    | 17,981              | 20,249              | 16,813              | 19,305              |
|                   | 4,333               | 3,328               | 4,333               | 3,328               |

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|  |        |        |        |        |
|--|--------|--------|--------|--------|
|  | -----  | -----  | -----  | -----  |
|  | 22,314 | 23,577 | 21,146 | 22,633 |
|  | =====  | =====  | =====  | =====  |
| Including current maturities of<br>long-term debt related to<br>capital leases | 282    | 278    | 282    | 278    |
|  | =====  | =====  | =====  | =====  |

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Eltel Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 12 - OTHER LIABILITIES AND ACCRUED EXPENSES

|  | CONSOLIDATED        |                     | COMPANY             |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|  | -----               | -----               | -----               | -----               |
| Accrued payroll and related<br>benefits        | 3,747               | 3,825               | 3,134               | 3,091               |
| Vacation and other<br>employee benefits        | 2,232               | 2,631               | 2,099               | 2,409               |
| Government of Israel and other<br>Institutions | 372                 | 19                  | 372                 | 19                  |
| Accrued expenses                               | 1,822               | 4,041               | 1,333               | 3,867               |
| Other liabilities                              | 382*                | 567                 | 375                 | 550                 |
|  | -----               | -----               | -----               | -----               |
|  | 8,555               | 11,083              | 7,313               | 9,936               |
|  | =====               | =====               | =====               | =====               |

\* Reclassified

NOTE 13 - LONG-TERM DEBT, EXCLUDING CURRENT MATURITIES

CONSOLIDATED AND COMPANY

A. BANKS

|  | ANNUAL<br>INTEREST RATE<br>31/12/2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|--|---------------------------------------|---------------------|---------------------|
|  | -----                                 | -----               | -----               |
|  | %                                     |                     |                     |
|  | -----                                 |                     |                     |

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|                           |           |         |         |
|---------------------------|-----------|---------|---------|
| LINKAGE TERMS             |           |         |         |
| U.S. dollar               | 3.90-4.55 | 9,349   | 6,381   |
| CPI                       | 5.95-7.05 | 6,250   | 4,160   |
| Unlinked                  | 6.45-6.70 | 3,245   | 2,440   |
|                           |           | -----   | -----   |
|                           |           | 18,844  | 12,981  |
| Less - current maturities |           | (5,810) | (6,664) |
|                           |           | -----   | -----   |
|                           |           | 13,034  | 6,317   |
|                           |           | =====   | =====   |

B. CAPITAL LEASES

|                           |               |             |             |
|---------------------------|---------------|-------------|-------------|
|                           | ANNUAL        |             |             |
|                           | INTEREST RATE | DECEMBER 31 | DECEMBER 31 |
|                           | 31/12/2004    | 2003        | 2004        |
|                           | -----         | -----       | -----       |
|                           | %             |             |             |
|                           | -----         |             |             |
| U.S. dollars linked       | 2.90          | 940         | 648         |
| Less - current maturities |               | (282)       | (278)       |
|                           |               | -----       | -----       |
|                           |               | 658         | 370         |
|                           |               | =====       | =====       |
| TOTAL LONG-TERM DEBT      |               | 13,692      | 6,687       |
|                           |               | =====       | =====       |

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 13 - LONG-TERM DEBT, EXCLUDING CURRENT MATURITIES (CONT'D)

CONSOLIDATED AND COMPANY

C. The aggregate maturities of long-term debt for each of the five years subsequent to December 31, 2004 are as follows:

|                                 |             |             |
|---------------------------------|-------------|-------------|
|                                 | DECEMBER 31 | DECEMBER 31 |
|                                 | 2003        | 2004        |
|                                 | -----       | -----       |
| First year (current maturities) | 6,092       | 6,942       |
|                                 | -----       | -----       |
| Second year                     | 7,176       | 5,178       |

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|                           |        |        |
|---------------------------|--------|--------|
| Third year                | 5,067  | 1,509  |
| Fourth year               | 1,449  | -      |
| Fifth year and thereafter | -      | -      |
|                           | -----  | -----  |
|                           | 13,692 | 6,687  |
|                           | -----  | -----  |
|                           | 19,784 | 13,629 |
|                           | =====  | =====  |

As to pledges securing the loans - see Note 15A.

### NOTE 14 - EMPLOYEE SEVERANCE BENEFITS, NET

1. The Company participates in a defined contribution pension plan and makes regular deposits with a pension fund securing pension rights on behalf of most of its non-senior employees. The custody and management of the amounts so deposited are independent of the Company and the amounts funded are credited to personal accounts of the employees. Accordingly, such amounts funded (included in expenses on an accrual basis) and the total liability are reflected in the balance sheet on a net basis. In respect of its other employees, the Company purchases individual insurance policies intended to cover the Company's retirement benefits obligations. Similar to that stated above regarding the pension plan deposits, the amounts paid for the insurance policies are not reflected in the balance sheet as such amounts are not under the Company's control.

In addition, occasionally, the Company makes deposits with a Central Severance Pay Fund ("CSPF") in respect of those obligations under the Israeli Severance Pay Law which may not be covered in full by the above arrangements.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

### NOTE 14 - EMPLOYEE SEVERANCE BENEFITS, NET (CONT'D)

2. The Company's severance obligation is calculated on the basis of the latest monthly salary of each employee multiplied by the number of years of employment with the Company. The obligation is partially funded.
3. Kubatronik owns an insurance policy and makes regular deposits with an insurance company for securing pension rights on behalf of one of its key employees. Such amounts deposited and the related liability are reflected in the consolidated balance sheet.

In respect of its other employees, Kubatronik does not make any deposits for pension or retirement rights since such deposits are not required under the German law.

4. Details of the provision and amounts funded in respect of CSPF:

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|  | CONSOLIDATED        |                     | COMPANY             |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
| Liability for employee<br>severance benefits | 3,792               | 4,105               | 3,622               | 3,890               |
| Assets held for severance benefits           | (2,852)             | (3,057)             | (2,758)             | (2,934)             |
| Employee severance benefits, net             | 940                 | 1,048               | 864                 | 956                 |

NOTE 15 - COMMITMENTS AND CONTINGENT LIABILITIES

- A.
1. The Company has pledged certain assets and the rights to any insurance claims on such assets to secure its indebtedness with banks, as well as floating liens on all of its remaining assets in favor of the banks.
  2. As a guarantee of the implementation of the approved projects and in compliance with the conditions of the approval (see Note 24A), pledges have been recorded on the Company's assets in favor of the State of Israel.
  3. The Company has also pledged a computer system to a supplier to secure its indebtedness.

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Eltex Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 15 - COMMITMENTS AND CONTINGENT LIABILITIES (CONT'D)

- A. (CONT'D)
4. Financial covenants in respect of the Company's credit facilities and long-term loans require the Company to maintain the higher of shareholders' equity of NIS 20.0 million or 20% of the Company's total assets according to the loan from Discount Bank and to maintain the higher of shareholders' equity of NIS 17.0 million or 20% of the Company's total assets, according to the loan from Leumi Bank. For these purposes, shareholders' equity includes the Company's outstanding convertible note and excludes prepaid expenses. As of December 31, 2003, the Company was in compliance with such covenants. However, on March 31 2004, the Company was in breach of such covenants and therefore negotiated with its banks and was granted a temporary waiver, reducing the Company's covenants to the higher of shareholders' equity of NIS 12 million

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or 15% of its total assets until the release of the Company's December 31, 2004 earnings (i.e. between March - June 2005). The waiver of Leumi Bank was subject to the repayment by the Company of NIS 1.5 million over a 15 month period (from October 1, 2004 to December 31, 2005). In March 2005, the banks agreed to extend the temporary covenants. Leumi Bank agreed to extend the temporary covenants until the release of the Company's June 30, 2005 earnings, following which and until the release of the Company's December 31, 2005 earnings (i.e. between March - June 2006), Leumi Bank agreed to set the shareholders' equity threshold to not less than NIS 16 million. In accordance with the Discount Bank extension of the temporary covenants, the Company is required to maintain the higher of shareholders' equity of NIS 13 million or 15% of its total assets until the release of the Company's December 31, 2005 earnings. Upon the release of the Company's December 31, 2005 earnings, it is required to comply with its original covenant terms. As of December 31, 2004, the Company was in compliance with the terms of such temporary covenants. The Company's management has programs and projects in place in order to continue to meet these terms.

5. In June 2003, the Company signed a factoring agreement with U Bank, pursuant to which the Company is entitled to \$ 1.0 million factoring facilities, in consideration for the assignment to U Bank of an equal amount of the Company's accounts receivable. The use of these factoring facilities by the Company is subject to the consent of Discount Bank, Bank Hapoalim and Leumi Bank, which initially was provided until June 30, 2004, and following two extensions, the banks have provided their consent until March 31, 2006.
6. The Company has signed a four-year agreement with a consulting company to incorporate the "Theory of Constraint" ("TOC") into its operation. The purpose is to improve several operational measures identified by the Company's Management. Pursuant to the agreement in 2004 the Company paid consultation fees and will pay bonuses to the consulting company based on its success.

Until December 31, 2004, the consulting company was not entitled to a bonus. The agreement will expire in December 31, 2007.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 15 - COMMITMENTS AND CONTINGENT LIABILITIES (CONT'D)

- B. 1. In June 2002, an action was initiated by a former employee, citing an alleged breach of an agreement for the payment of royalties in exchange for the use of his invention. The plaintiff is seeking damages of NIS 1.0 million. The Company intends to deny liability and to assert that no agreement was entered into between the parties, no compensation was agreed upon, and that the amount of the claim is baseless. Based on the opinion of the Company's legal counsel, the Company



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believes that it has good defenses against the claim, and that the outcome of this matter will not have a material adverse effect on its financial position or results of operations.

2. In 2002, one of the Company's customers demanded that the Company pay compensation of approximately \$250,000 with respect to damages claimed to have been incurred as a result of the use of defective PCB that were manufactured and supplied by the Company. The Company and its insurance company have agreed that according to the insurance policy terms, the insurance company will continue to negotiate the customer demand with its representatives. Although, the Company disagrees with the customer's claim, it has recorded a provision in respect of its deductible amount that is not covered by the Company's insurance. (See also Note 23).
- C. As of December 31, 2004, the Company and Kubatronik are committed to purchase equipment, services and inventories costing approximately NIS 3.3 million (Company - NIS 3.2 million).
- D.
1. The premises occupied by the Company and Kubatronik are leased under operating agreements which expire in December 2011 and June 2008, respectively.
  2. Two parking areas that serve the employees of the Company and Kubatronik are leased under operating agreements which expire in December 2006 and December 2010, respectively.
  3. The Company has signed several leasing and maintenance agreements for production equipment with Orbotech Ltd. Of such agreements, two main agreements will expire in June 2008 and February 2010.
  4. Three production machines are leased under operating agreements which will expire in May 2005, October 2005 and January 2008.
  5. The Company has signed a leasing agreement for production machine. The agreement will commence in April 2005 and will expire in March 2007
  6. The Company has signed several other maintenance agreements for production equipment.
  7. The majority of the Company's vehicles are leased under three years operating agreements.

Minimum future payments due under the above agreements are as follows:

|             | CONSOLIDATED | COMPANY     |
|-------------|--------------|-------------|
|             | -----        | -----       |
|             | DECEMBER 31  | DECEMBER 31 |
|             | 2004         | 2004        |
|             | -----        | -----       |
| First year  | 7,208        | 6,443       |
| Second year | 6,533        | 5,851       |
| Third year  | 5,632        | 4,929       |
| Fourth year | 4,405        | 4,121       |

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|                           |        |        |
|---------------------------|--------|--------|
| Fifth year and thereafter | 9,909  | 9,888  |
|                           | -----  | -----  |
|                           | 33,687 | 31,232 |
|                           | =====  | =====  |

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Eltex Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 15 - COMMITMENTS AND CONTINGENT LIABILITIES (CONT'D)

E. INDEMNIFICATION AGREEMENT

The Company entered into a new indemnification agreement with its directors and officers and undertook to enter into the same agreement with future directors and officers, for losses incurred by a director or officer that will not exceed the lesser of US\$ 2,000,000 or 25% of the Company's capital.

F. STAMP DUTY

Stamp duty applies in Israel to various types of documents at various rates, depending primarily on the type of the document and the amount specified therein. In June 2003, the statute imposing stamp duty was amended. Following this amendment, the Israeli Tax Authority has increased enforcement of this statute. The amendment to the statute and the enforcement actions taken by the Israeli Tax Authority are in legal dispute before the Israeli Supreme Court, which has not yet ruled on this matter. In addition, under current legislation the stamp duty statute is expected to be gradually abolished until its complete cancellation in 2008. To date, the Company has not received a demand for payment of stamp duty following this amendment. The outcome of the Supreme Court ruling is uncertain.

NOTE 16 - CONVERTIBLE NOTE

In July 2003, the Company issued a convertible note ("the Note") in the principal amount of \$500,000 to Merhav M.N.F - an Israeli private company controlled by the Company's major shareholder ("Merhav").

The Note will be due four years from its issuance date. The Note bears interest at the rate of 10% per year, compounded on a quarterly basis.

Merhav has the right, at any time, to convert the Note and any accrued interest thereon into ordinary shares of the Company at a price of \$ 0.33 per ordinary share. The Company may at its sole discretion repay the accrued interest on the principal of the Note to Merhav.

In January 2004, \$ 200,000 of the principal amount of the Note was converted into 606,060 ordinary shares.

As of December 31, 2004, the Note including accrued interest is convertible into 1,085,197 ordinary shares which will constitute 16.5% of the company's ordinary shares after conversion.

Eltek Ltd.

## NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

## NOTE 17 - SHAREHOLDERS' EQUITY

- A. AUTHORIZED, ISSUED AND PAID UP SHARE CAPITAL IN HISTORICAL TERMS IS AS FOLLOWS:

|   | AUTHORIZED                   | ISSUED AND PAID     |                     |
|---|------------------------------|---------------------|---------------------|
|   | DECEMBER 31<br>2003 AND 2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|   | (IN THOUSANDS)               | (IN THOUSANDS)      | (IN THOUSANDS)      |
| Number of shares:                         |                              |                     |                     |
| Ordinary Shares of par value NIS 0.6 each | 50,000                       | 4,886               | 5,492               |
| Amount in nominal NIS:                    |                              |                     |                     |
| Ordinary Shares of par value NIS 0.6 each | 30,000                       | 2,932               | 3,295               |

## B. OPTIONS

In January 1997, the Company adopted the Eltek Ltd. 1996 Stock Option Plan (the "1996 Plan"). The 1996 Plan authorizes the issuance of options to purchase an aggregate number of 474,000 ordinary shares. The options generally (i) expire on the fifth anniversary of the day of grant, (ii) vest ratably over a three year period (iii) may not be exercised for a period of one year from the date of grant, and (iv) can be converted as the basis of one option per share.

The 1996 Plan is under the administration of the Compensation Committee appointed by the Board of Directors.

The Board of Directors of the Company may, at any time and at its sole and absolute discretion, suspend, terminate or amend the 1996 Plan in any manner. However, in no event may any action of the Company alter or impair the rights of a grantee under any outstanding option without their consent.

As of December 31, 2004, options for the purchase of 107,999 ordinary shares have been exercised in exercise price ranging from \$ 1.375 to \$ 1.75. There are no options currently outstanding under the 1996 Plan.

In August 2000, the Company adopted the Eltek Ltd. 2000 stock option plan (the "2000 Plan"). The 2000 Plan authorizes the issuance of options to purchase an aggregate of 750,000 ordinary shares. The options generally (i) expire on the fifth anniversary of the day of grant, (ii) vest ratably over a three-year period and (iii) may not be exercised for a period of

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one year from the date of grant. The exercise price of these options is equal to the market value of the underlying stock on the date of the grant.

As of December 31, 2004, options for the purchase of 394,933 ordinary shares having exercise price of \$ 4.375 per share and options for the purchase of 20,000 ordinary shares having exercise price of \$ 1.14 per share had been granted under the 2000 Plan.

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Eltek Ltd.

### NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 17 - SHAREHOLDERS' EQUITY (CONT'D)

##### B. OPTIONS (CONT'D)

A summary of the Company's plans and the options that were granted to the Company's employees is presented below:

|                                 | NUMBER<br>OF<br>OPTIONS | WEIGHTED<br>AVERAGE<br>EXERCISE PRICE |
|---------------------------------|-------------------------|---------------------------------------|
|                                 | -----                   | -----                                 |
|                                 |                         | US\$                                  |
|                                 | -----                   | -----                                 |
| Balance as at December 31, 2001 | 569,567                 | 4.07                                  |
| Forfeited                       | (30,634)                | 3.80                                  |
|                                 | -----                   |                                       |
| Balance as at December 31, 2002 | 538,933                 | 4.09                                  |
| Expired                         | (14,000)*               | 1.75                                  |
| Forfeited                       | (71,600)*               | 4.08                                  |
|                                 | -----                   |                                       |
| Balance as at December 31, 2003 | 453,333                 | 4.16                                  |
| Granted                         | 20,000                  | 1.14                                  |
| Expired                         | (37,000)                | 1.75                                  |
| Forfeited                       | (21,400)                | 4.38                                  |
|                                 | -----                   |                                       |
| BALANCE AS AT DECEMBER 31, 2004 | 414,933                 | 4.22                                  |
|                                 | =====                   |                                       |

\* Reclassified

The following table summarizes information concerning options outstanding at December 31, 2004.

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| EXERCISE PRICES<br>(U.S.\$) | NUMBER OF<br>OPTIONS<br>OUTSTANDING AT<br>DECEMBER 31<br>2004 | NUMBER OF<br>OPTIONS<br>EXERCISABLE AT<br>DECEMBER 31<br>2004 | REMAINING<br>CONTRACTUAL LIFE<br>(IN YEARS) |
|-----------------------------|---|---|---|
| 4.38                        | 381,333   | 381,333   | 0.6   |
| 4.38                        | 13,600  | 13,600  | 1.4   |
| 1.14                        | 20,000  | -   | 4.9   |
|                             | 414,933   | 394,933   |   |

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 18 - REVENUES

A. REVENUES BY ACTIVITIES

|                                    | CONSOLIDATED                      |                                   |                                   | COMPANY                           |                                   |                                   |
|------------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|                                    | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 |
| Sales of manufactured products     | 107,409                           | 107,212                           | 122,127                           | 99,919                            | 92,691                            |                                   |
| Sales of non-manufactured products | 105                               | 786                               | 2,219                             | 105                               | 786                               |                                   |
| Commissions                        | 521                               | 305                               | 656                               | 521                               | 340                               |                                   |
|                                    | 108,035                           | 108,303                           | 125,002                           | 100,545                           | 93,817                            |                                   |

- B. (1) During the year ended December 31, 2004, one customer accounted for NIS 15,359 thousand (12.3%) of the total consolidated revenues. During the years ended December 31, 2002 and 2003 there were no customers who accounted for more than 10% of the total consolidated revenues.
- (2) During the year ended December 31, 2004, the Company had one customer who accounted for NIS 15,359 thousand (14.1%) of the

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total Company's revenues.

During the year ended December 31, 2003, the Company had two customers who accounted for NIS 9,864 thousand (10.5%) and NIS 9,522 thousand (10.2%) of the company revenues (in 2002 - there were no customers who accounted for more than 10% of the company revenues).

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 19 - COST OF REVENUES

|  | CONSOLIDATED                      |                                   |                                   | COMPANY                           |                                   |
|--|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|  | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 |
| Cost of materials and non-manufactured products (1)                | 39,516*                           | 37,742*                           | 42,117                            | 38,541*                           | 35,659*                           |
| Payroll and related benefits                                       | 35,541                            | 33,086                            | 35,699                            | 32,976                            | 27,240                            |
| Manufacturing expenses   | 16,960*                           | 18,088*                           | 19,491                            | 15,975*                           | 15,713*                           |
| Depreciation   | 13,488                            | 14,517                            | 13,136                            | 12,561                            | 12,665                            |
| Changes in inventories of completed products and work-in-process** | 953*                              | (790)*                            | (445)                             | 925*                              | (474)*                            |
|  | 106,458                           | 102,643                           | 109,998                           | 100,978                           | 90,803                            |

\* Reclassified

\*\* Including changes in non-manufactured products.

(1) The Company has two major suppliers of raw material, each of whom supplies more than 10% of its raw material. The following table shows the amounts of the purchases from each of the two suppliers:

CONSOLIDATED

COMPANY

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|            | PERCENTAGE OF<br>TOTAL PURCHASES<br>FROM RAW<br>MATERIAL SUPPLIERS | YEAR ENDED<br>DECEMBER 31<br>2004 | PERCENTAGE OF<br>TOTAL PURCHASES<br>FROM RAW<br>MATERIAL SUPPLIERS | YEAR ENDED<br>DECEMBER 31<br>2004 |
|------------|--|-----------------------------------|--|-----------------------------------|
|            | -----<br>%<br>-----  | -----<br>NIS<br>-----             | -----<br>%<br>-----  | -----<br>NIS<br>-----             |
| Supplier 1 | 19.9   | 8,373                             | 21.7   | 8,373                             |
| Supplier 2 | 14.3   | 6,038                             | 15.7   | 6,038                             |

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 20 - RESEARCH AND DEVELOPMENT EXPENSES (INCOME), NET

CONSOLIDATED AND COMPANY

|   | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 |
|---|-----------------------------------|-----------------------------------|-----------------------------------|
|   | -----                             | -----                             | -----                             |
| (Approved) unapproved grants from the OCS | 116                               | (18)                              | -                                 |
|   | =====                             | =====                             | =====                             |

In January 1999, the Company joined a consortium of companies for a period which ended in July 2001. The consortium was under the supervision of the OCS. Within the framework of the consortium, the Company specialized in High Density Interconnect ("HDI") technology.

Under the terms of the consortium, each member of the consortium was provided with an advance for its research and development costs for a specific research and development project assigned to it by the consortium. The OCS reimbursed 66% of such approved research and development expenses.

These reimbursements were contingent upon the Company submitting monthly reports prepared in accordance with the requirements of the OCS but were not contingent upon royalties or any future payments being made by the Company.

Unapproved reimbursements from the OCS relating to research and development expenses that were debited in 2001 in the amount of NIS 116 thousand were included in research and development expenses, net in the year 2002.

In 2003, after the consortium has been discontinued, a surplus amount of money was distributed among the members and has been recognized as income.

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 21 - SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

|                                       | CONSOLIDATED                      |                                   |                                   | COMPANY                           |                                   |                                   |
|---------------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|                                       | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 |
| Payroll and related benefits expenses | 6,930                             | 7,386                             | 8,437                             | 5,805                             | 5,674                             | 6,930                             |
| Commissions                           | 597                               | 1,232                             | 1,476                             | 788                               | 802                               | 1,476                             |
| Export and delivery expenses          | 1,400                             | 1,275                             | 1,592                             | 1,261                             | 972                               | 1,592                             |
| Office maintenance                    | 815                               | 870                               | 890                               | 756                               | 676                               | 890                               |
| Traveling                             | 631                               | 422                               | 594                               | 565                               | 349                               | 594                               |
| Depreciation                          | 416                               | 421                               | 292                               | 380                               | 328                               | 292                               |
| Professional services                 | 1,757                             | 1,420                             | 2,215                             | 1,334                             | 1,012                             | 2,215                             |
| Car maintenance                       | 605                               | 579                               | 710                               | 533                               | 516                               | 710                               |
| Investors relations                   | 687                               | 383                               | 230                               | 687                               | 383                               | 230                               |
| Other                                 | 1,314                             | 1,008                             | 1,829                             | 1,296                             | 975                               | 1,829                             |
|                                       | 15,152                            | 14,996                            | 18,265                            | 13,405                            | 11,687                            | 15,152                            |

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 22 - FINANCIAL EXPENSES, NET



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|   | CONSOLIDATED                      |                                   |                                   | COMPANY                           |                                   |
|---|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|   | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 |
| Expenses on long-term loans net of erosion                    | 540*                              | 399                               | 864                               | 540*                              | 399                               |
| Expenses on short-term credit and bank charges net of erosion | 885*                              | 1,706                             | 1,465                             | 871*                              | 1,692                             |
| Effect of exchange rate differences expenses                  | (918)*                            | (68)*                             | 319                               | (972)*                            | (209)*                            |
| Expenses on convertible note                                  | -                                 | 112                               | 150                               | -                                 | 112                               |
| Other financing expenses (income), net                        | 936*                              | 840*                              | 150                               | 642*                              | 232*                              |
|   | 1,443                             | 2,989                             | 2,948                             | 1,081                             | 2,226                             |

\* Reclassified

NOTE 23 - OTHER INCOME (EXPENSES), NET

|  | CONSOLIDATED                      |                                   |                                   | COMPANY                           |                                   |
|--|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|  | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 |
| Indemnification to customer (1)        | (116)                             | (161)                             | -                                 | (116)                             | (161)                             |
| Gain on disposals of fixed assets, net | 415                               | 200                               | 86                                | 8                                 | 112                               |
| Customs charges                        | -                                 | (59)                              | -                                 | -                                 | (59)                              |
| Other expenses                         | (9)                               | -                                 | (34)                              | -                                 | -                                 |
|  | 290                               | (20)                              | 52                                | (108)                             | (108)                             |

(1) During 2002, the Company received a demand from one of its customers to compensate it with respect to damages it claimed to have occurred as a result of the use of defective PCB that were manufactured and supplied by the Company. The Company has recorded a provision in respect of its deductible amount that is not covered by the company's insurance. (See Note

15.B.2).

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Eltek Ltd.

NOTES TO THE CONSOLIDATED AND COMPANY FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 24 - TAXES ON INCOME

A. TAX BENEFITS UNDER THE LAW FOR THE ENCOURAGEMENT OF CAPITAL INVESTMENTS, 1959 (THE "LAW")

Certain of the Company's investment programs in expanding its production facilities in Israel were granted "approved enterprise" status in accordance with the above Law. As of the date of these financial statements, two approved investment programs are applicable to the Company.

The investment programs are based on the Alternative Benefits track and provide for tax benefits as follows: a zero tax rate on the Company's undistributed income arising from the revenue that is derived from the "approved enterprise", for a period of two years, starting with the year in which the "Approved Enterprise" first earns taxable income. The income so derived in the five subsequent years will be subject to tax at a reduced rate of 25%. The periods of tax benefits relating to these programs have not yet commenced, and will expire no later than 2005 for one program and 2016 for the other.

Entitlement to the above benefits is conditional upon the Company complying with the conditions stipulated by the Law and the regulations promulgated thereunder, as well as the criteria set forth in the approval for the specific investment in the "approved enterprise". In the event of failure to comply with these conditions, the tax benefits may be cancelled, and the Company may be required to refund the amount of the cancelled benefits, together with CPI linkage adjustment and interest. See Note 15(A)(2) for a pledge registered in this respect.

The period of tax benefits described above is limited to 12 years from the commencement of production, or 14 years from the approval date, whichever is earlier.

The Law also grants entitlement to claim accelerated depreciation for tax purposes on machinery and equipment used by the "approved enterprise".

Income of the Company not derived from the "approved enterprise" is subject to the regular corporate tax rate, which is 35% in 2004.

Dividends paid out of income derived from an approved enterprise (or out of dividends received from a company whose income is derived from an approved enterprise) are generally subject to withholding tax at the rate of 15% (deductible at source). The rate of 15% is limited to dividends and distributions out of income derived during the benefits period and actually paid at any time up to 12 years thereafter. A company which elects the Alternative Benefits track will be subject to corporate tax at the otherwise applicable rate of 25% in respect of the gross amount of the dividend if it pays a dividend out of income derived from its approved

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enterprise during the tax exemption period.

### B. TAXATION OF EMPLOYEE STOCK OPTION PLANS

In respect to employee stock incentive plan, the 2003 Israeli tax reform codified past practice and determined three alternative tracks for taxing employee stock option plans. Where a trustee arrangement is in place, the employer can either claim an expense for tax purposes while the employee will be fully taxed up to the maximum marginal tax rate of 49% (the "Ordinary Income Route") or the Company can waive the tax expense and the employee will pay a reduced tax rate of 25% (the "Capital Gains Route"). Where there is no trustee arrangement, the employee is fully taxed and no expense is allowed to the Company. There are detailed provisions for implementing these tracks. The tax reform's new practice is not in effect for options granted before December 31, 2002 under plans adopted before December 31, 2002. The options granted by the Company during 2004 were granted pursuant the Capital Gains Route.

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Eltex Ltd.

### NOTES TO THE FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 24 - TAXES ON INCOME (CONT'D)

##### C. AMENDMENTS TO THE INCOME TAX ORDINANCE

On June 29, 2004, the Israeli parliament passed the "Law for the Amendment of the Income Tax Ordinance (Amendment No. 140 and Temporary Order) - 2004" ("the Amendment"). The Amendment provides for a gradual reduction in the corporate tax rate from 36% to 30% in the following manner: 35% for the 2004 tax year, 34% for the 2005 tax year, 32% for the 2006 tax year and 30% for the 2007 tax year and thereafter.

##### D. MEASUREMENT OF RESULTS FOR TAX PURPOSES UNDER THE INCOME TAX (INFLATIONARY ADJUSTMENTS) LAW, 1985 (THE "INFLATIONARY ADJUSTMENT LAW")

The Company is taxed in accordance with the Inflationary Adjustment Law. Under the Inflationary Adjustment Law, taxable income as determined by the provisions of the Income Tax Ordinance is adjusted for the effect of inflation by allowing a "capital preservation deduction" or by charging an "addition for inflation" depending on whether the entity shows a positive or negative net equity adjusted for inflation on the basis of the changes in the CPI, in terms of the provisions of the Inflationary Adjustment Law.

##### E. CARRYFORWARD TAX LOSSES

As of December 31, 2004, the consolidated tax loss carryforwards was approximately NIS 68.3 million (Company - NIS 62 million). As discussed in Note 2M above, the Company has not recorded a deferred tax asset in respect of these losses as available evidence indicates that it is not expected that such assets will be realized in the foreseeable future. These losses do not have expiry date.

In the consolidated balance sheet, a deferred tax asset has been recorded

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in respect of Kubatronik's tax loss carryforwards in the amount of NIS 753 thousand. These losses do not have expiry date.

### F. INCOME TAX ASSESSMENTS

The Company has received final tax assessments through the 1995 tax year.

Kubatronik is subject to German corporate tax of approximately 38% and has received final tax assessments through the 2003 tax year.

The Company's other subsidiaries have not yet received any final tax assessments since incorporation.

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Elttek Ltd.

### NOTES TO THE FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 24 - TAXES ON INCOME (CONT'D)

##### G. RECONCILIATION OF THE THEORETICAL TAX EXPENSE TO THE ACTUAL TAX EXPENSE

A reconciliation of the theoretical tax expense, assuming all income is taxable at the statutory rates applicable in Israel, and the actual tax expense, is as follows:

|   | CONSOLIDATED  |                                   |                                   | COMPANY                           |                                   |
|---|---|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
|   | YEAR ENDED<br>DECEMBER 31<br>2002                                     | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 |
|   | Loss before taxes<br>as reported in the<br>statement of<br>operations |                                   |                                   |                                   |                                   |
| Statutory tax                           | (15,136)  | (12,911)                          | (6,750)                           | (15,143)                          | (10,989)                          |
| Primary tax rate                        | 36%   | 36%                               | 35%                               | 36%                               | 36%                               |
| Tax calculated                          | (5,448)   | (4,648)                           | (2,363)                           | (5,451)                           | (3,956)                           |
| Non-deductible<br>operating<br>expenses | 134*  | 120*                              | 160                               | 134*                              | 120*                              |
| Taxes on account<br>of previous years   | -   | 445*                              | -                                 | -                                 | -                                 |
| Amortization of<br>goodwill             | 105*  | 214*                              | 216                               | -                                 | -                                 |
| Unrecognized<br>deferred taxes          | 5,544*  | 4,199*                            | 1,544                             | 5,164*                            | 4,099*                            |

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|   |        |        |       |       |        |
|---|--------|--------|-------|-------|--------|
| Depreciation and inflation impact   | 153*   | (263)* | (261) | 153*  | (263)* |
| Tax losses that no deferred tax was computed on difference between tax rate and tax rules | -      | 383*   | -     | -     | -      |
| Applicable to foreign subsidiary  | (108)* | (256)* | (9)   | 94*   | (96)*  |
|   | -----  | -----  | ----- | ----- | -----  |
| Total   | 5,828  | 4,842  | 1,650 | 5,545 | 3,860  |
|   | -----  | -----  | ----- | ----- | -----  |
| Tax (benefit) expenses  | 380    | 194    | (713) | 94    | (96)   |
|   | =====  | =====  | ===== | ===== | =====  |

\* Reclassified

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Elttek Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 24 - TAXES ON INCOME (CONT'D)

H. RECOGNIZED DEFERRED TAX ASSETS

Deferred tax assets are attributable to the following:

|                               | CONSOLIDATED        |                     |
|-------------------------------|---------------------|---------------------|
|                               | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|                               | -----               | -----               |
| Loss carryforwards in Germany | -                   | 753                 |
|                               | -----               | -----               |

I. UNRECOGNIZED DEFERRED TAX ASSETS

Deferred assets have not been recognized in respect of the following items:

|  | CONSOLIDATED        |                     | COMPANY             |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 | DECEMBER 31<br>2003 | DECEMBER 31<br>2004 |
|  | -----               | -----               | -----               | -----               |

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|                                 | -----   | -----  | -----   | -----  |
|---------------------------------|---------|--------|---------|--------|
| Deferred tax assets comprise:   |         |        |         |        |
| Losses carryforward             | 22,578* | 21,079 | 22,578* | 21,079 |
| Severance pay                   | 338     | 287    | 311     | 287    |
| Vacation pay                    | 804     | 752    | 756     | 752    |
| Allowance for doubtful accounts | 491     | 549    | 467     | 549    |
|                                 | -----   | -----  | -----   | -----  |
| Total                           | 24,211  | 22,667 | 24,112  | 22,667 |
|                                 | =====   | =====  | =====   | =====  |

\* Reclassified

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Eltek Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 25 - SEGMENT REPORTING

The Company has identified three reportable geographic segments in 2004, i.e. Israel, Europe and others - mainly the United States and India.

|  | YEAR ENDED DECEMBER 31, 2004 |         |         |             |              |
|--|------------------------------|---------|---------|-------------|--------------|
|  | ISRAEL                       | EUROPE  | OTHER   | ADJUSTMENTS | CONSOLIDATED |
|  | -----                        | -----   | -----   | -----       | -----        |
| External revenues for the segment              | 67,867                       | 48,005  | 9,130   | -           | 125,002      |
| Internal revenues for the segment              | 60                           | 8,750   | -       | (8,810)     | -            |
|  | -----                        | -----   | -----   | -----       | -----        |
| Total revenues for the segment                 | 67,927                       | 56,755  | 9,130   | (8,810)     | 125,002      |
|  | =====                        | =====   | =====   | =====       | =====        |
| Operating income (loss)                        | 1,313                        | (4,039) | (1,078) | (50)        | (3,854)      |
| Financial expenses                             | (1,944)                      | (1,718) | (261)   | 649         | (3,274)      |
| Financial income                               | 4                            | 921     | 64      | (663)       | 326          |
| Other income, net                              | 43                           | 9       | -       | -           | 52           |
| Company's share in losses of subsidiaries, net | (2,017)                      | -       | -       | 2,017       | -            |
| Tax benefit                                    | -                            | 713     | -       | -           | 713          |
| Minority share in subsidiary's net results     | -                            | 182     | -       | -           | 182          |
|  | -----                        | -----   | -----   | -----       | -----        |
| Net loss                                       | (2,601)                      | (3,932) | (1,275) | 1,953       | (5,855)      |
|  | =====                        | =====   | =====   | =====       | =====        |
| Total assets for the segment                   | 45,866                       | 38,280  | 6,603   | (11,061)    | 79,688       |

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|                               |        |        |       |          |        |
|-------------------------------|--------|--------|-------|----------|--------|
| Deferred taxes                | -      | -      | -     | -        | 753    |
|                               | -----  | -----  | ----- | -----    | -----  |
| Total assets                  | 45,866 | 38,280 | 6,603 | (11,061) | 80,441 |
|                               | =====  | =====  | ===== | =====    | =====  |
| Total liabilities             | 40,261 | 35,379 | 5,359 | (15,549) | 65,450 |
|                               | =====  | =====  | ===== | =====    | =====  |
| Capital expenditure           | 743    | 627    | 100   | -        | 1,470  |
|                               | =====  | =====  | ===== | =====    | =====  |
| Depreciation and amortization | 7,345  | 5,686  | 990   | -        | 14,021 |
|                               | =====  | =====  | ===== | =====    | =====  |

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Eltex Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 25 - SEGMENT REPORTING (CONT'D)

The Company has identified three reportable geographic segments in 2003, i.e. Israel, Europe and others - mainly the United States and India.

|  | YEAR ENDED DECEMBER 31, 2003 |         |         |             |              |
|--|------------------------------|---------|---------|-------------|--------------|
|  | ISRAEL                       | EUROPE  | OTHER   | ADJUSTMENTS | CONSOLIDATED |
|  | -----                        | -----   | -----   | -----       | -----        |
| External revenues for the segment              | 72,584                       | 30,814  | 4,905   | -           | 108,303      |
| Internal revenues for the segment              | 35                           | 2,806   | -       | (2,841)     | -            |
|  | -----                        | -----   | -----   | -----       | -----        |
| Total revenues for the segment                 | 72,619                       | 33,620  | 4,905   | (2,841)     | 108,303      |
|  | =====                        | =====   | =====   | =====       | =====        |
| Operating loss                                 | (4,572)                      | (4,257) | (1,269) | 196         | (9,902)      |
| Financial expenses                             | (2,434)                      | (1,351) | (213)   | 506         | (3,492)      |
| Financial income                               | 12                           | 1,116   | -       | (625)       | 503          |
| Other income (expenses), net                   | (108)                        | 88      | -       | -           | (20)         |
| Company's share in losses of subsidiaries, net | (2,094)                      | -       | -       | 2,094       | -            |
| Tax expenses                                   | -                            | (194)   | -       | -           | (194)        |
| Minority share in subsidiary's net results     | -                            | 118     | -       | -           | 118          |
|  | -----                        | -----   | -----   | -----       | -----        |
| Net loss                                       | (9,196)                      | (4,480) | (1,482) | 2,171       | (12,987)     |

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|                               |        |        |       |          |        |
|-------------------------------|--------|--------|-------|----------|--------|
| Total assets for the segment  | 68,812 | 27,668 | 4,008 | (11,864) | 88,624 |
| Total liabilities             | 52,325 | 27,792 | 3,201 | (14,091) | 69,227 |
| Capital expenditure           | 1,262  | 2,414  | 121   | -        | 3,797  |
| Depreciation and amortization | 10,056 | 4,792  | 674   | -        | 15,222 |

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Eltex Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 25 - SEGMENT REPORTING (CONT'D)

The Company has identified three reportable geographic segments in 2002, i.e. Israel, Europe and others.

|  | YEAR ENDED DECEMBER 31, 2002 |         |         |             |              |
|--|------------------------------|---------|---------|-------------|--------------|
|  | ISRAEL                       | EUROPE  | OTHER   | ADJUSTMENTS | CONSOLIDATED |
| External revenues for the segment              | 81,839                       | 21,544  | 4,652   | -           | 108,035      |
| Internal revenues for the segment              | -                            | 1,323   | -       | (1,323)     | -            |
| Total revenues for the segment                 | 81,839                       | 22,867  | 4,652   | (1,323)     | 108,035      |
| Operating loss                                 | (9,697)                      | (3,261) | (1,005) | (20)        | (13,983)     |
| Financial expenses                             | (2,290)                      | (849)   | (129)   | 390         | (2,878)      |
| Financial income                               | 131                          | 1,547   | 128     | (371)       | 1,435        |
| Other income (expenses), net                   | (108)                        | 398     | -       | -           | 290          |
| Company's share in losses of subsidiaries, net | (477)                        | -       | -       | 477         | -            |
| Tax expenses                                   | -                            | (380)   | -       | -           | (380)        |
| Minority share in subsidiary's net results     | -                            | (198)   | -       | -           | (198)        |



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|                               |          |         |         |          |          |
|-------------------------------|----------|---------|---------|----------|----------|
| Net loss                      | (12,441) | (2,743) | (1,006) | 476      | (15,714) |
|                               | =====    | =====   | =====   | =====    | =====    |
| Total assets for the segment  | 86,702   | 26,733  | 3,782   | (11,386) | 105,831  |
|                               | =====    | =====   | =====   | =====    | =====    |
| Total liabilities             | 60,194   | 24,242  | 3,273   | (12,797) | 74,912   |
|                               | =====    | =====   | =====   | =====    | =====    |
| Capital expenditure           | 6,692    | 12,912  | 378     | (6,498)  | 13,484   |
|                               | =====    | =====   | =====   | =====    | =====    |
| Depreciation and amortization | 10,534   | 3,067   | 595     | -        | 14,196   |
|                               | =====    | =====   | =====   | =====    | =====    |

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Eltex Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 26 - BENEFITS TO RELATED AND INTERESTED PARTIES AND TRANSACTIONS WITH THEM

CONSOLIDATED AND COMPANY

|  | YEAR ENDED<br>DECEMBER 31<br>2002 | YEAR ENDED<br>DECEMBER 31<br>2003 | YEAR ENDED<br>DECEMBER 31<br>2004 |
|--|-----------------------------------|-----------------------------------|-----------------------------------|
|  | -----                             | -----                             | -----                             |
| A. SALARIES AND RELATED EXPENSES TO INTERESTED PARTIES (1) |                                   |                                   |                                   |
| (1) 5 persons in each year.                                | 1,329                             | 1,422                             | 1,382                             |
| B. INTEREST AND EXCHANGE RATE EXPENSES (2)                 |                                   |                                   |                                   |
| (2) Expenses on convertible note (see Note 16).            | -                                 | 112                               | 150                               |

C. Subsidiaries debt included in the financial statements of the Company as at December 31, 2004 and 2003 is NIS 17,449 thousand and NIS 16,061 thousand, respectively (see Note 5 and Note 7).

D. COMPENSATION OF DIRECTORS

The Chairman of the Board of Directors and the external directors are compensated for their service on the Board of Directors and its committees. During the year ended December 31, 2004, the Company paid its directors NIS 321 thousand (in 2003 - NIS 272 thousands, in 2002 - NIS 267 thousand).

The transactions with interested parties were conducted at "arms-length".

NOTE 27 - DISCLOSURES REGARDING FAIR VALUE OF FINANCIAL INSTRUMENTS

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The Company's financial instruments consist primarily of cash and cash equivalents, trade and other receivables, trade payables, short-term credit and long-term debt. The carrying amounts of the short-term financial instruments, approximates their fair value because of the short maturity of these instruments.

Management estimates that the carrying value of its long-term debt as at December 31, 2004 also approximates its fair value because the interest on the long-term debt is similar to the market interest rate for similar debt instruments of comparable maturities.

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Eltek Ltd.

### NOTES TO THE FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

#### NOTE 28 - EFFECT OF SIGNIFICANT DIFFERENCES BETWEEN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN ISRAEL AND THE UNITED STATES

The financial statements of the Company conform to Israeli GAAP which varies in certain significant respects from those followed in the United States of America. The effect of such differences on net loss and shareholders' equity are set out below.

##### A. EFFECT OF INFLATION

The Company, in accordance with Israeli GAAP, comprehensively includes the effect of price level changes in the accompanying financial statements, as described in Note 2B. According to such Israeli accounting principles, the Company has discontinued the adjustment of the financial statements as of January 1, 2004.

U.S. GAAP does not provide for recognition of the effects of such price level changes. Such effects have not been included in a reconciliation to U.S. GAAP.

##### B. LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

Under Israeli GAAP, the severance obligation is presented on the balance sheet net of the assets held by the CSPF, whereas under U.S. GAAP, such assets are presented as long-term assets of the Company. (See also Note 14.4.)

##### C. CONVERTIBLE NOTE

Under Israeli GAAP, the convertible note is presented on the balance sheet as a separate item between long-term liabilities and shareholders' equity, whereas under U.S. GAAP it should be presented as a liability.

##### D. GOODWILL AMORTIZATION

Under Israeli GAAP, goodwill derived from the acquisition of Kubatronik (see Note 1) is being amortized on a straight-line basis over 10 years. Under US GAAP, goodwill is no longer amortized but is evaluated for impairment in accordance with SFAS No. 142.

## NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 28 - EFFECT OF SIGNIFICANT DIFFERENCES BETWEEN GENERALLY ACCEPTED  
ACCOUNTING PRINCIPLES IN ISRAEL AND THE UNITED STATES (CONT'D)

E. FINANCIAL DERIVATIVE

As described in Note 1, the seller of Kubatronik has the right to require the Company to purchase (put option) the sellers remaining 24% holdings of Kubatronik

Under Israeli GAAP, there are no accounting consequences.

Under US GAAP, according to SFAS 133 "Accounting for Derivative Instruments and Hedging Activities", the put option should be considered as a financial instrument and such an instrument should be marked to market every reporting period.

1) EFFECT ON BALANCE SHEET ITEMS:

|                                   | CONSOLIDATED |             |
|-----------------------------------|--------------|-------------|
|                                   | DECEMBER 31  | DECEMBER 31 |
|                                   | 2003         | 2004        |
|                                   | -----        | -----       |
| Israeli GAAP -                    |              |             |
| Goodwill, net of amortization (D) | 4,972        | 4,656       |
| US GAAP -                         |              |             |
| Goodwill                          | 5,888        | 6,254       |

|  | CONSOLIDATED |             |
|--|--------------|-------------|
|  | DECEMBER 31  | DECEMBER 31 |
|  | 2003         | 2004        |
|  | -----        | -----       |
| Israeli GAAP -                         |              |             |
| Other liabilities and accrued expenses | 8,555        | 11,083      |
| US GAAP -                              |              |             |
| Put option (E)                         | -            | 114         |
|  | -----        | -----       |
| Other liabilities and accrued expenses | 8,555        | 11,197      |
|  | =====        | =====       |

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2) EFFECT ON STATEMENTS OF OPERATION ITEMS:

|                                      | CONSOLIDATED AND COMPANY  |                           |                           |
|--------------------------------------|---------------------------|---------------------------|---------------------------|
|                                      | YEAR ENDED<br>DECEMBER 31 | YEAR ENDED<br>DECEMBER 31 | YEAR ENDED<br>DECEMBER 31 |
|                                      | 2002                      | 2003                      | 2004                      |
| Net loss reported under Israeli GAAP | (15,714)                  | (12,987)                  | (5,855)                   |
| Amortization of goodwill (D)         | 292                       | 584                       | 593                       |
| Put option (E)                       | -                         | -                         | (114)                     |
| Net loss under US GAAP               | (15,422)                  | (12,403)                  | (5,376)                   |

3) EFFECT ON SHAREHOLDERS EQUITY

|   |        |        |        |
|---|--------|--------|--------|
| Total shareholders equity - Israeli GAAP          | 30,919 | 19,397 | 14,991 |
| Accumulated amortization of goodwill (D)          | 292    | 876    | 1,469  |
| Translation adjustments in respect<br>of goodwill | -      | -      | 129    |
| Put option (E)                                    | -      | -      | (114)  |
| Total shareholders equity - US GAAP               | 31,211 | 20,273 | 16,475 |

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Eltek Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 28 - EFFECT OF SIGNIFICANT DIFFERENCES BETWEEN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN ISRAEL AND THE UNITED STATES (CONT'D)

F. EARNINGS (LOSS) PER SHARE ("EPS")

Under Israeli GAAP and pursuant to Opinion No. 55, the dilutive effect of stock options and convertible note is included in the computation of basic EPS only if their exercise or conversion is considered to be probable. Calculation of the probability is based on the ratio between the market price of the shares and the present value of the exercise price of the stock options and convertible note.

In accordance with Statement of Financial Accounting Standards No. 128 "Earnings Per Share" ("Statement 128"), basic EPS is calculated by dividing the net income or loss attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year. Diluted EPS assumes the issuance of ordinary shares for all potential dilutive ordinary shares outstanding during the year without consideration of the probability of conversion.

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Following are the details of the basic and diluted EPS under U.S. GAAP\*:

|   | CONSOLIDATED AND COMPANY  |                           |                           |
|---|---------------------------|---------------------------|---------------------------|
|   | YEAR ENDED<br>DECEMBER 31 | YEAR ENDED<br>DECEMBER 31 | YEAR ENDED<br>DECEMBER 31 |
|   | 2002                      | 2003                      | 2004                      |
| Basic and diluted EPS (NIS)   | (3.16)                    | (2.54)                    | (0.98)                    |
| Weighted average number of shares used in basic and diluted EPS calculation (thousands) | 4,886                     | 4,886                     | 5,492                     |

\* EPS data is provided for one ordinary share of a par value of NIS 0.6 the actual par value of the shares as compared to the disclosure in the statement of operations where EPS data is presented based on NIS 1 par value per share as required under Israeli GAAP.

### G. STATEMENT OF OTHER COMPREHENSIVE INCOME

1. In June 1997, the Financial Accounting Standards Board issued Financial Accounting Standard No. 130 "Reporting Comprehensive Income" ("Statement 130"). The Company adopted Statement 130 during the year ended March 31, 1999. Statement 130 requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed in the same prominence as other financial statements. It requires that an enterprise (a) classify items of other comprehensive income by their nature in a financial statement and (b) display the accumulated balance of other comprehensive income separately from retained earnings and additional paid in capital in the equity section of the statement of financial position.

|                                  | CONSOLIDATED AND COMPANY  |                           |                           |
|----------------------------------|---------------------------|---------------------------|---------------------------|
|                                  | YEAR ENDED<br>DECEMBER 31 | YEAR ENDED<br>DECEMBER 31 | YEAR ENDED<br>DECEMBER 31 |
|                                  | 2002                      | 2003                      | 2004                      |
| Net loss - US GAAP               | (15,422)                  | (12,403)                  | (5,376)                   |
| Translation adjustments          | 539                       | 1,504*                    | 699                       |
| Net comprehensive loss - US GAAP | (14,883)                  | (10,899)                  | (4,677)                   |

\* Restated - see Note 28(G) (2).

NOTES TO THE FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 28 - EFFECT OF SIGNIFICANT DIFFERENCES BETWEEN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN ISRAEL AND THE UNITED STATES (CONT'D)

G. STATEMENT OF OTHER COMPREHENSIVE INCOME (CONT'D)

2. RESTATEMENT

The statements of other comprehensive income for the year ended December 31, 2003 has been restated in order to reflect a correction in 2003 figures. The correction in 2003 is due to an error, which consisted of recording the aggregate translation adjustments for the years 2002 and 2003, rather than the impact for the respective year:

|  | CONSOLIDATED<br>AND COMPANY<br>-----<br>YEAR ENDED<br>DECEMBER 31<br>2003<br>----- |
|--|--|
| Translation adjustments - as reported            | 2,004  |
| Translation adjustments - as restated            | 1,504  |
| Net comprehensive loss - U.S. GAAP - as reported | (10,399)   |
| Net comprehensive loss - U.S. GAAP - as restated | (10,899)   |

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NOTES TO THE FINANCIAL STATEMENTS

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(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 29 - ASSETS AND LIABILITIES ANALYZED BY CURRENCY AND LINKAGE BASIS

A. CONSOLIDATED

| DECEMBER 31, 2004         |                     |  |                                      |                                    |
|---------------------------|---------------------|--|--------------------------------------|------------------------------------|
| LINKED<br>TO CPI<br>----- | NON-LINKED<br>----- | FOREIGN<br>CURRENCY<br>U.S. DOLLARS<br>----- | FOREIGN<br>CURRENCY<br>EURO<br>----- | OTHER FOREIGN<br>CURRENCY<br>----- |
|                           |                     |  |                                      |                                    |

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|   |         |          |         |       |     |
|---|---------|----------|---------|-------|-----|
| Cash and cash equivalents                                   | -       | 260      | 1,906   | 2,105 | 3   |
| Trade and other receivables and prepaid expenses            | 126     | 11,323   | 10,831  | 2,713 | -   |
| Inventories   | -       | -        | -       | -     | -   |
| Deferred taxes  | -       | -        | -       | 753   | -   |
| Property and equipment, net                                 | -       | -        | -       | -     | -   |
| Goodwill  | -       | -        | -       | -     | -   |
|   | -----   | -----    | -----   | ----- | --- |
| TOTAL ASSETS  | 126     | 11,583   | 12,737  | 5,571 | 3   |
|   | =====   | =====    | =====   | ===== | === |
| Short-term credit and current maturities of long-term debts | 2,735   | 12,548   | 4,306   | -     | -   |
| Trade payables  | -       | 14,863   | 5,197   | 3,517 | -   |
| Other liabilities and accrued expenses                      | 2,561   | 5,917    | 1,218   | 1,377 | 10  |
| Long-term debt, excluding current maturities                | 1,425   | 1,292    | 3,970   | -     | -   |
| Employee severance benefits, net                            | -       | 956      | -       | 92    | -   |
| Minority interests  | -       | -        | -       | -     | -   |
| Convertible note  | -       | -        | 1,566   | -     | -   |
|   | -----   | -----    | -----   | ----- | --- |
| TOTAL LIABILITIES   | 6,721   | 35,576   | 16,257  | 4,986 | 10  |
|   | -----   | -----    | -----   | ----- | --- |
| TOTAL SHAREHOLDERS' EQUITY                                  | (6,595) | (23,993) | (3,520) | 585   | (7) |
|   | =====   | =====    | =====   | ===== | === |

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Eltek Ltd.

NOTES TO THE FINANCIAL STATEMENTS

(ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 29 - ASSETS AND LIABILITIES ANALYZED BY CURRENCY AND LINKAGE BASIS (CONT'D)

B. CONSOLIDATED

DECEMBER 31, 2003

|  | LINKED<br>TO CPI | NON-LINKED | FOREIGN<br>CURRENCY<br>U.S. DOLLARS | FOREIGN<br>CURRENCY<br>EURO | OTHER FOREIGN<br>CURRENCY |
|--|------------------|------------|-------------------------------------|-----------------------------|---------------------------|
|  | -----            | -----      | -----                               | -----                       | -----                     |
| Cash and cash equivalents                        | -                | 537        | 693                                 | 3,055                       |                           |
| Trade and other receivables and prepaid expenses | 155              | 16,561     | 3,547                               | 1,741                       |                           |
| Inventories                                      | -                | -          | -                                   | -                           |                           |
| Property and equipment, net                      | -                | -          | -                                   | -                           |                           |
| Goodwill   | -                | -          | -                                   | -                           |                           |
|  | -----            | -----      | -----                               | -----                       | -----                     |

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|   |         |          |          |         |       |
|---|---------|----------|----------|---------|-------|
| TOTAL ASSETS  | 155     | 17,098   | 4,240    | 4,796   |       |
|   | =====   | =====    | =====    | =====   | ===== |
| Short-term credit and current maturities of long-term debts | 2,350   | 13,272   | 3,839    | -       |       |
| Trade payables  | -       | 11,582   | 4,648    | 6,084   |       |
| Other liabilities and accrued expenses                      | 493     | 5,968    | 818      | 1,260   |       |
| Long-term debt, excluding current maturities                | 3,900   | 2,073    | 7,719    | -       |       |
| Employee severance benefits, net                            | -       | 864      | -        | 76      |       |
| Minority interests  | -       | -        | -        | -       |       |
| Convertible note  | -       | -        | 2,295    | -       |       |
|   | -----   | -----    | -----    | -----   | ----- |
| TOTAL LIABILITIES   | 6,743   | 33,759   | 19,319   | 7,420   |       |
|   | -----   | -----    | -----    | -----   | ----- |
| TOTAL SHAREHOLDERS' EQUITY                                  | (6,588) | (16,661) | (15,079) | (2,624) |       |
|   | =====   | =====    | =====    | =====   | ===== |

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Eltex Ltd.

NOTES TO THE FINANCIAL STATEMENTS

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 (ALL AMOUNTS IN THOUSANDS OF REPORTED NIS, EXCEPT WHERE OTHERWISE STATED)

NOTE 30 - SUBSEQUENT EVENTS

Subsequent to the balance sheet date, 110,800 stock options were exercised by employees into shares with capital contribution of NIS 2,120 thousand which were received on April 5, 2005.

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