



## **Electronics Line 3000 Board of Director's Report**

### **General**

We hereby submit, pursuant to the Securities Regulations, Periodical and Immediate Reports, 5730-1970, the Directors' Report for the quarter and six month period ending June 30, 2005.

### **Corporate Description and Business Environment**

Electronics Line 3000 ("the Company") engages in the design, development, production, marketing and sale of electronic security with remote management solutions and complementary products for the mass residential and commercial markets. These solutions can be monitored and enable remote management of the premises for security and automation and video applications.

On January 1, 2003, the assets, operations and related liabilities pertaining to the development, production, sales and marketing functions ("the Technological Operations") of Electronics Line (E.L.) Ltd. ("EL"), were transferred to a newly established subsidiary, Electronics Line 3000 ("the Company"). The Company was specifically established to absorb the Technological Operations of EL. This transaction involved the transfer of EL's Technological Operations to the Company in exchange for newly issued shares of the Company, all in accordance with the Israeli Income Tax (Section 104A).

In 2001, an American investor group, Argyle Global Opportunities, headed by Bob Marbut, purchased 15% of EL, thereby opening new opportunities for the Company in the U.S. market. SecTecGLOBAL was created, with Mr. Marbut as its CEO, and is now successfully selling solutions to the cable market in the United States. On November 1, 2004, Argyle transferred all of its holdings of EL's shares in exchange for the entire holdings (28.23%) of the Krubiner Group in the Company's shares. Subsequent to the exchange, Argyle's ownership of the Company increased to 43.23%.

Today, the majority of the Company's revenues come from Europe and the United States; therefore, the Company views these markets as strategic and will continue to concentrate its marketing efforts in these markets. In addition, the Company will continue to develop new markets, including the Far East, Latin America and elsewhere.

Over 99% of the Company's sales are in markets outside of Israel, with approximately 66% in Europe. The Company has four wholly-owned subsidiaries -- one in England, one in France and two in the United States. These entities serve as local and regional marketing companies. In addition, throughout the rest of the world, the Company sells direct via regional sales managers and indirect via local distributors, integrators and dealers.



Customers include leading international security, utility and communications service providers primarily in Europe and the United States, and distribution networks and security systems installation companies worldwide. Most orders occur on a monthly basis and not through a long-term backlog process.

### **General Results Review**

The Company's sales in the second quarter of 2005, ending June 30, 2005, ('the reported quarter') amounted to NIS. 49,743 thousand compared to NIS. 38,633 thousand in the same period last year. Sales in the first half of 2005, ending June 30, 2005, ('the reported period') amounted to NIS. 91,471 thousand, compared to NIS 79,539 thousand in the same period last year. Total sales for 2004 were NIS. 155,377 thousand.

The 30% increase in sales in the reported quarter compared to the sales in the same quarter last year, and the 15% increase in sales in the reported period compared to the same period last year were mainly derived from:

- Increased sales to new service providers
- Increased sales to existing customers in European markets.

The company's gross margins in the reported period were 39%, compared to 38% in the same period last year. Total gross margins for 2004 were 33%.

The gross profit in the reported quarter amounted to NIS. 19,892 thousand, compared to NIS. 15,968 thousand in the same quarter last year. The gross profit in the reported period amounted to NIS. 35,660 thousand, compared to NIS. 30,182 thousand in the same period last year. Total gross profit for 2004 was NIS. 51,117 thousand.

The substantial improvement in gross profit margins is derived from four main factors:

- Focus on more profitable products
- Targeting higher margin customers
- Cost reduction in some of the primary raw materials which the company uses
- Downsizing, with the resulting reduction of labor costs.

Research and development costs and know-how, including some costs that were capitalized during the reported quarter, amounted to NIS. 2,717 thousand, compared to NIS. 2,598 thousand in the same quarter last year.

Research and development related costs in the reported period were NIS. 4,973 thousand compared to NIS. 4,993 thousand in the same period last year. Total research and development related costs in 2004 were NIS. 11,581 thousand .



Sales and marketing expenses in the reported quarter were NIS. 10,345 thousand compared to NIS. 9,211 thousand during the same quarter last year. Sales and marketing expenses in the reported period were NIS. 19,978 thousand, compared to NIS 18,990 thousand during the same period last year. Total sales and marketing expenses for 2004 were NIS. 39,605 thousand. The increase in sales and marketing expenses during the reported period was because the company rebuilt the sales and marketing organization to support rapid growth.

Administrative and general expenses in the reported quarter were NIS. 6,217 thousand compared to NIS. 5,026 thousand during the same quarter last year. Administrative and general expenses in the reported period were NIS. 10,577 thousand compared to NIS.f 10,563 thousand during the same period last year. Total administrative and general expenses for 2004 were NIS. 21,577 thousand.

The Company's operating income during the reported period was NIS. 1,965 thousand, compared to an operating loss of NIS. 2,658 thousand during the same period last year, and a total loss of NIS. 17,093 thousand for 2004. As a result of the successful increase in sales, significant improvement in company profitability and the launch of a new effectiveness and efficiency plan during the reported period, the Company has achieved operational profitability during both the reported quarter and the reported period.

Financing and other expenses in the reported quarter were NIS. 861 thousand compared to NIS. 2,198 thousand during the same quarter last year. Financing and other expenses in the reported period were NIS. 895 thousand compared to NIS. 3,025 thousand during the same period last year. Total financing and other expenses for 2004 were NIS. 6,160 thousand. The decrease is a result of the control and management of currency exposure risks and due to the decrease of interest rates in Israel.

Income before income taxes in the reported quarter were NIS. 796 thousand compared to a loss of NIS 2,137 thousand during the same quarter last year. Income before income taxes in the reported period were NIS. 1,070 thousand compared to a loss of NIS 5,683 thousand during the same period last year. Total losses before income taxes for 2004 were NIS. 23,253 thousand.

Tax on income for the reported quarter were NIS. 18 thousand compared to income of NIS. 710 thousand during the same quarter last year. Taxes on income for the reported period were NIS. 127 thousand compared to an income of NIS. 1,365 thousand during the same period last year. Total income for 2004 was NIS. 2,691 thousand.

The Company ended the reported quarter with a net income of NIS. 778 thousand compared to a net loss of NIS. 1,427. thousand during the same quarter last year. The Company ended the reported period with a net income of NIS. 943 thousand compared to a net loss of NIS. 4,318 thousand during the same period last year. Total net loss for 2004 was NIS. 20,562 thousand. The Company has achieved profitability



during the reported period as a direct result of its improved sales and margins and reduced operating expenses.

### **The Company's Financial Position**

The Company's trade receivables as of June 30, 2005 (hereinafter: "the reported date") were NIS. 40,992 thousand, compared to NIS. 28,724 thousand on December 31, 2004.

The Company's other accounts receivables on the reported date were NIS. 7,607 thousand, compared to NIS. 12,345 thousand on December 31, 2004. The reduction is a result of the receipt of income tax refunds for previous years for amounts that had been overpaid by the Company.

The Company's inventories on the reported date amounted to NIS. 29,331 thousand, compared to NIS. 28,264 thousand on December 31, 2004. The increase in inventory is a direct result of rapid sales growth and the need to fulfill the orders in the company's current backlog.

The net investment in other assets, less amortization, in the amount of NIS. 27,825 thousand, is comprised of the following:

- Net investment in research and development for products that have been proven to be technologically feasible, but have not yet been released, less amortization, was NIS. 22,060 thousand on the reported date, compared to NIS. 22,101 thousand on December 31, 2004.
- Deferred taxes were NIS. 5,765 thousand as of the Reported Date and also as of December 31, 2004.

The credit from banks and other credit providers, less cash balances and cash equivalents on the reported date, amounted to NIS. 58,625 thousand, compared to NIS. 62,803 thousand on December 31, 2004. The company paid some of its banks loans with the cash that was generated from day-to-day operations.

The liabilities of trade payables increased from NIS. 20,936 thousand on December 31, 2004 to NIS. 28,351 thousand on June 30, 2005.

### **Financial ratios:**

|               | <b>June 30, 2005</b> | <b>December 31, 2004</b> |
|---------------|----------------------|--------------------------|
| Current ratio | 0.82                 | 0.78                     |
| Quick ratio   | 0.59                 | 0.55                     |

### **Liquidity**

- a. Liquidity Balances



The balance of liquid assets (cash and cash equivalents) on June 30, 2005 was NIS. 26,195 thousand, compared to NIS. 28,684 thousand on December 31, 2004.

b. Cash Flow

During the reported period, net cash provided by operating activities was NIS. 6,285 thousand, compared to NIS. 6,923 thousand used by the Company during the same period last year. Total cash used in operating activities for 2004 was NIS. 1,410 thousand.

During the reported period, the Company directed NIS. 2,107 thousand towards investment activities, compared to NIS. 3,726 thousand during the same period last year. Total cash directed to investment activities in 2004 was NIS. 6,954 thousand.

During the reported period, cash used in financing activities amounted to NIS. 6,667 thousand, compared to NIS. 9,860 thousand provided by financing activities during the same period last year. Total cash used in financing activities for 2004 was NIS. 16,552 thousand.

**Financing Sources**

Shareholders' equity as of June 30, 2005 amounted to NIS. 26,271 thousand, a ratio of 16.6% to the total balance sheet, compared to NIS. 24,528 thousand and 15.9%, respectively, as of December 31, 2004.

On June 30, 2005, short-term bank credit designated for financing working capital and investments in fixed assets and rental property was NIS. 84,820 thousand, compared to a credit balance of NIS. 91,487 thousand on December 31, 2004.

During the reported period, the Company's management introduced a number of efficiency measures, including a reduction in workforce of approximately 25 employees. This had a direct impact on the results of the reported period. The Company's management believes that the Company will have sufficient income in the future to finance its operations and meet future liabilities.

Subsequent to the closing of the quarter, the Company has reached an agreement with the banks regarding the financial covenants the Company will have to meet. The Company is in compliance with those covenants that are currently in effect.



### **Report of Exposure To, and Managing, Market Risks**

As a result of its activities, the Company is exposed mainly to the following market risks:

- Changes in currency and interest rates.
- Price fluctuations in raw materials.

#### **Foreign Currency Rates**

The Company's reporting currency is NIS – New Israeli Shekels (in nominal terms). At certain points in time, differences arise between the Company's financial assets denominated in or linked to other currencies, when compared to its financial liabilities in the same currencies, and this difference is exposed to changes in the currency rates relative to the shekel.

Moreover, most of the Company's sales are transacted in a currency other than the shekel, thus creating exposure due to the changes in the value of the currency of the sale relative to the shekel.

#### **Changes in Raw Material Prices**

The Company's raw materials (mainly electronics components) are purchased from suppliers in Israel and abroad, and their prices generally are set in the international market in U.S. dollars, creating an exposure to changes that occur in the value of the currency of purchase compared to the shekel.



Electronics Line 3000 Ltd.

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\_\_\_\_\_  
Yossef Ben-Haim  
Managing Director

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Bob Marbut  
Chairman of the Board

Petach Tikvah, August 8, 2005

**ELECTRONICS LINE 3000 LTD.**

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF JUNE 30, 2005**

**UNAUDITED**

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The Board of Directors  
Electronics Line 3000 Ltd.

Re: Review of unaudited interim consolidated financial statements  
as of and for the six and three months periods ended June 30, 2005

At your request, we have reviewed the interim consolidated balance sheet of Electronics Line 3000 Ltd. as of June 30, 2005 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the six and three months periods then ended. Our review was made in accordance with the procedures established by the Institute of Certified Public Accountants in Israel. These procedures included reading the above mentioned financial statements, reading minutes of meetings of the shareholders and of the board of directors and its committees, and making inquiries of certain officers responsible for financial and accounting matters.

We have been furnished with reports of other accountants in respect of the review of the interim financial statements of certain subsidiaries, whose assets constitute approximately 27% of total consolidated assets as of June 30, 2005 and whose revenues constitute approximately 44% and 43% of total consolidated revenues for the six and three months periods then ended, respectively.

A review is substantially less in scope than an audit in accordance with generally accepted auditing standards, and accordingly, we do not express an opinion on the interim consolidated statements.

Based on our review and the reports of other accountants, we are not aware of any material modifications that should be made to the above mentioned statements in order for them to be in conformity with generally accepted accounting principles in Israel and with the Securities Regulations (Periodic and Immediate Reports), 1970.

Tel-Aviv, Israel  
August 8, 2005

**KOST FORER GABBAY & KASIERER**  
A Member of Ernst & Young Global

**CONSOLIDATED BALANCE SHEETS**

|                                 | <u>June 30,</u>                  |                       | <u>December 31,</u>   |
|---------------------------------|----------------------------------|-----------------------|-----------------------|
|                                 | <u>2005</u>                      | <u>2004</u>           | <u>2004</u>           |
|                                 | <u>Unaudited</u>                 |                       | <u>Audited</u>        |
|                                 | <u>Reported NIS in thousands</u> |                       |                       |
| <b>ASSETS</b>                   |                                  |                       |                       |
| <b>CURRENT ASSETS:</b>          |                                  |                       |                       |
| Cash and cash equivalents       | 26,195                           | 19,707                | 28,684                |
| Trade receivables               | 40,992                           | 38,780                | 28,724                |
| Other accounts receivable       | 7,607                            | *) 12,531             | 12,345                |
| Inventory                       | 29,331                           | 33,239                | 28,264                |
|                                 | <u>104,125</u>                   | <u>104,257</u>        | <u>98,017</u>         |
| <b>LONG-TERM RECEIVABLES</b>    | <u>487</u>                       | *) <u>367</u>         | <u>459</u>            |
| <b>FIXED ASSETS:</b>            |                                  |                       |                       |
| Cost                            | 59,107                           | *) 58,483             | 59,242                |
| Less - accumulated depreciation | 33,077                           | *) 28,120             | 31,090                |
|                                 | <u>26,030</u>                    | <u>30,363</u>         | <u>28,152</u>         |
| <b>OTHER ASSETS, NET</b>        | <u>27,825</u>                    | *) <u>25,130</u>      | <u>27,866</u>         |
|                                 | <u><u>158,467</u></u>            | <u><u>160,117</u></u> | <u><u>154,494</u></u> |

\*) Reclassified.

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

**CONSOLIDATED BALANCE SHEETS**

|   | <u>June 30,</u>                  |                | <u>December 31,</u> |
|---|----------------------------------|----------------|---------------------|
|   | <u>2005</u>                      | <u>2004</u>    | <u>2004</u>         |
|   | <u>Unaudited</u>                 |                | <u>Audited</u>      |
|   | <u>Reported NIS in thousands</u> |                |                     |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b> |                                  |                |                     |
| <b>CURRENT LIABILITIES:</b>                 |                                  |                |                     |
| Credit from banks                           | 84,820                           | 89,183         | 91,487              |
| Shareholders' loan                          | 2,321                            | -              | 2,160               |
| Trade payables                              | 28,351                           | 21,611         | 20,936              |
| Other accounts payable                      | 12,365                           | 6,499          | 11,302              |
|   | <u>127,857</u>                   | <u>117,293</u> | <u>125,885</u>      |
| <b>LONG-TERM LIABILITIES:</b>               |                                  |                |                     |
| Shareholders' loan                          | 2,321                            | -              | 2,160               |
| Accrued severance pay, net                  | 2,018                            | 2,052          | 1,921               |
|   | <u>4,339</u>                     | <u>2,052</u>   | <u>4,081</u>        |
| <b>SHAREHOLDERS' EQUITY:</b>                |                                  |                |                     |
| Share capital                               | 46,861                           | 46,861         | 46,861              |
| Share premium                               | 4,887                            | 4,887          | 4,887               |
| Capital surplus                             | 2,858                            | 2,058          | 2,058               |
| Accumulated deficit                         | (28,335)                         | (13,034)       | (29,278)            |
|   | <u>26,271</u>                    | <u>40,772</u>  | <u>24,528</u>       |
|   | <u>158,467</u>                   | <u>160,117</u> | <u>154,494</u>      |

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

|   |                                       |                       |                        |
|---|---------------------------------------|-----------------------|------------------------|
| <u>August 8, 2005</u>                           | <u>Bob Marbut</u>                     | <u>Yossi Ben-Haim</u> | <u>Amir Blumenfeld</u> |
| Date of approval of the<br>financial statements | Chairman of the<br>Board of Directors | Managing Director     | CFO                    |

**CONSOLIDATED STATEMENTS OF OPERATIONS**

|   | Six months ended<br>June 30,                         |         | Three months ended<br>June 30, |         | Year ended<br>December 31, |
|---|--|---------|--------------------------------|---------|----------------------------|
|   | 2005   | 2004    | 2005                           | 2004    | 2004                       |
|   | Unaudited  |         |                                |         | Audited                    |
|   | Reported NIS in thousands (except per share amounts) |         |                                |         |                            |
| Sales   | 91,471   | 79,539  | 49,743                         | 38,633  | 155,377                    |
| Cost of sales   | 55,811   | 49,357  | 29,851                         | 22,665  | 104,260                    |
| Gross profit  | 35,660   | 30,182  | 19,892                         | 15,968  | 51,117                     |
| Research and development costs  | 3,140  | 3,287   | 1,673                          | 1,670   | 7,028                      |
| Selling and marketing expenses  | 19,978   | 18,990  | 10,345                         | 9,211   | 39,605                     |
| General and administrative expenses   | 10,577   | 10,563  | 6,217                          | 5,026   | 21,577                     |
|   | 33,695   | 32,840  | 18,235                         | 15,907  | 68,210                     |
| Operating income (loss)   | 1,965  | (2,658) | 1,657                          | 61      | (17,093)                   |
| Financial expenses, net   | (882)  | (2,703) | (839)                          | (1,875) | (5,744)                    |
| Other expenses, net   | (13)   | (322)   | (22)                           | (323)   | (416)                      |
| Income (loss) before taxes on income  | 1,070  | (5,683) | 796                            | (2,137) | (23,253)                   |
| Taxes on income   | 127  | (1,365) | 18                             | (710)   | (2,691)                    |
| Net income (loss)   | 943  | (4,318) | 778                            | (1,427) | (20,562)                   |
| Net earnings (loss) per NIS 1 par value of<br>Ordinary shares (in reported NIS) | 0.03   | (0.15)  | 0.02                           | (0.05)  | (0.57)                     |

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

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

|   | <b>Six months ended June 30, 2005 (unaudited)</b> |                      |                        |                            |               |
|---|---|----------------------|------------------------|----------------------------|---------------|
|   | <b>Share capital</b>                              | <b>Share premium</b> | <b>Capital surplus</b> | <b>Accumulated deficit</b> | <b>Total</b>  |
|   | <b>Reported NIS in thousands</b>                  |                      |                        |                            |               |
| Balance at the beginning of the period (audited)                              | 46,861  | 4,887                | 2,058                  | (29,278)                   | 24,528        |
| Capital surplus from waive of salary by controlling shareholder (see Note 4b) | -   | -                    | 800                    | -                          | 800           |
| Net income  | -   | -                    | -                      | 943                        | 943           |
| Balance at the end of the period  | <u>46,861</u>                                     | <u>4,887</u>         | <u>2,858</u>           | <u>(28,335)</u>            | <u>26,271</u> |
|   | <b>Six months ended June 30, 2004 (unaudited)</b> |                      |                        |                            |               |
|   | <b>Share capital</b>                              | <b>Share premium</b> | <b>Capital surplus</b> | <b>Accumulated deficit</b> | <b>Total</b>  |
|   | <b>Reported NIS in thousands</b>                  |                      |                        |                            |               |
| Balance at the beginning of the period (audited)                              | 32,553  | 4,887                | 2,058                  | (8,716)                    | 30,782        |
| Issuance of share capital against conversion of shareholders' loan            | 14,308  | -                    | -                      | -                          | 14,308        |
| Loss  | -   | -                    | -                      | (4,318)                    | (4,318)       |
| Balance at the end of the period  | <u>46,861</u>                                     | <u>4,887</u>         | <u>2,058</u>           | <u>(13,034)</u>            | <u>40,772</u> |

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

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

|   | <b>Three months ended June 30, 2005 (unaudited)</b> |                      |                        |                            |               |
|---|---|----------------------|------------------------|----------------------------|---------------|
|   | <b>Share capital</b>                                | <b>Share premium</b> | <b>Capital surplus</b> | <b>Accumulated deficit</b> | <b>Total</b>  |
|   | <b>Reported NIS in thousands</b>                    |                      |                        |                            |               |
| Balance at the beginning of the period (audited)                              | 46,861  | 4,887                | 2,440                  | (29,113)                   | 25,075        |
| Capital surplus from waive of salary by controlling shareholder (see Note 4b) | -   | -                    | 418                    | -                          | 418           |
| Net income  | -   | -                    | -                      | 778                        | 778           |
| Balance at the end of the period  | <u>46,861</u>                                       | <u>4,887</u>         | <u>2,858</u>           | <u>(28,335)</u>            | <u>26,271</u> |
|   | <b>Three months ended June 30, 2004 (unaudited)</b> |                      |                        |                            |               |
|   | <b>Share capital</b>                                | <b>Share premium</b> | <b>Capital surplus</b> | <b>Accumulated deficit</b> | <b>Total</b>  |
|   | <b>Reported NIS in thousands</b>                    |                      |                        |                            |               |
| Balance at the beginning of the period (audited)                              | 32,553  | 4,887                | 2,058                  | (11,607)                   | 27,891        |
| Issuance of share capital against conversion of shareholders' loan            | 14,308  | -                    | -                      | -                          | 14,308        |
| Loss  | -   | -                    | -                      | (1,427)                    | (1,427)       |
| Balance at the end of the period  | <u>46,861</u>                                       | <u>4,887</u>         | <u>2,058</u>           | <u>(13,034)</u>            | <u>40,772</u> |
|   | <b>Year ended December 31, 2004 (audited)</b>       |                      |                        |                            |               |
|   | <b>Share capital</b>                                | <b>Share premium</b> | <b>Capital surplus</b> | <b>Accumulated deficit</b> | <b>Total</b>  |
|   | <b>Reported NIS in thousands</b>                    |                      |                        |                            |               |
| Balance at the beginning of the year  | 32,553  | 4,887                | 2,058                  | (8,716)                    | 30,782        |
| Issuance of share capital against conversion of shareholders' loan            | 14,308  | -                    | -                      | -                          | 14,308        |
| Loss  | -   | -                    | -                      | (20,562)                   | (20,562)      |
| Balance at the end of the year  | <u>46,861</u>                                       | <u>4,887</u>         | <u>2,058</u>           | <u>(29,278)</u>            | <u>24,528</u> |

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | Six months ended<br>June 30, |            | Three months ended<br>June 30, |            | Year ended<br>December 31, |
|---|------------------------------|------------|--------------------------------|------------|----------------------------|
|   | 2005                         | 2004       | 2005                           | 2004       | 2004                       |
|   | Unaudited                    |            |                                |            | Audited                    |
|   | Reported NIS in thousands    |            |                                |            |                            |
| <u>Cash flows from operating activities:</u>  |                              |            |                                |            |                            |
| Net income (loss)   | 943                          | (4,318)    | 778                            | (1,427)    | (20,562)                   |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities (a) | 5,342                        | (2,605)    | 4,516                          | (4,321)    | 19,152                     |
| Net cash flows provided by (used in) operating activities   | 6,285                        | (6,923)    | 5,294                          | (5,748)    | (1,410)                    |
| <u>Cash flows from investing activities:</u>  |                              |            |                                |            |                            |
| Purchase of other assets  | (1,833)                      | *) (2,228) | (1,044)                        | *) (1,217) | (4,553)                    |
| Purchase of fixed assets  | (644)                        | *) (1,640) | (229)                          | *) (504)   | (2,599)                    |
| Proceeds from sale of fixed assets  | 370                          | 142        | 168                            | -          | 198                        |
| Net cash flows used in investing activities   | (2,107)                      | (3,726)    | (1,105)                        | (1,721)    | (6,954)                    |
| <u>Cash flows from financing activities:</u>  |                              |            |                                |            |                            |
| Receipt of shareholders' loan from controlling shareholder  | -                            | -          | -                              | -          | 4,388                      |
| Short-term credit from banks, net   | (6,667)                      | 9,860      | (6,335)                        | 8,306      | 12,164                     |
| Net cash flows provided by (used in) financing activities   | (6,667)                      | 9,860      | (6,335)                        | 8,306      | 16,552                     |
| Increase (decrease) in cash and cash equivalents  | (2,489)                      | (789)      | (2,146)                        | 837        | 8,188                      |
| Cash and cash equivalents at the beginning of the period  | 28,684                       | 20,496     | 28,341                         | 18,870     | 20,496                     |
| Cash and cash equivalents at the end of the period  | 26,195                       | 19,707     | 26,195                         | 19,707     | 28,684                     |

\*) Reclassified.

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | Six months ended<br>June 30, |                | Three months ended<br>June 30, |                | Year ended<br>December 31, |
|---|------------------------------|----------------|--------------------------------|----------------|----------------------------|
|   | 2005                         | 2004           | 2005                           | 2004           | 2004                       |
|   | Unaudited                    |                |                                |                | Audited                    |
|   | Reported NIS in thousands    |                |                                |                |                            |
| (a) <u>Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:</u> |                              |                |                                |                |                            |
| Income and expenses not involving cash flows:   |                              |                |                                |                |                            |
| Depreciation and amortization   | 4,168                        | 3,911          | 2,230                          | 1,930          | 7,901                      |
| Loss (gain) from sale of fixed assets   | 102                          | (1)            | 13                             | -              | 6                          |
| Accrued severance pay, net  | 97                           | 172            | (83)                           | 57             | 41                         |
| Deferred taxes, net   | 93                           | -              | 26                             | -              | (3,047)                    |
| Increase in value (erosion) of shareholders' loan   | 322                          | (1,854)        | 242                            | (867)          | (68)                       |
| Waive of salary by controlling shareholder  | 800                          | -              | 418                            | -              | -                          |
| Changes in asset and liability items:   |                              |                |                                |                |                            |
| Decrease (increase) in trade receivables  | (12,268)                     | (296)          | (5,277)                        | 1,586          | 9,760                      |
| Decrease (increase) in other accounts receivable (including long-term receivables)                            | 4,617                        | (493)          | (160)                          | (694)          | (500)                      |
| Decrease (increase) in inventory  | (1,067)                      | (3,754)        | 445                            | (3,955)        | 1,221                      |
| Increase (decrease) in trade payables   | 7,415                        | 2,047          | 4,451                          | (18)           | 1,372                      |
| Increase (decrease) in other accounts payable   | 1,063                        | (2,337)        | 2,211                          | (2,360)        | 2,466                      |
|   | <u>5,342</u>                 | <u>(2,605)</u> | <u>4,516</u>                   | <u>(4,321)</u> | <u>19,152</u>              |
| (b) <u>Significant non-cash operations:</u>   |                              |                |                                |                |                            |
| Issuance of share capital against conversion of shareholders' loan  | -                            | 14,308         | -                              | 14,308         | 14,308                     |

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

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****NOTE 1:- GENERAL**

These financial statements have been prepared in a condensed format as of June 30, 2005, and for the six and three months then ended ("interim financial statements"). These financial statements should be read in conjunction with the Company's audited annual financial statements and accompanying notes as of December 31, 2004 and for the year then ended.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

- a. The interim financial statements have been prepared in accordance with generally accepted accounting principles for the preparation of financial statements for interim periods, as prescribed in Accounting Standard No. 14 of the Israel Accounting Standards Board and in accordance with the Chapter D of the Securities Regulations (Periodic and Immediate Reports), 1970.

The significant accounting policies and methods of computation followed in the preparation of the interim financial statements are identical to those followed in the preparation of the latest annual financial statements, except as described in b below.

- b. Initial adoption of Accounting Standard No. 19 with respect to taxes on income:

On January 1, 2005, the Company adopted Accounting Standard No. 19, "Taxes on Income" ("the Standard") of the Israel Accounting Standards Board. The Standard prescribes the principles for recognition, measurement, presentation and disclosure of taxes on income and deferred taxes in the financial statements.

The major change promulgated by the Standard in relation to the accounting principles which were previously in effect is the recognition of deferred taxes for temporary differences relating to land.

The initial adoption of the provisions of the Standard did not have a material impact on the interim financial statements.

- c. Following are data regarding the exchange rate of the U.S. dollar and the Euro:

| <b>As of</b>                    | <b>Exchange rate of<br/>U.S. dollar<br/>NIS</b> | <b>Exchange rate of<br/>Euro<br/>NIS</b> |
|---------------------------------|---|--|
| June 30, 2005                   | 4.574   | 5.5270                                   |
| June 30, 2004                   | 4.497   | 5.4657                                   |
| December 31, 2004               | 4.308   | 5.8768                                   |
| <b>Change during the period</b> | <b>%</b>  | <b>%</b>                                 |
| June 2005 (six months)          | 6.2   | (5.9)                                    |
| June 2005 (three months)        | 4.9   | (2.2)                                    |
| June 2004 (six months)          | 2.7   | (1.2)                                    |
| June 2004 (three months)        | (0.7)   | (1.6)                                    |
| December 2004 (12 months)       | (1.6)   | 6.2                                      |

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**


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**NOTE 3:- FINANCIAL COVENANTS**

- a. On August 8, 2005, one of the banks (Bank A) suspended its demand to comply with the financial covenants as determined for a period ending on August 30, 2006. The above suspension of Bank A, as above, is conditional upon pledging an additional deposit of \$ 800 thousand in its favor by the Company and recording a floating charge on the Company's assets until September 30, 2005. Further, Bank A expressed its willingness to waive on the demand to comply with the financial covenants, as above, if the Company records the aforementioned floating charge. On March 20, 2005, the Company's Board approved the recording of a floating charge in favor of Bank A. As of the date of the approval of the interim financial statements, a floating charge in favor of that bank has not yet been recorded. As of June 30, 2005, the Company's balance of credit from Bank A is NIS 30,682 thousand.
- b. On August 7, 2005, the Company approved new financial covenants toward Bank B according to which the Company and Bank B reached an understanding as to certain accepted financial covenants that the Company will have to fulfill, including shareholders' equity to total balance sheet ratio, certain profitability level, cash balances and other balance sheet ratios. Part of these financial covenants will be measured as from December 31, 2005. The Company's management believes that the Company is meeting the covenants that it has undertaken to fulfill at the date of these statements. As of June 30, 2005, the Company's balance of credit from Bank B is NIS 26,070 thousand.

**NOTE 4:- TRANSACTIONS WITH A CONTROLLING SHAREHOLDER**

- a. Pro forma statements:

As a result of entering into new lease, management and consulting agreements with the former parent company, as described in Note 29c to the annual financial statements, following is the effect on the data for the reported periods (until November 1, 2004, as discussed in Note 29b(2) to the annual financial statements), assuming that the changes in terms were in effect for all reported periods.

|  | Six months ended<br>June 30, 2004                    |                   | Three months ended<br>June 30, 2004 |                   | Year ended<br>December 31, 2004 |                   |
|--|--|-------------------|-------------------------------------|-------------------|---------------------------------|-------------------|
|  | Actual<br>data                                       | Pro forma<br>data | Actual<br>data                      | Pro forma<br>data | Actual<br>data                  | Pro forma<br>data |
|  | Unaudited  |                   |                                     |                   | Audited                         |                   |
|  | Reported NIS in thousands (except per share amounts) |                   |                                     |                   |                                 |                   |
| Cost of sales                                      | 49,357   | 49,345            | 22,665                              | 22,734            | 104,260                         | 104,093           |
| Research and<br>development costs                  | 3,287  | 3,256             | 1,670                               | 1,682             | 7,028                           | 6,919             |
| Selling and marketing<br>expenses                  | 18,990   | 18,976            | 9,211                               | 9,216             | 39,605                          | 39,560            |
| General and<br>administrative expenses             | 10,563   | 8,481             | 5,026                               | 4,214             | 21,577                          | 19,456            |
| Taxes on income                                    | (1,365)  | (653)             | (710)                               | (468)             | (2,691)                         | (1,878)           |
| Loss   | (4,318)  | (2,891)           | (1,427)                             | (942)             | (20,562)                        | (18,933)          |
| Loss per NIS 1 par value<br>of Ordinary shares (in | (0.15)   | (0.10)            | (0.05)                              | (0.03)            | (0.57)                          | (0.52)            |

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

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reported NIS)

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**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****NOTE 4:- TRANSACTIONS WITH A CONTROLLING SHAREHOLDER (Cont.)**

- b. Since March 1, 2003, Mr. Bob Marbut, who is the Chairman of the Board and an indirect controlling shareholder in the Company, has been acting as CEO and president of a subsidiary in the United States ("STG"). The employment contract is for a period of one year from the signing of the contract but is automatically extended by an additional year at the end of each period, unless one of the parties notifies of its cancellation 90 days in advance. In consideration for Mr. Marbut's services, STG pays a total of \$ 350 thousand annually.

Despite the aforementioned, during 2005, Mr. Marbut has agreed not to receive payment for his services.

In accordance with Israel's Securities Regulations (Presentation of Transactions Between a Corporation and a Controlling Shareholder in the Financial Statements), 1996, the waiver of salary in the amount of NIS 800 thousand and NIS 418 thousand was recorded as an expense against capital surplus in the interim financial statements for the six and three months periods ended June 30, 2005, respectively.

**NOTE 5:- ADDITIONAL INFORMATION**

On June 8, 2005, the Company's Board adopted a share option plan in the context of which, up to 290,735 non-marketable options exercisable into Ordinary shares of the Company of 5 NIS par value for an exercise increment that equals to the average price of the Company's share on the end of the most recent 30 days which preceded each offering, will be allocated to officers, directors, employees and consultants of the Company or its related companies. As of the date of the approval of the financial statements, the amount of the options that will be allocated and the optionees' identity has not yet been determined.

**NOTE 6:- GEOGRAPHIC SEGMENTS**

- a. General information:

The Company and the Group companies operate in two major geographic segments: the U.S. and Europe.

- b. Information about geographic segments:

|                    | <b>Six months ended June 30, 2005 (unaudited)</b> |               |                        |                    | <b>Total - consolidated</b> |
|--------------------|---|---------------|------------------------|--------------------|-----------------------------|
|                    | <b>U.S.</b>                                       | <b>Europe</b> | <b>Other countries</b> | <b>Adjustments</b> |                             |
|                    | <b>Reported NIS in thousands</b>                  |               |                        |                    |                             |
| Segment's revenues | <u>23,470</u>                                     | <u>66,084</u> | <u>9,706</u>           | <u>(7,789)</u>     | <u>91,471</u>               |
| Segment's results  | <u>684</u>  | <u>13,335</u> | <u>1,166</u>           | <u>*) (13,220)</u> | <u>1,965</u>                |

\*) Including expenses not allocated to segments.

## NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 6:- GEOGRAPHIC SEGMENTS (Cont.)

|                    | <b>Six months ended June 30, 2004 (unaudited)</b>   |                |                        |                    |                             |
|--------------------|---|----------------|------------------------|--------------------|-----------------------------|
|                    | <b>U.S.</b>   | <b>Europe</b>  | <b>Other countries</b> | <b>Adjustments</b> | <b>Total - consolidated</b> |
|                    | <b>Reported NIS in thousands</b>                    |                |                        |                    |                             |
| Segment's revenues | <u>21,692</u>                                       | <u>57,949</u>  | <u>8,830</u>           | <u>(8,932)</u>     | <u>79,539</u>               |
| Segment's results  | <u>2,027</u>  | <u>9,951</u>   | <u>(240)</u>           | <u>*) (14,396)</u> | <u>(2,658)</u>              |
|                    | <b>Three months ended June 30, 2005 (unaudited)</b> |                |                        |                    |                             |
|                    | <b>U.S.</b>   | <b>Europe</b>  | <b>Other countries</b> | <b>Adjustments</b> | <b>Total - consolidated</b> |
|                    | <b>Reported NIS in thousands</b>                    |                |                        |                    |                             |
| Segment's revenues | <u>12,838</u>                                       | <u>35,151</u>  | <u>5,687</u>           | <u>(3,933)</u>     | <u>49,743</u>               |
| Segment's results  | <u>684</u>  | <u>6,236</u>   | <u>873</u>             | <u>*) (6,136)</u>  | <u>1,657</u>                |
|                    | <b>Three months ended June 30, 2004 (unaudited)</b> |                |                        |                    |                             |
|                    | <b>U.S.</b>   | <b>Europe</b>  | <b>Other countries</b> | <b>Adjustments</b> | <b>Total - consolidated</b> |
|                    | <b>Reported NIS in thousands</b>                    |                |                        |                    |                             |
| Segment's revenues | <u>11,037</u>                                       | <u>28,328</u>  | <u>4,663</u>           | <u>(5,395)</u>     | <u>38,633</u>               |
| Segment's results  | <u>2,453</u>  | <u>4,853</u>   | <u>(595)</u>           | <u>*) (6,650)</u>  | <u>61</u>                   |
|                    | <b>Year ended December 31, 2004 (audited)</b>       |                |                        |                    |                             |
|                    | <b>U.S.</b>   | <b>Europe</b>  | <b>Other countries</b> | <b>Adjustments</b> | <b>Total - consolidated</b> |
|                    | <b>Reported NIS in thousands</b>                    |                |                        |                    |                             |
| Segment's revenues | <u>48,818</u>                                       | <u>107,954</u> | <u>19,554</u>          | <u>(20,949)</u>    | <u>155,377</u>              |
| Segment's results  | <u>(1,710)</u>                                      | <u>7,089</u>   | <u>(1,563)</u>         | <u>*) (20,909)</u> | <u>(17,093)</u>             |

\*) Including expenses not allocated to segments.

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 7:- EVENTS SUBSEQUENT TO THE BALANCE SHEET DATE**

- a. On July 10, 2005, the Company's Board resolved to approve a private placement of 500,000 Ordinary shares of NIS 5 par value to a third party in consideration of €2 per share. The third party shall transfer the shares close after the issuance to several buyers, who subsequent to the transfer will each hold less than 5% of the Company's aggregate issued share capital. The shares issued will confer same rights as the Company's existing shares.

On July 11, 2005, the 500,000 shares were allocated to the third party. As of the date of the approval of the financial statements, the shares were transferred to the buyers.

- b. On July 25, 2005, the Knesset (Israeli Parliament) passed the Law for the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

Management estimates that the effect of the amendment on the Company's balance of deferred taxes as of June 30, 2005 is expected to result in an increase in tax expense in the amount of approximately NIS 200 thousand, which will be recorded in the financial statements as of September 30, 2005 and for the three months then ended.

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