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RADA ELECTRONIC INDUSTRIES LTD  
Form 20-F  
March 28, 2008

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON D.C. 20549

FORM 20-F

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

OR

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007

OR

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

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

OR

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

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

COMMISSION FILE NUMBER: 0-15375

RADA ELECTRONIC INDUSTRIES LTD.  
(Exact Name of Registrant as Specified in Its Charter  
and Translation of Registrant's Name Into English)

ISRAEL  
(Jurisdiction of Incorporation or Organization)

7 GIBOREI ISRAEL STREET, NETANYA 42504, ISRAEL  
(Address of Principal Executive Offices)

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

| TITLE OF EACH CLASS                  | NAME OF EACH EXCHANGE ON WHICH REGISTERED |
|--------------------------------------|---|
| ORDINARY SHARES, NIS 0.015 PAR VALUE | NASDAQ CAPITAL MARKET                     |

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

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 0.015 PER SHARE...8,705,788  
(As of December 31, 2007)

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

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

Yes  No

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Item 17  Item 18

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

Yes  No

This Report on Form 20-F is incorporated by reference into our Form F-3 Registration Statements File Nos. 333-117954, 333-115598 and 333-12074, and our Form S-8 Registration Statements File Nos. 333-111437 and 333-12844.

### INTRODUCTION

RADA Electronic Industries Ltd., an Israeli corporation, is engaged in the military and commercial aerospace industries. We develop, manufacture and sell avionics systems, including digital video recorders, ground debriefing stations, stores management systems, flight data recorders, inertial navigation systems, trainers upgrades, avionics systems for the avionics for unmanned aerial vehicles market, and electro-optic cameras for airplanes and armored vehicles.

Our shares are traded on the NASDAQ Capital Market, under the symbol "RADA." As used in this annual report, the terms "we," "us" and "our" mean RADA Electronic Industries Ltd. and its subsidiaries, unless otherwise indicated.

We currently use CATS(TM), ACE(TM) and FACE(TM) as trade names. We acquired

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the rights to the Israeli trademark VDS(R) and to the U.S. trademark application for the same trademark in February 2005. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to "dollars" or "\$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

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 previous filing with the Securities and Exchange Commission, you may read the document itself for a complete recitation of its terms.

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. Such forward-looking statements are also included in Item 4 - "Information on the Company" and Item 5 - "Operating and Financial Review and Prospects." 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 3D. "Key Information - Risk Factors."

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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

We derived the following consolidated statements of operations data for the years ended December 31, 2005, 2006 and 2007 and the consolidated balance sheet data as of December 31, 2006 and 2007 from our audited consolidated financial statements included in this annual report. We derived the consolidated statements of operations data for the years ended December 31, 2003 and 2004, and the consolidated balance sheet data as of December 31, 2003, 2004 and 2005 from our audited consolidated financial statements that are not included in this annual report. All share and per share amounts have been restated for all prior periods to reflect a one share for three shares reverse stock split that was effective February 14, 2007.

|   | YEAR ENDED DECEMBER 31,                            |           |            |            |
|---|--|-----------|------------|------------|
|   | 2003   | 2004      | 2005       | 2006       |
|   | -----  | -----     | -----      | -----      |
|   | (In thousands, except share and per share amounts) |           |            |            |
| Revenues  | \$ 12,315  | \$ 14,160 | \$ 13,421  | \$ 13,421  |
| Cost of revenues  | 9,592  | 10,287    | 12,082     | 12,082     |
| Gross profit  | 2,723  | 3,873     | 1,339      | 1,339      |
| Research and development expenses                       | -  | -         | -          | -          |
| Marketing, selling, general and administrative expenses | 2,698  | 2,854     | 3,094      | 3,094      |
| Operating income (loss)                                 | 25   | 1,019     | (1,755)    | (1,755)    |
| Financial income (expenses), net                        | 708  | (248)     | (624)      | (624)      |
| Other income (expenses), net                            | (2)  | 23        | 33         | 33         |
| Minority interest in losses (gains) of subsidiary       | 27   | 28        | 17         | 17         |
| Net income (loss)                                       | \$ 758   | \$ 822    | \$ (2,329) | \$ (2,329) |
|   | =====  | =====     | =====      | =====      |
| Basic net income (loss) per share                       | \$ 0.12  | \$ 0.12   | \$ (0.31)  | \$ (0.31)  |
|   | =====  | =====     | =====      | =====      |
| Diluted net income (loss) per share                     | \$ 0.12  | \$ 0.09   | \$ (0.31)  | \$ (0.31)  |

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|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Weighted average number of shares used<br>to compute basic net income (loss) per<br>share   | ===== | ===== | ===== | ===== |
|   | 6,170 | 6,458 | 7,504 |       |
|   | ===== | ===== | ===== | ===== |
| Weighted average number of shares used<br>to compute diluted net income (loss) per<br>share | ===== | ===== | ===== | ===== |
|   | 6,568 | 7,895 | 7,504 |       |
|   | ===== | ===== | ===== | ===== |

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|   | AS OF DECEMBER 31,          |          |          |          |
|---|-----------------------------|----------|----------|----------|
|   | 2003                        | 2004     | 2005     | 2006     |
|   | (U.S. dollars in thousands) |          |          |          |
| BALANCE SHEET DATA:   |                             |          |          |          |
| Working capital (deficiency)                                    | \$ (2,716)                  | \$ 2,265 | \$ 3,575 | \$ 2,265 |
| Total assets  | 14,549                      | 18,297   | 18,890   | 17,890   |
| Short-term credits and current maturities of<br>long-term loans | 1,123                       | 14       | 877      | 14       |
| Long-term debt, net of current maturities                       | 1,220                       | -        | -        | -        |
| Convertible note  | -                           | 2,346    | 2,560    | 2,560    |
| Shareholders' equity  | 2,878                       | 7,232    | 7,735    | 6,232    |

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 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.

RISKS RELATED TO OUR BUSINESS AND OUR INDUSTRY

WE HAVE A HISTORY OF LOSSES, AND MAY NOT BE ABLE TO ACHIEVE OR SUSTAIN PROFITABILITY IN THE FUTURE.

In the year ended December 31, 2007, we recorded a net loss of \$1.1 million, and we have incurred losses in three out of the last five years. As of December 31, 2007 our accumulated deficit was \$62.4 million. We may not be able to achieve or sustain profitability in the future.

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

Our working capital requirements and the cash flow from our operating activities are likely to vary greatly from quarter to quarter, depending on the timing of orders and deliveries, the build-up of inventories, and the payment

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terms offered to our customers. As a consequence of our significant losses, we incurred significant bank debt and sold equity and debt securities in private placements in the years 1997 through 2007. We may need to raise additional funds for a number of uses, including:

- o Working capital and operating activities;
- o Implementing marketing and sales activities for our products;
- o Maintaining and expanding research and development programs;
- o Hiring additional qualified personnel; and
- o Supporting an increased level of operations.

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We may not be able to obtain additional funds on favorable terms. If we cannot raise needed funds on favorable terms, we may be required to delay, scale back or eliminate some aspects of our operations and we may not be able to:

- o Develop new products;
- o Enhance our existing products;
- o Remain current with evolving industry standards;
- o Fulfill our contractual obligations;
- o Take advantage of future opportunities;
- o Respond to competitive pressures or unanticipated requirements; or
- o Retain our listing on the NASDAQ Capital Market.

If adequate funds are not available to us, our business, and results of operations and financial condition will be materially and adversely affected. Any equity or debt financings may cause dilution to our then-existing shareholders and may increase our financing expenses. If additional funds are raised through the issuance of equity securities, the net tangible book value per share of our ordinary shares would decrease and the percentage ownership of then current shareholders would be diluted.

WE MAY NOT BE ABLE TO IMPLEMENT OUR GROWTH STRATEGY, WHICH COULD ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

In line with our growth strategy, we have entered into teaming agreements and other co-operation agreements with General Electric Aviation System (formerly Smiths Aerospace Electronic Systems) or GE Aviation, and Lockheed Martin Aerospace to increase our penetration into the aviation market. We are currently investing and intend to continue to invest significant resources to develop these relationships. Should our relationships fail to materialize into significant agreements or should we fail to work efficiently with such parties, we may lose sales and marketing opportunities and our business, results of operations and financial condition could be adversely affected.

Our growth is partially dependant on the development of new products, based on internal research and development. Although we carefully analyze the market needs before we invest in the development of a new product, we cannot be sure

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that the needs we identify are true, we might face difficulties or delays in the development process that will result in changes of the market needs and competing products may emerge during the development and certification process.

COMPETITION IN THE MARKET FOR AUTOMATED TEST EQUIPMENT AND AVIONICS EQUIPMENT IS INTENSE. OUR PRODUCTS MAY NOT ACHIEVE MARKET ACCEPTANCE, WHICH COULD ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The market for our products is highly competitive, and we may not be able to compete effectively in our market. Our principal competitors in the automated test equipment market are Zaban in Israel, and Aerospatiale Avionique and Avtron abroad. Our principal competitors in the avionics market are Harris, Rockwell Collins, Honeywell, Elbit Systems Ltd., or Elbit, Israel Aircraft Industries Ltd., or IAI, R.S.L. Ltd., TEAC, Enertec and Calculex. We expect to continue to face competition from these and other competitors. Most, if not all, of our competitors are far larger, have substantially greater resources including financial, technological, marketing and distribution capabilities, and enjoy greater market recognition than we have. These competitors may be able to achieve greater economies of scale and may be less vulnerable to price competition than us. We may not be able to offer our products as part of integrated systems to the same extent as our competitors or successfully develop or introduce new products that are more cost effective or offer better performance than those of our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

OUR INITIATIVE OF PROVIDING MANUFACTURING SERVICES MAY NOT SUCCEED, AND AS A RESULT, WE MAY BE UNABLE TO ACHIEVE PROFITABILITY IN OUR BEIT-SHE'AN PRODUCTION FACILITY AND MAY BE FORCED TO SHUT DOWN ITS OPERATIONS.

In June 2000, we began to provide manufacturing services to original equipment manufacturers in Israel and the United States, using the manufacturing capabilities of our Beit-She'an plant. The market for our manufacturing services is highly competitive, and we may not be able to compete effectively in this market. The cost of labor and the efficiency of the production equipment and production processes are crucial to our success in this market. Consequently, should we fail to maintain low labor costs, enhance our production equipment and develop new and more efficient production methods, we may have to shut down the operations of our Beit-She'an plant, which may harm our competitiveness and could adversely affect our business, results of operations and financial condition.

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REDUCTION IN MILITARY BUDGETS WORLDWIDE MAY CAUSE A REDUCTION IN OUR REVENUES, WHICH WOULD ADVERSELY AFFECT OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION.

A significant portion of our revenues is derived from the sale of products with military applications. These revenues, on a consolidated basis, totaled approximately \$11.6 million, or 83% of revenues, in 2007, \$11.6 million, or 89% of revenues, in 2006 and \$11.8 million, or 88 % of revenues, in 2005. The military budgets of a number of countries may be reduced in the future. Declines in military budgets may result in reduced demand for our products and manufacturing services. This would result in reduction in our core business' revenues and adversely affect our business, results of operations and financial condition.

SALES OF OUR PRODUCTS ARE SUBJECT TO GOVERNMENTAL PROCUREMENT PROCEDURES AND PRACTICES; TERMINATION, REDUCTION OR MODIFICATION OF CONTRACTS WITH OUR



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CUSTOMERS, AND ESPECIALLY WITH THE GOVERNMENT OF ISRAEL, OR A SUBSTANTIAL DECREASE IN OUR CUSTOMERS' BUDGETS MAY ADVERSELY AFFECT OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION.

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

Further, our business with the State of Israel and other governmental entities is, in general, subject to delays in funding and performance of contracts and the termination of contracts or subcontracts for convenience, among others. The termination, reduction or modification of our contracts or subcontracts with the Government of Israel in the event of change in requirements, policies or budgetary constraints would have an adverse effect on our business, operating results and financial condition.

IF WE DO NOT RECEIVE THE GOVERNMENTAL APPROVALS NECESSARY FOR THE EXPORT OF OUR PRODUCTS, OUR REVENUES MAY DECREASE. SIMILARLY IF OUR SUPPLIERS AND PARTNERS DO NOT RECEIVE GOVERNMENT APPROVALS NECESSARY TO EXPORT THEIR PRODUCTS OR DESIGNS TO US, OUR REVENUES MAY DECREASE AND WE MAY FAIL TO IMPLEMENT OUR GROWTH STRATEGY.

Under Israeli law, the export of certain of our products and know-how is subject to approval by the Israeli Ministry of Defense. To initiate sales proposals with regard to exports of our products and know-how and to export such products or know-how, we must obtain permits from the Ministry of Defense. We may not be able to receive in a timely manner all the required permits for which we may apply in the future.

Similarly, under foreign laws the export of certain military products, technical designs and spare parts require the prior approval of, or export license from, such foreign governments. In order to maintain our third party production, certain co-development activities and procurements required for the performance of certain contracts, we must receive detailed technical designs, products or products' parts samples from our strategic partners or suppliers. We may not be able to receive all the required permits and/or licenses in a timely manner. Consequently, our revenues may decrease and we may fail to implement our growth strategy.

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WE DEPEND ON SALES TO KEY CUSTOMERS AND THE LOSS OF ONE OR MORE OF OUR KEY CUSTOMERS WOULD RESULT IN A LOSS OF A SIGNIFICANT AMOUNT OF OUR REVENUES, WHICH WOULD ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

A significant portion of our revenues is derived from a small number of customers. Our major customers during the three years ended December 31, 2007 were as follows:

| PERCENTAGE OF REVENUES |      |      |
|------------------------|------|------|
| -----                  |      |      |
| 2005                   | 2006 | 2007 |

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|                                 | ----- | ----- | ----- |
|---------------------------------|-------|-------|-------|
| GE Aviation                     | 21%   | 38%   | 17%   |
| Israeli Ministry of Defense     | 12%   | 5%    | 5%    |
| Israel Aviation Industries      | 14%   | 20%   | 17%   |
| RAFAEL Advanced Defense Systems | -     | 2%    | 10%   |
| Lockheed Martin                 | 12%   | 9%    | 4%    |
| Hindustan Aeronautics           | 5%    | 3%    | 14%   |

We anticipate that a significant portion of our future revenues will continue to be derived from sales to a small number of customers. If our principal customers do not continue to purchase products from us at current levels or if such customers are not retained and we are not able to derive sufficient revenues from sales to new customers to compensate for their loss, our revenues would be reduced and adversely affect our business, financial condition and results of operations.

WE DEPEND ON A LIMITED NUMBER OF SUPPLIERS OF COMPONENTS FOR OUR PRODUCTS AND IF WE ARE UNABLE TO OBTAIN THESE COMPONENTS WHEN NEEDED, WE WOULD EXPERIENCE DELAYS IN MANUFACTURING OUR PRODUCTS AND OUR FINANCIAL RESULTS COULD BE ADVERSELY AFFECTED.

We acquire most of the components for the manufacturing of our products from a limited number of suppliers and subcontractors, most of whom are located in Israel and the United States. Certain of these suppliers are currently the sole source of one or more components upon which we are dependent. Suppliers of some of the components for manufacturing require us to place orders with significant lead-time to assure supply in accordance with our manufacturing requirements. Inadequacy of operating funds may cause us to delay placement of such orders and may result in delays in supply. Delays in supply may significantly hurt our ability to fulfill our contractual obligations and may significantly hurt our business and result of operations. We may not be able to continue to obtain such components from these suppliers on satisfactory commercial terms. Temporary disruptions of our manufacturing operations would ensue if we were required to obtain components from alternative sources, which may have an adverse effect on our financial results.

RAPID TECHNOLOGICAL CHANGES MAY ADVERSELY AFFECT THE MARKET ACCEPTANCE OF OUR PRODUCTS AND COULD ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The avionics market in which we compete is subject to technological changes, introduction of new products, change in customer demands and evolving industry standards. Our future success will depend upon our ability to keep pace with technological developments and to timely address the increasingly sophisticated needs of our customers by supporting existing and new technologies and by developing and introducing enhancements to our current products and new products. We may not be successful in developing and marketing enhancements to our products that will respond to technological change, evolving industry standards or customer requirements. In addition, we may experience difficulties that could delay or prevent the successful development, introduction and sale of such enhancements and such enhancements may not adequately meet the requirements of the market and may not achieve any significant degrees of market acceptance. If release dates of our new products or enhancements are delayed or, if when released, they fail to achieve market acceptance, our business, operating results and financial condition would be materially adversely affected.

WE MAY ENCOUNTER DIFFICULTIES WITH OUR INTERNATIONAL OPERATIONS AND SALES.

Exports accounted for 62% of our sales in 2007, 67% of our sales in 2006 and 59% of our sales in 2005. This subjects us to many risks inherent in engaging in export international business, including:

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- o Limitations and disruptions resulting from the imposition of government controls;
- o Changes in regulatory requirements;
- o Export license requirements;

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- o Economic or political instability;
- o Trade restrictions;
- o Changes in tariffs;
- o Currency fluctuations;
- o Longer receivable collection periods and greater difficulty in accounts receivable collection;
- o Greater difficulty in safeguarding intellectual property;
- o Difficulties in managing overseas subsidiaries and international operations; and
- o Potential adverse tax consequences.

We may not be able to sustain or increase revenues from international operations and may encounter significant difficulties in connection with the sale of our products in international markets. Any of these events will have a material adverse affect on our business, operating results and financial condition.

CURRENCY EXCHANGE RATE FLUCTUATIONS IN THE WORLD MARKETS IN WHICH WE CONDUCT BUSINESS COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS, RESULTS OF OPERATIONS AND FINANCIAL CONDITION.

We may be adversely affected by fluctuations in currency exchange rates. While our revenues are generally denominated in U.S. dollars, a significant portion of our expenses is incurred in NIS. As of December 31, 2007 our losses due to the decrease of the U.S dollars were approximately \$200,000. We do not currently engage in any currency hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. If we were to determine that it was in our best interests to enter into any hedging transactions in the future, we may not be able to do so. Furthermore, such transactions, if entered into, may not 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. In the future, such fluctuations may have a material adverse effect on revenues from international sales, operating expenses and consequently, on our business, operating results and financial condition.

WE ARE DEPENDENT ON OUR SENIOR MANAGEMENT AND KEY PERSONNEL, IN PARTICULAR HERZLE BODINGER, THE CHAIRMAN OF OUR BOARD OF DIRECTORS, AND OUR PRESIDENT, AND MR. ZVI ALON, OUR CHIEF EXECUTIVE OFFICER, WHOSE LOSS COULD ADVERSELY AFFECT OUR BUSINESS.

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Our future success depends in large part on the continued services of our senior management and key personnel. In particular, we are dependent on the services of Herzle Bodinger, the chairman of our Board of Directors and our president, and Mr. Zvi Alon, our chief executive officer. Any loss of the services of Herzle Bodinger, other members of senior management or other key personnel could negatively and materially affect our business.

OUR PROPRIETARY TECHNOLOGY IS DIFFICULT TO PROTECT AND UNAUTHORIZED USE OF OUR PROPRIETARY TECHNOLOGY BY THIRD PARTIES MAY IMPAIR OUR ABILITY TO COMPETE EFFECTIVELY, WHICH COULD ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Our success and ability to compete largely depends upon protecting our proprietary technology. We rely on a combination of trade secrets, copyright law and confidentiality, non-disclosure and assignment-of-inventions agreements to protect our proprietary technology. Except for a patent that relates to our ACE(TM) system, we do not have any patents.

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OUR PRODUCTS MAY INFRINGE ON THE INTELLECTUAL PROPERTY RIGHTS OF OTHERS.

Third parties may assert infringement claims against us or claims that we have violated a patent or infringed on a copyright, trademark or other proprietary right belonging to them. In addition, any infringement claim, even one without merit, could result in the expenditure of significant financial and managerial resources to defend.

THE STATUS OF OUR CHINESE SUBSIDIARY AND ITS JOINT VENTURE WITH BEIJING TIANZU FORESTRY COMPANY IS UNCERTAIN AND WE MAY BE REQUIRED TO INITIATE LITIGATION IN ORDER TO ENFORCE OUR RIGHTS.

Beijing Huarui Aircraft Components Maintenance and Services Co., Ltd. or CACS, our Chinese subsidiary, conducts its business in an approximately 16,000 square foot facility in Beijing that includes offices and test and repair facilities. The land for this facility was leased by Beijing Tianzu Forestry Company or Tianzu, the minority shareholder in CACS, from the Chinese government for 30 years. Under a joint venture agreement, and in consideration for its equity investment in CACS, Tianzu granted CACS usage rights in the land, constructed the buildings and granted CACS the ownership of these buildings. However, the transfer of the title to the land and the buildings has not been completed. Although Tianzu is legally obligated to complete such transfer of title to the land and the buildings, such transfer may not be completed and we may be required to initiate litigation in order to enforce our rights to receive title to the land and buildings.

WE MAY FAIL TO MAINTAIN EFFECTIVE INTERNAL CONTROLS IN ACCORDANCE WITH SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002, WHICH COULD HAVE AN ADVERSE EFFECT ON OUR FINANCIAL RESULTS AND THE MARKET PRICE OF OUR ORDINARY SHARES.

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 governing internal controls and procedures for financial reporting, which started in connection with this Annual Report on Form 20-F, have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to require the continued commitment of significant resources. We may identify

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material weaknesses or significant deficiencies in our assessments of our internal controls over financial reporting. Failure to maintain effective internal controls over financial reporting could result in investigation or sanctions by regulatory authorities and could have a material adverse effect on our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

### RISK FACTORS RELATED TO OUR ORDINARY SHARES

OUR SHARE PRICE HAS BEEN VOLATILE IN THE PAST AND MAY DECLINE 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;
- o Delisting of our shares from the NASDAQ Capital Market; and
- o Stock market price and volume fluctuations.

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.

In the past, securities class action litigation has often been brought against companies following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources both of which could have a material adverse effect on our business and results of operations.

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SUBSTANTIAL FUTURE SALES OF OUR ORDINARY SHARES MAY DEPRESS OUR SHARE PRICE.

If our principal shareholders sell substantial amounts of their ordinary shares, including shares registered under effective registration statements and shares issuable upon the exercise of outstanding warrants, or convertible notes, or if the perception exists that our principal shareholders may sell a substantial number of our ordinary shares, the market price of our ordinary shares may fall. Any substantial sales of our shares in the public market also might make it more difficult for us to sell equity or equity-related securities in the future at a time, in a place and on terms we deem appropriate.

WE DO NOT INTEND TO PAY DIVIDENDS.

We have never declared or paid cash dividends on our ordinary shares and do not expect to do so in the foreseeable future. The declaration of dividends is subject to the discretion of our board of directors and will depend on various factors, including our operating results, financial condition, future prospects and any other factors deemed relevant by our board of directors. You should not rely on an investment in our company if you require dividend income from your investment in our company. The success of your investment will likely depend entirely upon any future appreciation of the market price of our ordinary shares, which is uncertain and unpredictable. There is no guarantee that our ordinary shares will appreciate in value or even maintain the price at which you purchased your ordinary shares.

RISKS RELATING TO OUR LOCATION IN ISRAEL

POLITICAL, ECONOMIC AND MILITARY INSTABILITY IN ISRAEL MAY DISRUPT OUR OPERATIONS AND NEGATIVELY AFFECT OUR BUSINESS CONDITION, HARM OUR RESULTS OF OPERATIONS AND ADVERSELY AFFECT OUR SHARE PRICE.

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. As a result, political, economic and military conditions affecting Israel directly influence us. 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 could have a material adverse effect on our business, financial condition and results of operations.

Since the establishment of the State of Israel in 1948, Israel and its Arab neighbors have engaged in a number of armed conflicts. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Major hostilities between Israel and its neighbors may hinder Israel's international trade and lead to economic downturn. This, in turn, could have a material adverse effect on our operations and business. There has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2007. The future effect of this deterioration and violence on the Israeli economy and our operations is unclear. Recently, there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel's northern border with Lebanon in the summer of 2006, and extensive hostilities along Israel's border with the Gaza Strip since June 2007 when the Hamas effectively took control of the Gaza Strip, which have intensified since February 2008. Ongoing violence between Israel and the Palestinians as well as tension between Israel and the neighboring Syria and Lebanon may have a material adverse effect on our business, financial conditions and results of operations.

Many of our executive officers and employees in Israel are obligated to perform annual military reserve duty and are subject to being called for active

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duty under emergency circumstances. 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.

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FLUCTUATIONS IN THE EXCHANGE RATE BETWEEN THE U.S. DOLLAR AND FOREIGN CURRENCIES MAY AFFECT OUR OPERATING RESULTS.

A significant portion of the cost of our operations, mainly personnel and facility-related, is incurred in NIS. Therefore, our NIS related costs, as expressed in U.S. dollars, are influenced by the exchange rate between the U.S. dollar and the NIS. In addition, if the rate of inflation in Israel exceeds the rate of devaluation of the NIS in relation to the U.S. dollar, or if the timing of such devaluations were to lag considerably behind inflation, our cost as expressed in U.S. dollars may increase. NIS linked balance sheet items may create foreign exchange gains or losses, depending upon the relative dollar values of the NIS at the beginning and end of the reporting period, affecting our net income and earnings per share. Although we may use hedging techniques, we may not be able to eliminate the effects of currency fluctuations. Thus, exchange rate fluctuations could have a material adverse impact on our operating results and share price.

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, most of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, most of our directors and officers and the Israeli experts named in this annual report are located outside the U.S., 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.

YOUR RIGHTS AND RESPONSIBILITIES AS A SHAREHOLDER WILL BE GOVERNED BY ISRAELI LAW AND DIFFER IN SOME RESPECTS FROM THOSE OF A TYPICAL U.S. CORPORATION.

Because we are an Israeli company, the rights and responsibilities of our shareholders are governed by our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in a typical U.S. corporation. In particular, a shareholder of an Israeli company has a duty to act in good faith towards the company and other shareholders and to refrain from abusing his, her or its 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 to 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 shareholder who knows that it possesses the power to

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determine the outcome of a shareholders' vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness towards the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revisions in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

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

As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules. A foreign private issuer that elects to follow a home country practice instead of such requirements, must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. As a foreign private issuer listed on the NASDAQ Capital Market, we may follow home country practice with regard to, among other things, composition of the board of directors, director nomination procedure, compensation of officers, and quorum at shareholders' meetings. In addition, we may follow our home country law, instead of the NASDAQ Marketplace Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company.

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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 December 8, 1970. We are a public limited liability company under the Israeli Companies Law 1999-5759, or the Israeli Companies Law, and operate under this law and associated legislation. Our registered offices and principal place of business are located at 7 Giborei Israel Street, Netanya 42504, Israel, and our telephone number is 972-9-892-1111. Our address on the internet is [www.rada.com](http://www.rada.com). The information on our website is not incorporated by reference into this annual report.

We develop, manufacture and sell automated test equipment, avionics products and ground debriefing systems and provide manufacturing services for military and commercial use, mainly in Israel, the U.S. and Europe. We also provide test and repair services using our CATS(TM) testers and test program sets through our Chinese subsidiary. Our U.S.-based subsidiaries have been inactive since January 1, 2002.

In April 1985, we completed an initial public offering. Our ordinary shares were traded on the NASDAQ National Market from our initial public offering in 1985 until June 10, 2002 when the listing of our ordinary shares was transferred



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to the NASDAQ Capital Market. We are listed under the symbol "RADA."

In February 2005, we purchased certain assets and assumed certain liabilities related to the operations of Vectop, an Israeli company specializing in the design, development, marketing and sale of electro-optic equipment and debriefing systems. Such assets included the know-how, intellectual property and patents that were used by, or connected to Vectop's business, as well as full access to customer lists related to the products acquired.

Our capital expenditures for the years ended December 31, 2005, 2006 and 2007 were approximately \$411,000, \$236,000 and \$353,000, respectively. These expenditures were principally for machinery equipment and office furniture and equipment.

### B. BUSINESS OVERVIEW

#### INDUSTRY OVERVIEW

Our activity is focused on the defense electronics market. This market has been growing in recent years and is currently a large part of the defense business. Two contradictory forces control the defense electronics market: on the one hand, new military vehicles of all kinds are equipped with significantly more electronic systems than they used to carry a decade ago; in addition, the increasing usage of advanced electronics in modern vehicles, including upgrades of existing technology and growing number of unmanned vehicles of all kinds, has provided significant growth to the market. On the other hand, the significant reduction in the price of electronic systems is reducing the dollar value of the market.

Advanced defense electronics systems are, typically, derivatives or enhancements of industrial and consumer electronic systems. Most of the defense electronics systems are built of commercial components and even sub-systems, a fact that reduces the overall price and, at the same time, generates complex obsolescence issues.

Customers for defense electronics products are either governments or major integrators. Engaging in business relationships with these customers is complex, has a long sales cycle and requires long term commitments for future support of delivered hardware. Production batches of these products are usually small, especially in the retrofit market.

Suppliers of defense electronic systems are either providers of sub-systems to major integrators or providers of integrated systems to the industry or to the forces. These companies are typically very large and have diversified product offerings.

New products in the defense electronic market are usually developed utilizing internal and customers' research and development funds, and are tailored to specific customers' needs. In many cases, the customer who pays for the design and adaptation limits the use of intellectual property that was funded by it for other applications, due to either financial or security reasons.

#### PRODUCTS AND SERVICES

We primarily provide integrated avionic solutions. Our aim is to provide not only state of the art products but also comprehensive end-to-end solutions

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for one or more avionic systems.

Our current product lines are:

- o Trainer aircraft upgrades;
- o Data & video recording and management;
- o Avionics for unmanned aerial vehicles, or UAVs;
- o Inertial navigation products (based on ring laser gyros, or RLG, fiber optic gyros, or FOG, and micro-electro mechanical sensors, or MEMS); and
- o Optronic products (head-up displays, or HUD, cameras and rear-view cameras for tanks).

In addition, we continue to sell and support our traditional products and services, as follows:

- o Commercial aviation test stations - CATS(TM);
- o Manufacturing services to original equipment manufactures, or OEMs in Israel and in the United States, using the manufacturing capabilities of our Beit She'an plant; and
- o Test and repair services through our China based subsidiary using our CATS(TM) testers and test programs.

### TRAINER AIRCRAFT UPGRADES

We conducted an avionics upgrade program of all of the avionics systems of the A-4 "Skyhawk" fleet of the Israeli Airforce, or IAF, advanced trainer fleet. The aging avionics of the A-4 aircraft were completely replaced by a new, upgraded avionics package designed by us. Our new avionics package replaced the legacy weapon delivery and navigation system of the aircraft with a new state-of-the-art system that significantly improved the capabilities of the A-4, increased its reliability and provided advanced training capabilities. The upgrade package includes an inertial navigation system, or INS, global positioning system, or GPS, HUD, HUD Camera, central weapon delivery and navigation processor, and a control and display unit. The A-4 upgrade program was completed in 2005.

We believe that this program places RADA among the few companies worldwide that have performed a complete aircraft avionics system upgrade. The A-4 avionics package provides, at a very affordable price, a complete and modern avionics package tailored for trainer aircraft. We have launched marketing efforts to promote this package to several customers.

### DATA & VIDEO RECORDING AND MANAGEMENT

Our data & video recording and management solutions are a continuously expanding family of solutions that combine airborne data collection and recording systems with ground debriefing stations that together provide data/video/audio recording, retrieval, analysis and storage. This family of solutions includes, among others, our Fatigue Analysis And Autonomous Air Combat Evaluation System, or FACE(TM) and our Data Acquisition System, or DAS, flight data recorders, the Network-Centric Digital Recorder, or NCDR, and their supporting ground systems. The NCDR is our current best-selling product and is sold to customers worldwide.

### FATIGUE ANALYSIS AND AUTONOMOUS AIR COMBAT EVALUATION SYSTEM - FACE(TM)

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The FACE(TM) system is an avionics system designed to acquire, process and record data from various aircraft systems as well as from strain gauges (sensors) affixed to an aircraft structure. This data is used to streamline and manage the ongoing monitoring and maintenance of an aircraft and its systems. The FACE(TM) system communicates with a squadron's ground support logistic station, enabling downloading of data from an aircraft, analyzing the data, managing ongoing maintenance, creating and modifying the set-up configuration files and determining data for recording, as well as providing an interface to other applications.

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The FACE(TM) system is capable of communicating in real time with a voice and data recorder, which is a crash survival unit known as a "black box" manufactured by GE Aviation, for the purpose of recording flight safety related data. We are currently upgrading the FACE(TM) systems we supplied to the Royal Netherlands Air Force for its F-16 aircraft between the years 1996 and 1999. During 2004 we supplied FACE(TM) systems for the F-16 fleet of the Portuguese Air Force and for U.S. Navy aircraft, and during 2006 we supplied FACE(TM) systems to the United States Air Force, or USAF, as part of an FMS upgrade for F-16 aircraft of the Jordanian Air Force. The FACE(TM) is currently the only proven solution of its kind for F-16A/B aircraft. We believe that we will be able to continue to secure additional FACE(TM) contracts in the near future for F-16A/B users worldwide.

### DATA ACQUISITION SYSTEM - DAS

The DAS is an advanced avionics data acquisition system designed to acquire, process and record data from various aircraft systems. DAS consists of two sub-systems, a data acquisition unit, or DAU, and an enhanced crash survival memory unit, or ECSMU. The DAU interfaces with numerous data systems and data channels in the aircraft and acquires, processes and records data, mostly for maintenance purposes. The ECSMU is a "black box" capable of recording digital data and digitized audio transferred through the DAU. The DAS is a form fit replacement to the Crash-Survivable Flight Data Recording or CSFDR system, which is currently installed on most of the F-16 aircraft worldwide.

We have jointly developed the DAU with GE Aviation and together, we have successfully sold the DAS system to the IAF for its F-16I aircraft. The majority of the DAU units are produced by us.

The DAS is designed to meet all commercial aviation requirements for "black box" recorders, thus expanding its market potential beyond the defense electronics market. DAS is being offered as a substitute in various projects that require a flight data recorder with advanced capabilities and growth potential.

During 2004, we started supplying production DAS units for the IAF and entered into contracts to supply DAS units for the Polish Air Force and the Korean Air Force. The production for these programs is still ongoing. Additional DAS contracts with the USAF and other air forces are expected during 2008.

### NET CENTRIC DIGITAL RECORDER - NCDR

Recent developments in digital video recording systems and the significant reduction in size and cost of solid state memories have turned solid state digital video recording systems into the de-facto standard solution for airborne applications. These systems have begun penetrating the aviation industry in new

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aircraft such as the F-16I, as well as in the retrofit market. Identifying this trend, we developed the NCDR in 2005 with the view of capturing sales from: (i) new aircraft that will be delivered with digital recorders; (ii) the retrofit market for airborne video tape recorders; and (iii) the integration of various additional applications into the NCDR, making it an airborne server.

The NCDR, together with our ground debriefing system, provides advanced debriefing at an affordable price. We have identified a growing need for digital video replacement of aging analog airborne video tape recorders, or VTR. Over 10,000 VTRs are installed on board fighter aircraft today, and we have initiated a worldwide marketing effort to promote the replacement of these aging VTRs with our new NCDR. This marketing activity has been successful in several programs around the world, especially in our strategic markets (Israel, U.S. and India). We were awarded the U.S. Navy T-45 advanced trainer digital recorder and processor program at the end of 2005 and the program is still ongoing. We have completed the deliveries of NCDRs to the Chilean Air Force for its F-16 fleet. In 2006, we were chosen by Lockheed Martin to provide the NCDR for all Lockheed Martin F-16 aircraft, and started serial deliveries in 2007. We won a similar NCDR program for an Indian Navy aircraft.

The NCDR is fully qualified and is continuously being demonstrated to various potential customers. We currently market the NCDR jointly with GE Aviation utilizing GE Aviation's broad access to the world market, especially in the U.S. in 2007 we were awarded by the IAF a multi-year program to develop the next generation of the NCDR and equip all the IAF fighters aircraft with our advanced solution. We expect to complete the development by the second half of 2009 and to complete the equipment of all the IAF fighters aircraft by the end of 2010.

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Currently, additional applications are being developed and integrated into the NCDR in order to provide an integrated airborne data server. These applications include embedding data transfer capability to the system, enabling the NCDR not only to record during flight but also to provide data to the aircraft before flight, and the integration of ground collision warning based on digital terrain data stored in the NCDR memory.

### GROUND DEBRIEFING STATIONS

Since 1999, we have offered operational ground debriefing stations, or GDS, complementing our airborne systems. The operational ground debriefing station is a PC-based application operating in a Windows NT/2000/XP(R) environment. The solution provides a state-of-the-art debriefing environment, fully capitalizing on all available digital and video information in a completely synchronized presentation. Further capitalizing on current technologies, individual stations have a networking capability, providing data sharing, as well as cross-unit and inter-air force debriefing.

As part of Lockheed Martin Aerospace Peace Marble V (PM-V) Program, we developed the next generation of our ground debriefing solutions by advancing it to the digital video era. This modification has resulted in significant growth in the system's capability as well as establishing our system as a major and central device in the day-to-day operation of air force squadrons. We have delivered 22 stations to the PM-V Program as well as two additional debriefing systems to Lockheed Martin Aerospace for use in integration and flight-testing.

Currently, all of our NCDR programs incorporate similar ground debriefing solutions.

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### UNMANNED AERIAL VEHICLES AVIONICS

We identified the UAV avionics market as a fast growing market that will gradually replace the manned military airborne avionics. This market has many common aspects with manned avionics products; however, it requires slightly different technology and understanding of its specific requirements.

Typically, a UAV avionics package needs to be smaller, lighter, highly reliable and inexpensive when compared to a manned aircraft suite. The major attraction of the UAV avionics market is the large number of UAVs that are expected to be required in the future.

We initiated efforts to penetrate this market during 2001. Since then we have entered into a contract with IAI to develop and provide an input output controller, or IOC, a unit that is part of our data acquisition systems product line, for IAI's next generation UAV. We are continuing our efforts to widen our participation in this important program as well as in other programs. The development of this product was completed, and it is currently in production, including various derivatives that were added to a complete package that incorporates 10 units per aircraft. In addition, we have won and are delivering other types of units for the same UAV model which includes up to 23 units per aircraft. These numbers will provide us with significant sales volumes when the UAV program serial production picks up.

During 2004, we developed and delivered a miniature avionics module, or MAM, to IAI. This unit is aimed at the small-scale and medium-scale UAV markets, and provides complete avionics capabilities in a single miniaturized unit. This unit was recently selected to be used in the miniature UAV to be sold by IAI to a foreign customer. The contract was signed in 2007 and deliveries will be made throughout 2008.

### INERTIAL AND GPS-BASED NAVIGATION SOLUTIONS

During 2003, we developed an affordable navigation system based on the integration of a RLG with GPS. Our RLG based system is now qualified and operational as part of the IAF A-4 upgrade program. This development established our first product of INS solutions.

During 2005, we initiated a research and development program to integrate FOG and MEMS sensors into our navigation systems. Navigation systems based on these sensors are significantly more cost effective. We believe that the market for low cost navigation systems has significantly greater potential for installations of ground based and marine based systems.

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In 2007 we received an order from RAFAEL Advanced Defense Systems, or RAFAEL, to develop and produce a FOG-based new generation of inertial measurement units, or IMUs, for the Litening targeting pod. We expect to complete the development of this product in 2008 and start deliveries in 2009.

In 2007 we received our first order for MEMS-based INS for an Asian customer and signed an agreement with IAI for optional orders of this product during 2008.

We are continuing our research and development efforts with respect to the MEMS technology and intend to design a complete family of applications that will provide solutions for various UAV manufacturers. At the same time, we are

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marketing this product to our strategic customers and together with them are working to define the next versions of this family of products.

### OPTRONIC PRODUCTS FOR AIRBORNE AND GROUND VEHICLES

The acquisition of Vectop's assets in February 2005 provided us with a new product line. Airborne cameras are an integral part of any training and airborne debriefing system on board military platforms. Our customers include major Israeli integrators (such as IAF, IAI and Elbit), as well as foreign customers.

This product line includes:

- o EYE WITNESS - An airborne HUD camera, which is sold to customers in different configurations. We have over fifteen customers worldwide for this product, and revenues from this product are expected to continue in the next three years.
- o ARMOR SENTRY - A video camera developed for armored vehicles and tanks. This system is being delivered to the Israeli Defense Force, or IDF, ground forces for installation in the IDF "Merkava" main battle tank. We expect to receive additional orders of this product from the IDF in 2008.

### COMMERCIAL AVIATION TEST STATIONS - CATS(TM)

CATS(TM) is a family of multi-purpose, computerized automatic test equipment that meets the specific needs of airlines and third party maintenance companies. The CATS(TM) stations test a variety of electronic units in existing commercial aircraft, incorporating tools for testing, troubleshooting, and performing diagnostic procedures. CATS(TM) stations replace or augment test stations from aircraft manufacturers or avionics OEM suppliers, while automating multiple manual test procedures. Recently we are seeing renewed interest in this product, especially in the U.S. from smaller maintenance companies rather than from airlines. In addition, we are continuing to support our customers by providing maintenance and repair services through product support agreements.

### MANUFACTURING SERVICES

In 2000, we began providing manufacturing services to OEMs located in Israel and the U.S, using the excess manufacturing capacity of our Beit She'an plant. We offer manufacturing "built-to-print" turnkey solutions. To-date, we have provided manufacturing services to GE Aviation, IAI, and RAFAEL among others.

### TEST AND REPAIR SERVICES

We operate a test and repair shop based on the use of our CATS(TM) tester in Beijing, China through CACS, our 80% owned Chinese subsidiary. CACS was established as a joint venture company with Tianzu Forest Development Company, which owns the remaining 20% equity interest. Pursuant to the joint venture agreement, Tianzu Forest Development provided the facilities for CACS' operations while we provided CATS(TM) testers and test program set services.

### SALES AND MARKETING

#### STRATEGY

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Our sales and marketing strategy is based on the following principles:

- o Maintaining our business focus on electronics for the military market;
- o Expanding our product offerings by adding new applications to our existing product lines and by adapting our products to land systems;
- o Expanding our customer base by including our products in solutions and integrated systems for airborne and land vehicles;
- o Establishing marketing channels with system integrators and major manufacturers such as The Boeing Company, Lockheed Martin Aerospace, GE Aviation, IAI, RAFAEL, HAL and others; and
- o Expanding our activities to large potential markets, especially in the military and the unmanned combat air vehicle areas, and developing new marketing channels aimed directly at these customers.

### STRATEGIC RELATIONSHIPS

As part of our strategy, we have entered into a number of strategic relationships with Lockheed Martin Aerospace, GE Aviation, Israel Aerospace Industries, Hindustan Aeronautics Ltd. and Rafael Advanced Defense Systems Ltd. and have focused our marketing and sales efforts to support these relationships. In particular, we have identified the Israeli government-owned defense industries as potential customers and entities to cooperate with.

LOCKHEED MARTIN AEROSPACE. Our sales of avionics products focus mainly on the F-16 aircraft manufactured by Lockheed Martin Aerospace, the most popular fighter aircraft in the western world today. In cooperation with GE Aviation, we are supplying the data acquisition system that includes the advanced data acquisition unit which is manufactured in our Beit She'an production facility. In 2006 Lockheed Martin chose the GE Aviation - RADA team to supply our baseline NCDR and, or GDS, for all of its U.S. Sponsored F-16 Foreign Military Sales, or FMS, and upgrades.

GE Aviation. GE Aviation, (formerly Smiths Aerospace Electronic Systems, or Smiths) is a worldwide leader in avionics systems for fighter and commercial aircraft. In October 2003, we signed a teaming agreement with Smiths. The teaming agreement establishes cooperation in connection with the products for the PM-V Program and its derivatives. In addition, the agreement details commitments made by Smiths to purchase production services from us in the future. During 2004, we expanded our cooperation with Smith to include our newly developed NCDR and have jointly offered this advanced product to potential customers. In late 2006, we entered into a contract with Smiths, for the adaptation and production of the NCDR in the U.S., for various platforms, including the U.S. NAVY T-45 and for foreign military sales of F-16. In January 2007, General Electronic Co. purchased Smiths and our agreements were assigned to GE Aviation. Together with GE Aviation, we are currently exploring several additional opportunities in the U.S. for this product. In 2007, and after fruitful and successful cooperation in recent years, the teaming agreement was extended by three more years.

ISRAEL AEROSPACE INDUSTRIES (IAI). We are actively supplying avionics and test equipment to four different divisions of IAI. In particular the Lahav and Malat divisions of IAI, major aircraft integrators, require our services as an avionics and test equipment provider.

HINDUSTAN AERONAUTICS LTD. (HAL). HAL is the major aerospace integrator in India. We are cooperating with four divisions of HAL, and are supplying NCDRs, HUD Cameras, debriefing stations, support equipment, and other services to HAL in increasing numbers.

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RAFAEL ADVANCED DEFENSE SYSTEMS LTD. (RAFAEL). RAFAEL is a world leader in the development and supply of missiles, smart weapons and pods of various types. RAFAEL has gradually become a strategic customer for us as a result of our development and production of a few advanced built-to-spec products in recent years to both divisions of RAFAEL.

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### MARKETING

Our chairman, Herzle Bodinger, our chief executive officer, Zvi Alon and our vice president of business development, Dov Sella, lead our marketing efforts. We currently employ four additional persons in marketing our core business products. Our chief technology officer and our engineering department support our marketing efforts with respect to product pricing, technical and management proposals preparations, and technical demonstrations. In addition, we have sales consultants, agents and representatives in Europe, South America, and India who receive commissions for sales effected through them.

The Israeli Ministry of Defense has historically supported and continues to support our marketing efforts through its Export and Defense Assistance division, and various projects for the Israeli Defense Forces and its related divisions. The Israeli Ministry of Industry and Commerce supports our marketing efforts via its Industrial Cooperation Authority through the exploitation of "offset commitments" by Lockheed Martin Aerospace and the Boeing Company to the State of Israel. There is no guarantee that this kind of assistance will be available to us in the future.

### FIXED-PRICE CONTRACTS

The vast majority of our contracts are fixed-price contracts. Under fixed-price contracts, the price is not subject to adjustment by reason of the costs incurred in the performance of the contracts, as long as the costs incurred and work performed fall within governmental guidelines. Under our fixed-price contracts, we assume the risk that increased or unexpected costs may reduce our profits or generate a loss. This risk can be particularly significant under a fixed-price contract for research and development involving new technologies.

Our books and records may be subject to audits by the Israeli Ministry of Defense and other governmental agencies including the U.S. Department of Defense. These audits may result in adjustments to contract costs and profits. To date, we have not incurred any liability as a result of such audits.

### PRINCIPAL CUSTOMERS

Generally, we complete a few major transactions each year, each in an amount comprising approximately 10% of our revenues for such year. As a result, each year a significant portion of our revenues is derived from a small number of customers. The following table sets forth our principal customers in 2006 and 2007:

|                             | 2006 | 2007 |
|-----------------------------|------|------|
|                             | ---- | ---- |
| GE Aviation                 | 38%  | 17%  |
| Israeli Ministry of Defense | 5%   | 5%   |
| Israel Aviation Industries  | 20%  | 17%  |



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|                                 |    |     |
|---------------------------------|----|-----|
| Lockheed Martin                 | 9% | 4%  |
| Hindustan Aeronautics           | 3% | 14% |
| RAFAEL Advanced Defense Systems | 2% | 10% |

Although we are striving to increase the number of our customers, we anticipate that a significant portion of our future revenues will continue to be derived from sales to a small number of customers.

Like many companies deriving a substantial portion of their revenues from government contracts, we are subject to business risks, including changes in governmental appropriations and changes in national defense policies and priorities. Although many of the programs in which we participate as a contractor or subcontractor may extend for several years, our business is dependent upon annual appropriations and funding of new and existing contracts. Most of the contracts are subject to termination for the convenience of the customer, pursuant to which the customer pays only for reimbursement of costs incurred and the applicable profit on work performed. The Israeli Government or any other government may discontinue funding the purchase of our products over the long term.

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### MARKETS

We sell our products to various air forces and companies worldwide. The following table presents our revenues by geographical market for the periods indicated:

|                                | 2005 | 2006 | 2007 |
|--------------------------------|------|------|------|
|                                | ---- | ---- | ---- |
| Israel                         | 41%  | 33%  | 39%  |
| North America                  | 38%  | 36%  | 24%  |
| Europe                         | 5%   | 6%   | 13%  |
| India                          | 5%   | 5%   | 14%  |
| Other (mainly Central America) | 11%  | 20%  | 10%  |

### COMPETITION

The markets for our products are highly competitive. Our principal competitors in the avionics and military electronics market are Harris, Rockwell Collins, Honeywell, Elbit Systems Ltd., IAI, TEAC, Enertec, Calculex, and others. We expect to continue to face competition from these and other competitors. Most of our competitors are larger, have greater resources including financial, technological, marketing and distribution capabilities, and enjoy greater market recognition than we do. These competitors may be able to achieve greater economies of scale and may be less vulnerable to price competition than us. We may not be able to offer our products as part of integrated systems to the same extent as our competitors or successfully develop or introduce new products that are more cost effective or offer better performance than those of our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

### EXPORT POLICY

Exports of military related products are subject to the military export policy of the State of Israel. Current Israeli Government policy encourages export to approved customers of military products similar to those manufactured by us, provided that such export does not run counter to Israeli policy or

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national security considerations. We must obtain a permit to initiate a sales proposal and ultimately an export license for the transaction is required. We may not obtain export permits or licenses in the future and the Israeli governmental policy with respect to military exports may be altered. However, to date we have not encountered any significant difficulties in obtaining necessary permits or licenses for sale of our products.

### PROPRIETARY INFORMATION

We hold a patent for our ACE(TM) system in Israel and the U.S., U.S. Patent No. 5467274. In addition, in connection with the assets we acquired from Vectop Ltd. in February 2005, we acquired the rights to the following patents and patent applications: Israeli patents No. 121042, No. 116131, No. 124816 and No. 1088253, U.S. patents No. 6,061,182, No. 5,742,434, No. 6,301,052 and No. 5,699,440, European patents (France England and Italy) No. 0777142 and No. 1088253, Indian patent application No. IN/PCT/200/00611 and Japanese patent application No. 329384/94. Nevertheless, we generally do not consider patent protection significant to our current operations and rely upon a combination of security devices, copyrights, trademarks, trade secret laws and contractual restrictions to protect our rights in our products. Our policy is to require employees and consultants to execute confidentiality agreements upon the commencement of their relationships with us. These measures may not be adequate to protect our technology from third-party infringement, and our competitors might independently develop technologies that are substantially equivalent or superior to ours. Additionally, our products may be sold in foreign countries that provide less protection for intellectual property rights than that provided under U.S. or Israeli laws.

The Israeli Government usually retains certain rights in technologies and inventions resulting from our performance as a prime contractor or subcontractor under Israeli Government contracts and may generally disclose such information to third parties, including other defense contractors. When the Israeli Government funds research and development, it may acquire rights to proprietary data and title to inventions; we may retain a non-exclusive, royalty-free license for such inventions. However, if the Israeli Government purchases only the end product, we may retain the principal rights and the Government may use the data and take an irrevocable, non-exclusive, royalty-free license.

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### MANUFACTURING AND SUPPLY

Our main production facilities are located in Beit She'an, Israel. The plant is equipped to handle most of our manufacturing processes and testing requirements. For several specific processes we utilize subcontractors. This structure allow us flexibility and versatility.

We place great emphasis on quality control in our product realization process. Commencing with customer requirements and expectations via raw material inspection through completion, specifications are repeatedly checked. We maintain a quality assurance team that participates in every stage of the design and manufacture of the products. Our quality management system is certified by the Standards Institute of Israel, or SII, pursuant to ISO 9001 for hardware design and production and ISO 9000.3 for software, both since 1995. SII performs quality system audits twice a year and various customers perform audits four to six times a year. In April 2001, SII certified our environmental management system pursuant to ISO 14001. Our quality management system was revised to comply with ISO 9001:2000 in June 2003. During 2005 we were certified according to AS-9100, a quality management system for aerospace requirements.

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According to the standard warranty incorporated in most of our sales contracts, we warrant that our products will be free from defects in design, materials or workmanship, and guarantee repair or replacement of defective parts for a typical period of two years following delivery of a product to the customer. We also provide maintenance services to customers who sign maintenance contracts.

### SOURCE AND AVAILABILITY OF RAW MATERIALS

We acquire most of the components for the manufacturing of our products from a limited number of suppliers and subcontractors, most of whom are located in Israel and the U.S. Some of these suppliers are currently the sole source of one or more components upon which we are dependent. Since many of our purchases require long lead-times, a delay in supply of an item can significantly delay the delivery of a product. To date, we have not experienced any particular difficulty in obtaining timely deliveries of necessary components. See Item 3D "Risk Factors." We depend on a limited number of suppliers of components for our products and if we are unable to obtain these components when needed, we would experience delays in manufacturing our products and our financial results could be adversely affected.

### C. ORGANIZATIONAL STRUCTURE

We had one active subsidiary in 2007, Beijing Huarui Aircraft Components Maintenance and Services Co., an 80% owned subsidiary based in China that is engaged in aircraft repair services.

### D. PROPERTY, PLANTS AND EQUIPMENT

We own a 30,000 square feet building in Beit She'an, Israel. The building, which includes manufacturing facilities, warehouse space and a portion of our development facilities, is situated on land leased from the Israel Land Authority for a period of 49 years until 2034. The plant has sufficient capacity to meet our current requirements. If volume was to increase significantly, we believe that we will be able to increase the number of workers or shifts at the plant, or use more subcontractors.

Our executive offices and research and development facilities are located in a 12,500 square foot office facility in Netanya, Israel. The lease for this facility expires in January 2010.

The aggregate annual rent for our offices in Israel was approximately \$189,000 in 2007.

Our Chinese subsidiary, CACS, conducts its business in an approximately 16,000 square foot facility in Beijing that includes offices and test and repair facilities. The land for this facility was leased by Beijing Tianzu Forestry Company, or Tianzu, the minority shareholder in CACS, from the Chinese government for 30 years. Under a joint venture agreement, and in consideration for its equity investment in CACS, Tianzu granted CACS usage rights in the land, constructed the buildings and granted CACS the ownership of these buildings. However, the transfer of the title to the land and the buildings has not been completed. Although Tianzu is legally obligated to complete such transfer of title to the land and the buildings, we can not guarantee that such transfer will be completed, or that we will not be required to initiate litigation in order to enforce our rights to receive title to the land and buildings.

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### ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

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

#### A. OPERATING RESULTS

THE FOLLOWING DISCUSSION OF OUR RESULTS OF OPERATIONS SHOULD BE READ TOGETHER WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND THE RELATED NOTES, WHICH APPEAR ELSEWHERE IN THIS ANNUAL REPORT. THE FOLLOWING DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS THAT REFLECT OUR CURRENT PLANS, ESTIMATES AND BELIEFS AND INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE DISCUSSED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE OR CONTRIBUTE TO SUCH DIFFERENCES INCLUDE THOSE DISCUSSED BELOW AND ELSEWHERE IN THIS ANNUAL REPORT.

#### OVERVIEW

We develop, manufacture and sell automated test equipment, avionics products and ground debriefing systems and provide manufacturing services for military and commercial use, mainly in Israel, the U.S., India and Europe. We also provide test and repair services using our CATS(TM) testers and test program sets through our Chinese subsidiary.

#### GENERAL

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to "dollars" or "\$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board Statement No. 52. The majority of our sales are made outside Israel and a substantial part of them are in dollars. In addition, a substantial portion of our costs are incurred in dollars. Since the dollar is the primary currency of the economic environment in which we operate, the dollar is our functional and reporting currency and, accordingly, monetary accounts maintained in currencies other than the dollar are remeasured using the foreign exchange rate at the balance sheet date. Operational accounts and non monetary balance sheet accounts are measured and recorded at the exchange rate in effect at the date of the transaction. All monetary balance sheet accounts have been remeasured using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been remeasured using the average exchange rate for the period.

On February 14, 2007, we effected a one share for three shares reverse stock split with respect to our ordinary shares. All share and per share amounts in this report have been restated for all prior periods to reflect the reverse stock split.

#### DISCUSSION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATIONS

Our critical accounting policies, including the assumptions and judgments underlying them, are disclosed in the notes to our consolidated financial statements. These policies have been consistently applied in all material respects. While the estimates and judgments associated with the application of these policies may be affected by different assumptions or conditions, we believe the estimates and judgments associated with the reported amounts are appropriate in the circumstances.

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We believe the following accounting policies are the most critical in fully understanding and evaluating our financial condition and results of our operations under U.S. generally accepted accounting principles.

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REVENUE RECOGNITION. Our revenues mainly derived from sales of automated test equipment and avionics products and from long-term fixed price contracts for ATE, avionics and ground debriefing systems. In addition, we lease ATE and provide manufacturing, development and product support services. Product revenue is recognized when there is persuasive evidence of an arrangement, the fee is fixed or determinable, delivery of the product to the customer has occurred and the collection of the fee is probable. If the product requires specific customer acceptance, revenue is deferred until customer acceptance occurs or the acceptance provisions lapse, unless we can objectively and reliably demonstrate that the criteria specified in the acceptance provisions are satisfied.

Revenues from long-term fixed-price contracts are recognized by the percentage-of-completion method in accordance with the "Input Method." We apply this method when the total of the costs and revenues of the contract can reasonably be estimated. The percentage of completion is determined based on the ratio of actual costs incurred to total costs estimated to be incurred over the duration of the contract. With regard to contracts for which a loss is anticipated, a provision is made for the entire amount of the estimated loss at the time such loss becomes evident. Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit or loss are recorded in results of operations when they are reasonably determined by management on a cumulative catch-up basis.

Revenues from services are recognized when the service is performed. Revenues under operating leases of equipment are recognized ratably over the lease period. Revenues from certain arrangements may include multiple elements within a single contract. Generally, our multiple element arrangements are accounted for as separate units of accounting when it is possible to determine objective and reliable evidence of fair value of the undelivered elements in order to separate the fees among the elements. Revenues are recognized when the element is delivered and all other criteria for revenue recognition are met.

Revenues from software arrangements are recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectability is probable. Arrangements with payment terms extending beyond customary payment terms are considered not to be fixed or determinable. If the fee is considered not to be fixed or determinable, revenue is deferred and recognized when payments become due from the customer or are actually collected when collectability is not probable, providing that all other revenue recognition criteria have been met.

INTANGIBLE ASSETS. Costs of producing our TPS software library, which can be integrated with our CATS test station, incurred subsequent to achieving technological feasibility, were capitalized, and are amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the software. We assess the recoverability of these intangible assets at each balance sheet date by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software products sold. The use of

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different assumptions with respect to the expected cash flows from our assets and other economic variables may lead to different conclusions regarding the recoverability of our assets' carrying values and to the potential need to record an impairment loss for our intangible assets. An intangible asset related to customer relationships as well as has been recorded as a result of our acquisition of certain assets and liabilities of Vectop in February 2005 and is being amortized using a straight line basis over the expected useful life of five years. For the year ended December 31, 2007, no impairment was required.

**IMPAIRMENT OF LONG-LIVED ASSETS.** We are required to assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. We assess the impairment of our assets based on a number of factors, including any significant changes in the manner of our use of the respective assets or the strategy of our overall business and significant negative industry or economic trends. Upon determination that the carrying value of a long-lived asset may not be recoverable, based upon a comparison of expected undiscounted future cash flows to the carrying amount of the asset, an impairment charge is recorded in the amount the carrying value of the asset exceeds its fair value. For the year ended December 31, 2007, no impairment was required.

**SHARE-BASED COMPENSATION.** Effective January 1, 2006, we account for stock-based compensation in accordance with FASB Statement No. 123 (Revised 2004), "Share-Based Payment," or SFAS 123(R), applying the modified prospective method, and with Securities and Exchange Commission Staff Accounting Bulletin No. 107, "Share-Based Payment," or SAB 107. In accordance with SFAS 123(R), we measure the compensation cost associated with share-based payment transactions based on the fair value at the grant date of the options. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods, according to the straight-line method.

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For employee option grants, the fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with weighted average assumptions relating to the dividend yield, expected volatility, risk free interest rate and expected life of the option by the employee, in accordance with SAB 107. Changes in our assumptions with respect to these components may change the compensation award costs and amounts expensed in each period and consequently the results of our operations. For the year ended December 31, 2007 we incurred share-based compensation expense of \$178,000. As of December 31, 2007, there was \$79,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plans, which are expected to be recognized over a weighted-average period of one year.

Prior to the adoption of SFAS 123(R), the Company applied SFAS 123, amended by SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure," which allowed companies to apply the existing accounting rules under APB 25, "Accounting for Stock Issued to Employees," and related Interpretations. In general, as the exercise price of options granted under these plans was equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost was recognized in the net loss attributed to common stockholders for periods prior to the adoption of SFAS 123(R).

**PROVISION FOR LITIGATION.** Our former chief executive officer and a former officer have outstanding loans from us which they claim that they are not

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obliged to repay. We are engaged in legal actions with these former officers concerning, among other things, the repayment of the loans. According to our legal consultants, we have a strong case with regard to our claims for repayment of the outstanding loans. We recorded a provision for the loans receivable in the amount that we believe is sufficient to reflect the recoverability of the asset, based on management's estimation. Subsequent to balance sheet date, in March 2008, a counter claim of the former officer was dismissed and our claim was allowed almost in full. In addition, we have several additional legal proceedings outstanding. We have recorded provisions for litigation for claims that were estimable and for which there is a high probability that we will be held responsible based on our legal consultants' opinions and management's estimations. If our estimations are wrong, we may incur additional litigation expenses.

ACCOUNTING FOR INCOME TAXES. ON JANUARY 1, 2007, WE ADOPTED FIN 48, "ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES," WHICH CONTAINS A TWO-STEP APPROACH TO RECOGNIZING AND MEASURING UNCERTAIN TAX POSITIONS ACCOUNTED FOR IN ACCORDANCE WITH STATEMENT 109, "ACCOUNTING FOR INCOME TAXES." THE FIRST STEP IS TO EVALUATE THE TAX POSITION TAKEN OR EXPECTED TO BE TAKEN IN A TAX RETURN BY DETERMINING IF THE WEIGHT OF AVAILABLE EVIDENCE INDICATES THAT IT IS MORE LIKELY THAN NOT THAT, ON AN EVALUATION OF THE TECHNICAL MERITS, THE TAX POSITION WILL BE SUSTAINED ON AUDIT, INCLUDING RESOLUTION OF ANY RELATED APPEALS OR LITIGATION PROCESSES. THE SECOND STEP IS TO MEASURE THE TAX BENEFIT AS THE LARGEST AMOUNT THAT IS MORE THAN 50% LIKELY TO BE REALIZED UPON ULTIMATE SETTLEMENT. PRIOR TO JANUARY 1, 2007, WE ESTIMATED OUR UNCERTAIN INCOME TAX OBLIGATIONS IN ACCORDANCE WITH SFAS NO. 109, "ACCOUNTING FOR INCOME TAXES" (SFAS NO. 109) AND SFAS NO. 5 "ACCOUNTING FOR CONTINGENCIES" ("SFAS NO. 5"). NO PROVISION WAS RECORDED AS A RESULT OF THE ADOPTION OF FIN 48 OR FOR THE YEAR ENDED DECEMBER 31, 2007.

WE AND OUR SUBSIDIARY HAVE PROVIDED A VALUATION ALLOWANCE IN RESPECT TO THE DEFERRED TAX ASSETS RESULTING FROM OPERATING LOSS CARRYFORWARDS AND OTHER TEMPORARY DIFFERENCES. OUR MANAGEMENT CURRENTLY BELIEVES THAT SINCE WE AND OUR SUBSIDIARY HAVE A HISTORY OF LOSSES IT IS MORE LIKELY THAN NOT THAT THE DEFERRED TAX REGARDING THE LOSS CARRYFORWARDS AND OTHER TEMPORARY DIFFERENCES WILL NOT BE REALIZED IN THE FORESEEABLE FUTURE.

### SIGNIFICANT EXPENSES

Cost of Revenues. Cost of revenues consist primarily of manufacturing costs, depreciation of fixed assets, project development costs, impairment losses on long-lived assets, amortization of capitalized software and inventories write-downs.

MARKETING, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Marketing and selling expenses consist primarily of expenses for sales and marketing personnel, sales commissions, marketing activities, public relations, promotional materials, amortization of customer relationship assets, travel expenses and trade show exhibit expenses. General and administrative expenses consist primarily of salaries and related expenses for executive, accounting, administrative personnel, professional fees, provisions for doubtful accounts, and other general corporate expenses.

FINANCIAL INCOME (EXPENSES), NET. Financial expenses consist of interest and bank expenses, interest on convertible note and loans, amortization expenses of discount on convertible note, deferred charges and currency remeasurement losses. Financial income consists of interest on cash and cash equivalent balances and currency remeasurement gains.

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### RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for us beginning January 1, 2008. The FASB issues a FASB Staff Position (FSP) to defer the effective date of SFAS No. 157 for one year for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. We have not yet determined the effect that the adoption of SFAS No. 157 will have on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. The provisions of SFAS No. 159 are effective for the Company beginning January 1, 2008. We have not yet determined the effect that the adoption of SFAS No. 159 will have on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141R"). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning after December 15, 2008. Earlier adoption is prohibited. We do not expect that the adoption of SFAS 141R will have any impact on our consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51". SFAS No. 160 establishes accounting and reporting standards that require that the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity; the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; and changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We do not expect that the adoption of SFAS No. 160 will have significant impact on our consolidated financial statements.

### YEAR ENDED DECEMBER 31, 2007 COMPARED WITH YEAR ENDED DECEMBER 31, 2006

**Revenues.** Our revenues increased 7.7% to \$14.0 million in 2007 from \$13.0 million in 2006. We expect that in 2008 our revenues will be primarily generated from sales of our off-the-shelf products.

**Cost of Revenues.** Cost of revenues decreased 3% to \$10.7 million in 2007 from \$11.0 million in 2006. The decrease is mainly due to the decreased revenues from development programs which have lower profit margins. In 2008, we expect that our cost of revenues as a percentage of revenues will slightly increase.

**GROSS PROFIT.** Our gross profit increased 65% to approximately \$3.4 million



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in 2007 from \$2.0 million in 2006. Our profit margin increased to 24% in 2007 from 16% in 2006. The improved margin reflects the mix between our traditional and our off-the-shelf products that have higher margins and which accounted for a greater percentage of our 2007 sales.

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**RESEARCH AND DEVELOPMENT EXPENSES.** Research and development expenses were approximately \$324,000 in 2007 compared to \$181,000 in 2006. In 2008, we expect that our research and development expense will increase as we plan to initiate additional internally funded research.

**MARKETING, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES.** Marketing, selling, general and administrative expenses were approximately \$3.4 million in 2007 compared to \$3.1 million in 2006. We expect that marketing and selling expenses will remain at the same level in 2008.

**FINANCIAL INCOME (EXPENSES), NET.** Our financial expenses, net, were \$629,000 in 2007 compared to \$775,000 in 2006. Our decreased financial expenses in 2007 were attributable primarily to a lower level of borrowings on which interest was payable.

YEAR ENDED DECEMBER 31, 2006 COMPARED WITH YEAR ENDED DECEMBER 31, 2005

**REVENUES.** Our revenues decreased 3% to \$13.0 million in 2006 from \$13.4 million in 2005.

**COST OF REVENUES.** Cost of revenues decreased 9% to \$11.0 million in 2006 from \$12.1 million in 2005. The decrease is mainly due to the decreased revenues from development programs which have lower profit margins.

**GROSS PROFIT.** Our gross profit increased 54% to approximately \$2.0 million in 2006 from \$1.3 million in 2005. Our profit margin increased to 16% in 2006 from 10% in 2005. The improved margins reflects the mix between the traditional and new products that we sell and the lower margin of certain long-term fixed-price contracts whereby new products are being developed for our customers.

**RESEARCH AND DEVELOPMENT EXPENSES.** In 2006 we incurred \$181,000 of research and development expenses. In 2005 we did not incur any research and development expenses as we made a strategic decision not to engage in internal research, and development activities, but entered into development projects through customers orders.

**MARKETING, SELLING, GENERAL AND ADMINISTRATIVE EXPENSES.** Marketing, selling, general and administrative expenses were approximately \$3.1 million in both 2006 and in 2005. While we continue to implement our costs savings measures, we also continued to support our sales efforts in our current and new markets.

**FINANCIAL INCOME (EXPENSES), NET.** Our financial expenses, net, were \$775,000 in 2006 compared to \$624,000 in 2005. Our increased financial expenses in 2006 were attributable primarily to the interest payable and amortization expense on the deemed discount on the \$3.0 million of convertible notes issued in 2004 and to higher interest rates.

OUR LOCATION IN ISRAEL

We are incorporated under the laws of the State of Israel, and our

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principal executive offices and principal manufacture, research and development facilities are located in Israel. See Item 3D "Key Information - Risk Factors - Risks Relating to Our Operations in Israel" for a description of governmental, economic, fiscal, monetary or political policies or factors that have materially affected or could materially affect our operations.

### CORPORATE TAX RATE

Israeli companies are generally subject to income tax at the corporate tax rate. The applicable rate for 2007 of 29% will be reduced to 28% in 2008 and will be further reduced to 26% in 2009 and 25% in 2010 and thereafter.

As of December 31, 2007, our carried forward net operating loss for Israeli tax purposes was approximately \$63 million, including a carry forward capital loss amounting to approximately \$4 million.

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### IMPACT OF CURRENCY FLUCTUATION AND OF INFLATION

A significant portion of the cost of our Israeli operations, mainly personnel and facility-related, is incurred in NIS. Therefore, our NIS related costs, as expressed in U.S. dollars, are influenced by the exchange rate between the U.S. dollar and the NIS. In addition, if the rate of inflation in Israel exceeds the rate of devaluation of the NIS in relation to the U.S. dollar, or if the timing of such devaluations were to lag considerably behind inflation, our cost as expressed in U.S. dollars may increase. NIS linked balance sheet items, may also create foreign exchange gains or losses, depending upon the relative dollar values of the NIS at the beginning and end of the reporting period, affecting our net income and earnings per share. Although we may use hedging techniques, we may not be able to eliminate the effects of currency fluctuations. Thus, exchange rate fluctuations could have a material adverse impact on our operating results and share price. The caption "Financial and other income (expenses), net" in our consolidated financial statements includes the impact of these factors as well as traditional interest income or expense. See Note 13 to our consolidated financial statements.

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

|                                    | YEAR ENDED DECEMBER 31, |        |      |        |        |
|------------------------------------|-------------------------|--------|------|--------|--------|
|                                    | 2003                    | 2004   | 2005 | 2006   | 2007   |
| Devaluation of NIS vs. U.S. Dollar | (7.6)%                  | (1.6)% | 6.8% | (8.2)% | (8.9)% |
| Israeli Consumer Price Index       | (1.9)%                  | 1.2%   | 2.4% | (0.1)% | 3.4%   |

Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

### B. LIQUIDITY AND CAPITAL RESOURCES

We have historically met our financial requirements primarily through cash

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generated by operations, funds generated by our public offering in 1985, private placements of our ordinary shares and issuance of debt securities, loans from our principal shareholders, short-term loans and credit facilities from Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M., or the Banks, research and development grants from the Government of Israel and the Israel-U.S. Binational Industrial Research and Development Foundation, and investment grants for approved enterprise programs and marketing grants from the Government of Israel.

As a result of \$58.5 million in losses during the period 1999 through 2002, we were forced to incur significant debt and issue equity securities. During the four years ended December 31, 2003, we relied predominantly on Mr. Howard P.L. Yeung and our other principal shareholders and to a lesser extent on new investors to provide us with working capital. During this period, they provided us with \$13.1 million in equity capital, convertible debt and loans.

On June 22, 2003, we signed a memorandum of agreement with the Banks, which agreement was approved by our shareholders at an extraordinary general meeting of shareholders that was held on July 22, 2003. Pursuant to an agreement that was finalized on September 24, 2003, we restructured \$3,451,000 of our outstanding debt to the Banks. We repaid \$1,100,000 on account of our debt to the Banks, and the Banks forgave \$1,100,000 of debt and received warrants to purchase 1,260,665 of our ordinary shares, at an exercise price that is equal to the nominal (par) value of our shares, in lieu of \$1,251,000 of our debt. The Banks also granted us an additional short-term line of credit of \$500,000 to finance our cash flow requirements during 2003. As part of the agreement our controlling shareholder, Mr. Yeung, agreed to grant the Banks a put option allowing the Banks to require him to purchase the warrants granted to the Banks, for the consideration of \$1,251,000, exercisable within a period of 45 days commencing on March 24, 2005 and the Banks granted Mr. Yeung a call option allowing him to require the Banks, during a period of 18 months, commencing as of September 24, 2003, and in the event that the Banks did not exercise their put option, during additional 90 days period commencing as of May 9, 2005, to sell him such warrants at a price that is not lower than \$1,251,000 and not higher than \$1,770,165, depending on the average closing price of our ordinary shares during the last 90 business days prior to such exercise. In May 2005, Mr. Yeung exercised his call option to purchase the warrants from the Banks and in October 2005, exercised these warrants. Upon such exercise, we issued Mr. Yeung 1,260,665 ordinary shares. We also agreed to grant the Banks warrants to purchase an additional 366,667 ordinary shares at an exercise price of \$6.00 per share, exercisable for five years, commencing as of September 24, 2003.

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On July 12, 2004 we entered into a stock purchase agreement with certain institutional investors, pursuant to which such investors purchased 600,000 of our ordinary shares at a price of \$4.80 per share, together with additional investment rights to purchase up to an aggregate of an additional 366,667 ordinary shares at an exercise price of \$6.30 per share, for a period of 24 months from August 11, 2004. In addition, we issued to such investors an aggregate of \$3.0 million principal amount of convertible notes. Such convertible notes bore interest at a rate of six month LIBOR plus 2.5% and were convertible at the investors' option at a conversion price of \$6.30. The investors also received warrants exercisable for a period of five years beginning on January 12, 2005 to purchase up to an aggregate of 312,500 ordinary shares at an exercise price of \$7.50 per share. Such convertible notes matured on July 12, 2007. We repaid the \$3.0 million of convertible notes and the balance of the interest accrued thereon, in July 2007. We obtained the funds used to repay these notes from a loan that was provided to us by Mr. Yeung, our controlling shareholder in consideration for issuance of a convertible note and

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warrants, as described below.

On April 6, 2005 we entered into a stock purchase agreement with the same institutional investors, pursuant to which such investors purchased 321,978 of our ordinary shares. In addition, we issued the investors new warrants to purchase an additional 625,000 of our ordinary shares at a purchase price of \$6.30 per share for a period of 24 months. These warrants expired in April 2007 without being exercised. As part of this transaction the investors exercised 303,022 additional investment rights that were issued to them in the July 12, 2004 transaction, for the purchase of 303,022 ordinary shares. As a result, we received proceeds of approximately \$3,000,000.

On June 29, 2007 we entered into an amendment and exchange agreement with certain shareholders who participated in a private placement of our shares in June 2002. Pursuant to such agreement we received a loan in the principal aggregate amount of \$400,000 for a period of three years which born interest at a rate of 8% per annum, paid in arrears on a quarterly basis. In consideration for such loan, our audit committee and board of directors approved the extension of warrants to purchase up to an aggregate of 155,782 ordinary shares that were issued to these shareholders as part of the June 2002 private placement, until June 30, 2010, and the repricing of the exercise price of warrants to purchase up to an aggregate of 606,803 ordinary shares issued to some of the investors in the 2002 private placement, to \$1.88 per share which were also extended until June 30, 2010. As of December 31, 2007 none of the warrants held by the investors of the June 2002 private placement were exercised. Subsequent to the balance sheet date, we repaid \$300,000 of the loan to the shareholders in consideration for 152,765 ordinary shares.

On December 10, 2007 we issued \$3.0 million principal amount of convertible notes to Mr. Yeung, our controlling shareholder. The convertible notes will mature on December 10, 2010, bear interest at a rate of six month LIBOR plus 3.5% and are convertible into ordinary shares at a conversion price of \$2.09. Mr. Yeung also received warrants exercisable for a period of five years beginning on December 10, 2007 to purchase up to an aggregate of 1,578,947 ordinary shares at an exercise price of \$2.375 per share.

As of December 31, 2007, we owed the Banks \$157,000 under long-term loans and \$333,000 under credit facilities. In addition, the Banks provided \$816,000 of guarantees on our behalf to our customers and suppliers in the ordinary course of business. The guarantees are secured by a first priority floating charge on all our assets and by a fixed charge on goodwill (intangible assets), unpaid share capital and insurance rights (rights to proceeds on insured assets in the event of damage). Our agreements with the Banks prohibit us from selling or otherwise transferring any assets except in the ordinary course of business, from placing a lien on our assets without the Banks' consent and from declaring dividends to our shareholders. In addition, The Israeli Tax Authority has a first priority fixed charge on our fixed assets in the Beit She'an facility. This charge will be released when the litigation between us and our former chief executive officer is resolved.

We had capital expenditures of \$353,000 in 2007 and \$236, 000 in 2006. We currently do not have any significant capital spending or purchase commitments.

### CASH FLOWS

The following table summarizes our cash flows for the periods presented:

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|  | YEAR ENDED DECEMBER 31,     |       |
|--|-----------------------------|-------|
|  | -----                       |       |
|  | 2006                        | 2007  |
|  | ----                        | ----  |
|  | (U.S. dollars in thousands) |       |
| Net cash provided by (used in) operating activities  | 717                         | (118) |
| Net cash provided by (used in) investing activities  | 71                          | (226) |
| Net cash provided by (used in) financing activities  | (148)                       | 189   |
| Net increase (decrease) in cash and cash equivalents | 640                         | (155) |
| Cash and cash equivalents at beginning of the year   | 350                         | 990   |
| Cash and cash equivalents at end of the year         | 990                         | 835   |

Net cash used in operating activities was \$118,000 in 2007. This was primarily due to increase in trade receivables of \$611,000, increase in costs and estimated earnings in excess of billings, net of \$230,000 and decrease in trade payables of \$139,000. This was offset by a increase in other accounts payables of \$199,000 and an decrease in inventories of \$104,000. Net cash generated from operating activities was \$717,000 in 2006. This was primarily attributable to a net decrease in costs and estimated earnings in excess of billings of \$622,000, a \$126,000 increase in accounts payables, accrued expenses, depreciation and amortization of \$1.4 million and share-based compensation expenses of \$221,000 that was offset in part by our loss of \$2.0 million and an increase in inventories of \$526,000.

Net cash used in investing activities was approximately \$226,000 in 2007. This was mainly due to investing of \$353,000 in property, plant and equipment which was offset by decrease in restricted cash of \$106,000. Net cash provided from investing activities was approximately \$71,000 in 2006, mainly due to decrease of \$313,000 in restricted cash which was offset by investment of \$236,000 in property, plant and equipment.

Net cash provided by financing activities was \$189,000 in 2007. This amount was principally in respect of net proceeds of \$3.4 million from loans received from our shareholders which was offset by repayments of long term loans in the amount of \$3.3 million. Net cash used in financing activities was \$148,000 in 2006. This amount was principally in respect of our repayment of \$525,000 of current maturities of long-term loans offset by \$288,000 in proceeds from a long term loan.

As a result of the foregoing, at December 31, 2007, we had working capital of \$4.0 million and cash and cash equivalents of \$835,000 as compared to working capital of \$3.5 million and cash and cash equivalents of \$990,000 at December 31, 2006

We expect to fund our short-term liquidity needs, including our obligations under our credit facilities, other contractual agreements and any other working capital requirements, from our cash and cash equivalents, operating cash flow and our credit facilities. We believe that our current cash and cash equivalents, credit facilities and our expected cash flow from operations in 2008 will be sufficient to meet our cash requirements in 2008. However, we cannot assure that such funds will be sufficient to finance our operations. In such event, we expect our shareholders, other investors or the Banks will continue to provide us with funds.

As of March 27, 2008 there were 3,020,698 warrants outstanding to purchase 3,020,698 of our ordinary shares. Of such warrants, 606,803 warrants have an exercise price of \$1.88 per share, 1,578,947 warrants have an exercise price of \$2.38 per share, 522,449 warrants have an exercise price of \$6.00 and 312,500 warrants have an exercise price of \$7.50 per share. To the extent any warrants are exercised, the proceeds will be added to our working capital.

C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

RESEARCH AND DEVELOPMENT

Our research and development investments focus on improvements to our existing products and the development of complementary products that would provide continued support for our current customers and would improve our capability to market our products to new customers.

In 2007 and 2006, we incurred \$324,000 and \$181,000, respectively, of research and development expenses. In the year ended December 31, 2005, we didn't incur research and development costs. In 2008, we expect that we will continue to enter into new development projects and develop products through customer orders, and we will continue to initiate internally funded research and to invest in existing projects.

As of December 31, 2007, we employed 32 engineers in research and development, who spend most of their time on research and development activities generated through customer orders and an immaterial part of their time on internal research and development activities.

The Office of the Chief Scientist of the Israeli Ministry of Industry and Trade encourages research and development by providing grants to Israeli companies. The terms of such grants prohibit manufacture of the developed products outside Israel and the transfer of technologies developed using the grants to any person without the prior written consent of the Chief Scientist. We have not received any grants from the Office of the Chief Scientist since 1996.

Pursuant to applicable Israeli law, we are currently required to pay royalties at the rate of 3-5% of sales of products developed with certain grants received from the Chief Scientist, up to 100% of the amount of such grants, linked to the U.S. dollar. As of December 31, 2007, our total obligation for royalties payments, net of royalties paid or accrued is approximately \$883,000.

We are committed to pay royalties to the Israel - United States Binational Industrial Research and Development Foundation at the rate of 5% of the sales proceeds up to 150% of the research and development expenses financed by the foundation. Our total obligation for royalties, net of royalties paid or accrued, totaled approximately \$2.6 million as of December 31, 2007.

D. TREND INFORMATION

In 2006 and 2007 our revenues remained relatively constant. We expect that in 2008 the proportion of sales of off-the-shelf products will continue to increase in comparison to revenues from development programs and that as a result of such change in our product mix, our operating results will improve.

Our future revenues will, in great measure, be dependent upon the success of our sales and marketing strategy. We are currently focusing our sales efforts on:

- o Net Centric Digital Recorders (NCDR);
- o Inertial Navigation Systems

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- o Ground debriefing stations;
- o Optronic products; cameras for HUD and armored vehicles;
- o Testing solutions; and
- o Manufacturing services.

We cannot provide any assurances that we will be successful in meeting our targets in the future. As a result of the unpredictable business environment in which we operate, we are unable to provide any specific guidance as to sales and profitability trends. If we are unsuccessful in our sales efforts, it is unlikely that we will be able to achieve profitability in the future and we will require additional capital.

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### 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, 2007 and the effect we expect them to have on our liquidity and cash flow in future periods.

| CONTRACTUAL OBLIGATIONS     | PAYMENTS DUE BY PERIOD |                     |                |           |                 |
|-----------------------------|------------------------|---------------------|----------------|-----------|-----------------|
|                             | TOTAL                  | LESS THAN 1<br>YEAR | 1-3 YEARS      | 3-5 YEARS | MORE<br>5 YEARS |
|                             |                        |                     | (in thousands) |           |                 |
| Long-term debt obligations  | \$3,557,000            | \$ 157,000          | \$3,400,000    | -         |                 |
| Operating lease obligations | 820,000                | 350,000             | 470,000        | -         |                 |
| Total                       | \$4,377,000            | \$ 507,000          | \$3,870,000    | -         |                 |

In addition, we have long-term liabilities for severance pay that is calculated pursuant to Israeli severance pay law generally based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. As of December 31, 2007 our severance pay liability was \$2,442,000.

We have attempted to identify additional significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3 - "Key Information."

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

#### A. DIRECTORS AND SENIOR MANAGEMENT

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

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| NAME               | AGE | POSITION                                   |
|--------------------|-----|--|
| ----               | --- | -----                                      |
| Herzle Bodinger    | 65  | Chairman of the Board and President        |
| Zvi Alon           | 54  | Vice President and Chief Executive Officer |
| Dov Sella          | 52  | Vice President Marketing and Sales         |
| Shiri Lazarovich   | 33  | Chief Financial Officer                    |
| Yuval Dan-Gur      | 44  | Vice President Engineering                 |
| Oleg Kiperman      | 54  | Chief Technology Officer                   |
| Adrian Berg        | 60  | Director                                   |
| Roy Kui Chuen Chan | 61  | Director                                   |
| Ben Zion Gruber    | 49  | Director                                   |
| Michael Letchinger | 52  | Director                                   |
| Nurit Mor          | 64  | Outside director                           |
| Eli Akavia         | 60  | Outside director                           |

Mr. Berg will serve as a director until our 2008 annual general meeting of shareholders. Messrs. Chan and Gruber will serve as directors until our 2009 annual general meeting of shareholders. Messrs. Bodinger and Letchinger will serve as directors until our 2010 annual general meeting of shareholders.

Ms. Mor and Mr. Akavia will serve as outside directors pursuant to the provisions of the Israeli Companies Law for three-year terms until our 2009 annual general meeting of shareholders. Pursuant to the provisions of the Israeli Companies Law their terms may be extended for one additional three-year period.

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HERZLE BODINGER has served as our chairman of the Board of Directors since July 1998, and since 2001 has served as our president as well. General (Res.) Bodinger first joined us in May 1997 as the president of our U.S. subsidiary, Rada Electronic Industries Inc., and was appointed our chief executive officer in June 1998. He served as our chief executive officer from 1998 until 2001 and resumed this position from June 2006 until July 2007. General (Res.) Bodinger served as the Commander of the Israeli Air Force from January 1992 through July 1996. During the last 35 years of his service, he also served as a fighter pilot while holding various command positions. General (Res.) Bodinger holds a B.A. degree in Economics and Business Administration from the Bar-Ilan University and completed the 100th Advanced Management Program at Harvard University.

ZVI ALON has served as our chief executive officer since July 2007. Mr. Alon joined us in January 2000 and served as our vice president and chief operating officer until March 2003 when he was appointed vice president of marketing and sales. From 1982 to 1999, Mr. Alon served in various managerial positions with the Israel Aircraft Industries, as director of business development and marketing, director of electrical and avionics engineering, avionics programs manager and group leader and operational definition officer of the "Lavi" project office. Previously, Mr. Alon served in the Israeli Air Force for ten years. Mr. Alon holds a B.Sc. degree in Mathematics and Computer Science and a M.Sc. degree in Computer Science, both from Tel Aviv University.

SHIRI LAZAROVICH has served as our chief financial officer since December 2007. Ms. Lazarovich served as our controller since September 2004. Prior to that and from January 2000 she served as a manager in the accountant, assurance and business advisory services department of PricewaterhouseCoopers, Israel. Ms. Lazarovich holds a double bachelor's degree in Accounting and in Economics from the Hebrew University of Jerusalem, and is a Certified Public Accountant in Israel.



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DOV SELLA has served as our vice president of marketing and sales since July 2007. Prior to that, and since January 2003, Mr. Sella served as our chief operating officer. Mr. Sella has over 20 years of senior management and product development experience. From 1982 until 1997 Mr. Sella worked for Elbit Systems Ltd., a leading Israeli defense contractor. Among his positions at Elbit were director of programs, director of avionics engineering and director of business development. Between 1997 and 2000, Mr. Sella served UltraGuide Ltd., a medical devices start-up, as executive vice president and vice president of business development and vice president of research and development. During the three years prior to joining our company, Mr. Sella was the president of NeuroVision Inc., a medical technology start-up. Mr. Sella has a B.Sc. degree in Computer Engineering from the Technion Israel Institute of Technology, or the Technion, (cum laude). He served as a fighter aircraft navigator in the Israeli Air Force.

YUVAL DAN-GUR has served as our vice president engineering since July 2007. Prior to that and since October 2005, Mr. Dan-Gur served as our director of programs. Prior to his employment with Rada, from July 1998 until September 2005, Mr. Dan-Gur was in management of complex, inter-disciplinary projects using leading technologies for the Israeli MOD. Prior to that, from January 1996 until June 1998 Mr. Dan-Gur served as the head of the headquarters of the planning unit for operations of the Israeli's Navy Dockyards. Mr. Dan-Gur holds BSc in Electrical Engineering and MSc in Industrial and Management Engineering by the Technion and a PhD in Information Systems from Haifa University.

OLEG KIPERMAN has served as our chief technology officer since July 2007. Mr. Kiperman joined us in 1984 as project manager of several embedded avionics development programs and in 2000 was nominated as our director of engineering. From 1982 until 1984 Mr. Kiperman served as a hardware development team leader at Tadiran (developing digital communication systems). From 1977 until 1982 Mr. Kiperman served as a senior engineer in the IAF Weapons Control Branch. Mr. Kiperman holds a B.Sc. in Electrical Engineering from the Technion.

ADRIAN BERG has served as a director since November 1997. Mr. Berg is a designee of Horsham Enterprises Ltd. Since 1976, Mr. Berg has been a chartered accountant and senior partner at the U.K. firm, Alexander & Co., Chartered Accountants. Mr. Berg holds a B.Sc. degree in Industrial Administration from the University of Salford and received his qualification as a fellow of the U.K. Institute of Chartered Accountants in 1973 after he completed three years of training at Arthur Andersen & Co.

ROY KUI CHUEN CHAN has served as a director since November 1997. Mr. Chan is a designee of Horsham Enterprises Ltd. Mr. Chan has been legal consultant to Yeung Chi Shing Estates Limited, a Hong Kong holding company with major interests in hotels and real estate in Hong Kong, China, the U.S., Canada and Australia, and its international group of companies, since 1984. Mr. Chan presently serves as legal counsel to several Hong Kong companies, including Horsham Enterprises Ltd. Mr. Chan received his qualification as a solicitor and has been a member of the U.K. bar since 1979 after he completed five years of training at Turners Solicitors.

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BEN ZION GRUBER was elected as a director designee of the shareholders (excluding Howard Yeung) that participated in the private placement of our shares in June 2002. Mr. Gruber is founder and manager of several real estate and construction companies and an entrepreneur involved in several hi-tech companies. Mr. Gruber is a Colonel (Res) of the Israeli Defense Forces serving as Brigadier Commander of a tank battalion. Mr. Gruber holds an M.A. degree in Behavioral Sciences from Tel Aviv University, a B.Sc. degree in Engineering of

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microcomputers from "Lev" Technology Institute and is currently studying for his PhD degree in Behavioral Sciences at the University of Middlesex, England. In addition Mr. Gruber is a graduate of a summer course in Business Administration at Harvard University, as well as several other courses and training in management, finance and entrepreneurship. Mr. Gruber is a member of the Board of Employment Service of the Government of Israel. He also serves on the boards of directors of the Company for Development of Efrat Ltd., and the Association of Friends of "Kefar Shaul" Hospital. Mr. Gruber serves on the Ethics Committees of the Eitanim and Kefar Shaul Hospitals as well as a director of several other charitable organizations.

MICHAEL LETCHINGER was elected as a director designee of Horsham Enterprises Ltd. in November 2004. Since 2000, Mr. Letchinger has been General Counsel and Senior Vice President-Managing of Potomac Golf Properties, LLC, a company engaged in real estate development and free standing golf facilities. From 1994 to 2000, Mr. Letchinger was General Counsel and Senior Vice President-Managing of Potomac Development Associates, a sister company of Potomac Golf Properties, LLC. Mr. Letchinger holds a B.A. degree in economics from Brandeis University, Waltham, Massachusetts, and a JD from University of Chicago Law School.

NURIT MOR has served as our outside director since August 2006. Ms. Mor has served as an outside director of Aspen Real Estate Ltd. since September 2005 and from May 2004 Ms. Mor has served as an outside director of I.B.I Investment House Ltd., both Israeli public companies. From 1973 to 2003 Ms. Mor served in senior positions in the Bank of Israel, including in the public complaints and customer relations department. Ms. Mor holds a B.A. degree in Economics and Statistics a diploma in Business Administration from the Hebrew University, Jerusalem, and an M.A degree in Labor Studies form the Tel Aviv University.

ELI AKAVIA has served as our Outside Director since August 2006. Mr. Akavia has since August 2002 served as an independent consultant in accounting and audit issues. From 1979 to 2002 Mr. Akavia served as partner in various positions in Luboshitz Kasierer, which was merged into Kost, Forer, Gabbay which is currently a member firm of Ernst & Young International. Mr. Akavia serves as a director of Eden Springs Ltd., On Track Innovation Ltd., Starling Ltd. and Eshld Ltd., all of which are public Israeli companies. Mr. Akavia has been a Certified Public Accountant (Israel) since 1975 and holds a B.Sc. degree in Mathematics and Economics from the Hebrew University in Jerusalem and an M.B.A degree from the Tel Aviv University.

Elan Sigal, our former chief financial officer, resigned as of December 2007.

### 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 year ended December 31, 2007.

|   | SALARIES, FEES,<br>COMMISSIONS AND BONUSES | PENSION, RETIREMENT<br>AND SIMILAR BENEFITS |
|---|--|---|
|   | -----                                      | -----                                       |
| All directors and executive officers<br>as a group, consisting of 12persons | \$730,516                                  | \$268,844                                   |

During the year ended December 31, 2007, we paid each of our outside directors a per meeting attendance fee of NIS 1,000 (\$243) plus an annual fee of NIS 18,000 (\$4,382).

As of December 31, 2007, our directors and executive officers as a group,

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consisting of twelve persons, held options to purchase an aggregate of 626,666 ordinary shares, at exercise prices ranging from \$2.07 to \$4.02 per share, vesting over three years. These options were issued under our 2003 Stock Option Plan and expire in 2013. In 2007, 83,333 options having an exercise price of \$2.91 were granted under the 2003 Plan.

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### C. BOARD PRACTICES

#### INTRODUCTION

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

#### ELECTION OF DIRECTORS

Our articles of association provide for a board of directors consisting of no less than two and no more than eleven members or such other number as may be determined from time to time at a general meeting of shareholders. Our board of directors is currently composed of seven 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 (other than outside 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. The majority of directors may appoint additional directors to fill any vacancies in the board of directors until the next general meeting; provided, however that the total number of directors will not exceed the maximum number, if any, fixed by or in accordance with our articles of association, and that if the total number of directors decreases below six, the board of directors may call a general meeting of shareholders, so that following such meeting there will be at least six directors in office.

Mr. Berg is a Class C director and will hold office until the Annual General Meeting of Shareholders to be held in 2008. Messrs. Chan and Gruber are Class A directors and will hold office until the Annual General Meeting of Shareholders to be held in 2009. Messrs. Bodinger and Letchinger are Class B directors and will hold office until the Annual General Meeting of Shareholders to be held in 2010.

Ms. Mor and Mr. Akavia are outside directors and will hold office until our 2009 Annual General Meeting of shareholders.

We do not follow the requirements of the NASDAQ Marketplace Rules with regard to the nomination process of directors and instead follow Israeli law and practice. See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices."

#### OUTSIDE AND INDEPENDENT DIRECTORS

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OUTSIDE DIRECTORS. Under the Israeli Companies Law, companies incorporated under the laws of the State of Israel whose shares have been offered to the public are required to appoint at least two outside directors. The Israeli Companies Law provides that a person may not be appointed as an outside director if the person, or the person's relative, partner, employer or an entity under that person's control, has or had during the two years preceding the date of appointment any affiliation with the company, or any entity controlling, controlled by or under common control with the company. The term "relative" means a spouse, sibling, parent, grandparent, child or child of spouse or spouse of any of the above. The term "affiliation" includes an employment relationship, a business or professional relationship maintained on a regular basis, control and service as an office holder, as such term is defined below, excluding service as an outside director of a company that is offering its shares to the public for the first time.

In addition, no person may serve as an outside director if the person's position or other activities create, or may create, a conflict of interest with the person's responsibilities as director or may otherwise interfere with the person's ability to serve as director. If, at the time an outside director is appointed, all current members of the board of directors are of the same gender, then that outside director must be of the other gender. A director of one company may not be appointed as an outside director of another company if a director of the other company is acting as an outside director of the first company at such time.

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As of 2006, at least one of the elected outside directors must have "accounting and financial expertise" and any other outside director must have "accounting and financial expertise" or "professional qualification," as such terms are defined by regulations promulgated under the Israeli Companies Law. This requirement does not apply to outside directors appointed prior to 2006.

Outside directors are elected at our annual general meeting of 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. In general, 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 promulgated under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

INDEPENDENT DIRECTORS. In general, NASDAQ Marketplace Rules require that the board of directors of a NASDAQ-listed company have a majority of independent directors and its audit committee must have at least three members and be comprised only of independent directors, each of whom satisfies the respective "independence" requirements of NASDAQ and the Securities and Exchange

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Commission. However, foreign private issuers, such as our company, may follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules. We do not follow the requirement of the NASDAQ Marketplace Rules to maintain a majority of independent directors on our board and instead follow Israeli law and practice. See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices." However, in accordance with the rules of the Securities and Exchange Commission and NASDAQ, we have the mandated three independent directors, as defined by the rules of the Securities and Exchange Commission and NASDAQ Marketplace, on our audit committee.

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

We do not follow the requirements of the NASDAQ Marketplace Rules with regard to regularly scheduled meetings of independent directors. Under Israeli law independent directors are not required to hold executive sessions. See below in this Item 6C. "Directors, Senior Management and Employees - Board Practices - NASDAQ Marketplace Rules and Home Country Practices."

### COMMITTEES OF THE BOARD OF DIRECTORS

**AUDIT COMMITTEE.** Our audit committee, established in accordance with Section 114 of the Israeli Companies Law and Section 3(a)(58)(A) of the Securities Exchange Act of 1934, assists our board of directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent public accountants' qualifications and independence, the performance of our internal audit function and independent public accountants, finding any defects in the business management of our company for which purpose the audit committee may consult with our independent auditors and internal auditor, proposing to the board of directors ways to correct such defects, and such other duties as may be directed by our board of directors.

Our audit committee also has the responsibility of approving related-party transactions as required by Israeli 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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Our audit committee is generally authorized to investigate any matter within the scope of its responsibilities and has the power to obtain from our internal auditing unit, our independent auditors or any other officer or employee any information that is relevant to such investigations. Our audit committee also has the right to hire independent counsel and accountants to assist it in any investigation that it may instigate.

The current members of our audit committee are Ms. Nurit Mor, and Messrs Eli Akavia and Ben Zion Gruber, each of whom satisfies the respective "independence" requirements of the Securities and Exchange Commission and NASDAQ. We also comply with Israeli law requirements for audit committee

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members. The audit committee meets at least once each quarter.

COMPENSATION COMMITTEE. Our board of directors established a compensation committee composed of Ms. Nurit Mor and Mr. Adrian Berg. The compensation committee is authorized to determine all compensations issues, including the administration of our option plans subject to general guidelines determined by our board of directors from time to time. The compensation committee will also make recommendations to our board of directors in connection with the terms of employment of our chief executive officer and president.

### 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. An internal audit must satisfy the Israeli Companies Law's independence requirements. 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. Our internal auditor complies with the requirements of the Israeli Companies Law.

### DIRECTORS' SERVICE CONTRACTS

We do not have any service contracts with our directors. There are no arrangements or understandings between us and any of our subsidiaries, on the one hand, and any of our directors, on the other hand, providing for benefits upon termination of their employment or service as directors of our company or any of our subsidiaries.

### APPROVAL OF RELATED PARTY TRANSACTIONS UNDER ISRAELI LAW

### FIDUCIARY DUTIES OF OFFICE HOLDERS

The Israeli Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An "office holder" is defined in the Israeli Companies Law as a director, general manager, chief business manager, deputy general manager, vice general manager, other manager directly subordinate to the general manager or any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title. 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 care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to utilize reasonable means to obtain (i) information regarding the appropriateness of a given action brought for his approval or performed by him by virtue of his position and (ii) all other information of importance pertaining to the foregoing actions. The duty of loyalty includes (i) avoiding any conflict of interest between the office holder's position in the company and any other position he holds or his personal affairs, (ii) avoiding any competition with the company's business, (iii) avoiding exploiting any business opportunity of the company in order to receive personal gain for the office holder or others, and (iv) disclosing to the company any information or documents relating to the company's affairs that the office holder has received due to his position as an office holder.

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### DISCLOSURE OF PERSONAL INTERESTS OF AN OFFICE HOLDER

The Israeli Companies Law requires that an office holder promptly, and no

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later than the first board meeting at which such transaction is considered, disclose any personal interest that he or she may have and all related material information known to him or her and any documents in their position, 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.

### APPROVAL OF TRANSACTIONS WITH OFFICE HOLDERS

Under the Israeli Companies Law, all arrangements as to compensation of office holders who are not directors require approval by the board of directors, and exculpation, insurance and indemnification of, or an undertaking to, indemnify an office holder who is not a director requires both board of directors and audit committee approval. The compensation of office holders who are directors must be approved by our audit committee, board of directors and shareholders.

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, however, a transaction that is adverse to the company's interest may not be approved. In some cases, such a transaction must be approved by the audit committee and by the board of directors itself, and under certain circumstances shareholder approval may be required. A director who has a personal interest in a transaction that 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 the transaction, unless the transaction is not an extraordinary transaction or the majority of the members of the board or the audit committee have a personal interest, as the case may be. In the event the majority of the members of the board of directors or the audit committee have a personal interest, then the approval of the general meeting of shareholders is also required.

### DISCLOSURE OF PERSONAL INTERESTS OF A CONTROLLING SHAREHOLDER; APPROVAL OF TRANSACTIONS WITH CONTROLLING SHAREHOLDERS

The disclosure requirements which apply to an office holder also apply to a controlling shareholder with respect to his or her personal interest in any existing or proposed transaction by us. The Israeli Companies Law provides that an extraordinary transaction with a controlling shareholder or an extraordinary transaction with another person in whom the controlling shareholder has a personal interest or 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 a transaction must include at least one-third of the shareholders who have no personal interest in the transaction who voted on the matter (not including abstentions). 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.

Under the Companies Regulations (Relief from Related Party Transactions), 5760-2000, promulgated under the Israeli Companies Law, as amended, certain extraordinary transactions between a public company and its controlling shareholder(s) do not require shareholder approval. In addition, under such

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regulations, directors' compensation and employment arrangements in a public company do not require the approval of the shareholders if both the audit committee and the board of directors agree that such arrangements are solely for the benefit of the company. Also, employment and compensation arrangements for an office holder that is a controlling shareholder of a public company do not require shareholder approval if certain criteria are met. The foregoing exemptions from shareholder approval will not apply if one or more shareholders holding at least 1% of the issued and outstanding share capital of the company or of the company's voting rights, objects to the use of these exemptions provided that such objection is submitted to the company in writing not later than fourteen 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 transaction or compensation arrangement of the directors will require shareholders' approval as detailed above.

In addition, a private placement of securities that will (i) cause a person to become a controlling shareholder or (ii) increase the relative holdings of a shareholder that holds 5% or more of the company's outstanding share capital, or (iii) will cause any person to become, as a result of the issuance, a holder of more than 5% of the company's outstanding share capital in a private placement in which 20% or more of the company's outstanding share capital prior to the placement are offered, the payment for which (in whole or in part) is not in cash or not under market terms, requires approval by the board of directors and the shareholders of the company.

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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 was made in a private placement that received shareholder approval, (i) was from a 25% or greater shareholder of the company which resulted in the acquirer becoming a 25% or greater shareholder of the company, if there is not already a 25% or greater shareholder of the company, or (ii) was from a shareholder holding a 45% interest in the company which resulted in the acquirer becoming a holder of a 45% interest in the company if there is not already a 45% or greater shareholder of the company.

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a public company's outstanding shares or a class of shares, the acquisition must be made by means of a tender offer for all of the outstanding shares or a class of 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 acquirer may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares.

EXCULPATION, INDEMNIFICATION AND INSURANCE OF DIRECTORS AND OFFICERS



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### EXCULPATION OF OFFICE HOLDERS

The Israeli Companies Law provides that an Israeli company cannot exculpate an office holder from liability with respect to a breach of his or her duty of loyalty. If permitted by its articles of association, a company may exculpate in advance an office holder from his or her liability to the company, in whole or in part, with respect to a breach of his or her duty of care. However, a company may not exculpate in advance a director from his or her liability to the company with respect to a breach of his duty of care in the event of distributions.

### INSURANCE OF OFFICE HOLDERS

The Israeli Companies Law provides that a company may, if permitted by its articles of association, enter into a contract to insure office holders in respect of liabilities incurred by the office holder with a respect to an act performed in his or her capacity as an office holder, as a result of:

- o a breach of the office holder's duty of care to the company or to another person;
- o a breach of the office holder's duty of loyalty to the company, provided that the office holder acted in good faith and had reasonable cause to assume that his or her act would not prejudice the company's interests; or
- o a financial liability imposed upon the office holder in favor of another person.

### INDEMNIFICATION OF OFFICE HOLDERS

The Israeli Companies Law provides that a company may, if permitted by its articles of association, indemnify an office holder for acts or omissions performed by the office holder in such capacity for:

- o a monetary liability 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;

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- o reasonable litigation expenses, including attorney's fees, actually incurred by the office holder as a result of an investigation or proceeding instituted against him or her by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against the office holder or the imposition of any monetary liability in lieu of criminal proceedings, or concluded without the filing of an indictment against the office holder and a monetary liability was imposed on the officer holder 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 attorneys' fees, incurred by the office holder or which were imposed on him or her by a court, in an action instituted by the company or on the company's behalf or by another person, against the office holder, or in a criminal charge from which he was acquitted, or in a criminal proceeding in which the office holder was convicted of a criminal offense which does not require proof of criminal intent.

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In accordance with the Israeli Companies Law, a company's articles of association may permit the company to:

- o prospectively undertake to indemnify an office holder, except that with respect to a monetary liability imposed on the office holder by any judgment, settlement or court-approved arbitration award, the undertaking must be limited to types of events which the company's board of directors deems foreseeable considering the company's actual operations at the time of the undertaking, and to an amount or standard that the board of directors has determined as reasonable under the circumstances.
- o retroactively indemnify an office holder of the company.

### LIMITATIONS ON EXCULPATION, INSURANCE AND INDEMNIFICATION

The Israeli Companies Law provides that neither a provision of the articles of association permitting the company to enter into a contract to insure the liability of an office holder, nor a provision in the articles of association or a resolution of the board of directors permitting the indemnification of an office holder, nor a provision in the articles of association exculpating an office holder from duty to the company shall be valid, where such insurance, indemnification or exculpation relates to any of the following:

- o a breach by the office holder of his duty of loyalty unless, with respect to insurance coverage or indemnification, the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company;
- o a breach by the office holder of his duty of care if such breach was committed intentionally or recklessly, unless the breach was committed only negligently.
- o any act or omission done with the intent to unlawfully yield a personal benefit; or
- o any fine or forfeiture imposed on the office holder.

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

Our Articles of Association allow us to insure, indemnify and exempt our office holders to the fullest extent permitted by law, subject to the provisions of the Israeli Companies Law. We currently maintain a directors and officers liability insurance policy with a per claim and aggregate coverage limit of \$7.5 million.

### NASDAQ MARKETPLACE RULES AND HOME COUNTRY PRACTICES

Under NASDAQ Marketplace Rule 4350, or Rule 4350, foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of Rule 4350. A foreign private issuer that elects to follow a home country practice instead of any of such provisions of Rule 4350, must submit to NASDAQ, in advance, a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws.

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In May and August 2005, we provided NASDAQ with a notice of non-compliance with Rule 4350. We informed NASDAQ that we do not comply with the following requirements of Rule 4350, and instead follow Israeli law and practice in respect of such requirements:

- o the requirement to maintain a majority of independent directors, as defined under the NASDAQ Marketplace Rules. Instead, under Israeli law and practice, we are required to appoint at least two outside directors, within the meaning of the Israeli Companies Law, to our board of directors. In addition, in accordance with the rules of the Securities and Exchange Commission and NASDAQ, we have the mandated three independent directors, as defined by the rules of the Securities and Exchange Commission and NASDAQ, on our audit committee. See above in this Item 6C. "Directors, Senior Management and Employees - Board Practices - Independent and Outside Directors."
- o the requirement that our independent directors will have regularly scheduled meetings at which only independent directors are present. Under Israeli law independent directors are not required to hold executive sessions.
- o the requirement 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 compensation of officers. Instead, we follow Israeli law and practice. Under the Israeli Companies Law, all arrangements as to compensation of office holders who are not directors require the approval of the board of directors if the transaction is not an "extraordinary transaction," unless a company's articles of association provide otherwise, and if such transaction is an "extraordinary transaction," it requires the approval of the audit committee and the board of directors, in that order. The compensation of office holders who are directors must be approved by our Audit Committee, Board of Directors and shareholders, in that order.

### D. EMPLOYEES

On December 31, 2007, we employed 92 persons, of whom 32 were employed in research, development and engineering, 47 persons in manufacturing and logistics, 4 persons in sales and marketing, and 9 persons in administration and management and finance. All of our employees are located in Israel. In addition, CACS (our 80% owned subsidiary) employed 24 persons in China.

On December 31, 2006, we employed 97 persons, of whom 30 were employed in research, development and engineering, 55 persons in manufacturing and logistics, 5 persons in sales and marketing, and 7 persons in administration and management and finance. All of our employees are located in Israel. In addition, CACS (our 80% owned subsidiary) employed 15 persons in China.

On December 31, 2005, we employed 109 persons, of whom 38 were employed in research, development and engineering, 56 persons in manufacturing and logistics, 5 persons in sales and marketing, and 10 persons in administration and management and finance. All of our employees are located in Israel. In addition, CACS (our 80% owned subsidiary) employed 15 persons in China.

Our technical employees have signed nondisclosure agreements covering all proprietary information that they might possess or to which they might have

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access. Employees are not organized in any union, although they are employed according to provisions established by the Israeli Ministry of Labor. Certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (including the Industrialists Association) are applicable to our Israeli employees by order of the Israeli Ministry of Labor. These provisions concern mainly the length of the workday, minimum daily wages for professional workers, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums. Under the collective bargaining agreements, the wages of most of our employees are linked to the Israeli consumer price index, although the extent of the linkage is limited.

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Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without due cause. Further, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute which is similar to the United States Social Security Administration; such amounts also include payments for national health insurance. Most of our ongoing severance obligations for our Israeli employees are provided for by monthly payments made by us for insurance policies to cover these obligations.

### E. SHARE OWNERSHIP

#### BENEFICIAL OWNERSHIP OF EXECUTIVE OFFICERS AND DIRECTORS

The following table sets forth certain information as of March 27, 2008 regarding the beneficial ownership by each of our directors and executive officers:

| NAME<br>-----  | NUMBER OF ORDINARY SHARES<br>BENEFICIALLY OWNED (1)<br>----- | PERCENTAGE OF<br>OWNERSHIP (2)<br>----- |
|--|--|---|
| Herzle Bodinger (3) (4)  | 148,611  | 1.7%                                    |
| Zvi Alon (3) (5)   | 77,777   | *                                       |
| Shiri Lazarovich (3) (6)   | 14,222   | *                                       |
| Dov Sella (3) (5)  | 77,777   | *                                       |
| Yuval Dan-Gur (3) (7)  | 31,111   | *                                       |
| Oleg Kiperman (3) (8)  | 48,778   | *                                       |
| Adrian Berg (8) (10)   | 85,533   | 1.0%                                    |
| Roy Kui Chuen Chan (11) (12)   | 58,867   | *                                       |
| Ben Zion Gruber (3) (13)   | 50,681   | *                                       |
| Michael Letchinger (14)  | --   | --                                      |
| Nurit Mor (3)  | --   | --                                      |
| Eli Akavia (3)   | --   | --                                      |
| All directors and executive officers as a<br>group (12 persons) (14) | 593,357  | 6.8%                                    |

-----  
\* 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 and warrants 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 8,705,788 ordinary shares issued and outstanding as of March 27, 2008.
  - (3) The business addresses of Messrs. Bodinger, Alon, Sella, Dan-Gur, Kiperman, Gruber and Akavia and Ms. Mor and Ms. Lazarovich is c/o RADA Electronic Industries Ltd., 7 Giborei Israel Street, Netanya, Israel.
  - (4) All such ordinary shares are subject to currently exercisable options granted under our 2003 stock option plan. 100,000 options have an exercise price of \$4.02 per share and 48,611 options have an exercise price of \$3.87 per share. The options expire in January 2013.
  - (5) All such ordinary shares are subject to currently exercisable options granted under our 2003 stock option plan. 33,333 options have an exercise price of \$2.07 per share and 44,444 options have an exercise price of \$2.40 per share. The options expire in January 2013.
  - (6) All such ordinary shares are subject to currently exercisable options granted under our 1999 and 2003 stock option plans. 5,333 options have an exercise price of \$3.42 per share and 8,889 options have an exercise price of \$2.40 per share. 11,556 options expire in January 2013 and 2,667 options expire in December 2009.
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- (7) All such ordinary shares are subject to currently exercisable options granted under our 1999 and 2003 stock option plan. 13,333 options have an exercise price of \$3.42 per share and 17,778 options have an exercise price of \$2.40 per share. 24,444 options expire in January 2013 and 6,667 options expire in December 2009.
  - (8) All such ordinary shares are subject to currently exercisable options granted under our 1999 and 2003 stock option plan. 6,000 options have an exercise price of \$9.85 per share, 25,000 options have an exercise price of \$2.07 per share and 17,778 options have an exercise price of \$2.40 per share. 42,778 options expire in January 2013 and 6,000 options expire in December 2009.
  - (9) The business address of Mr. Berg is Alexander & Co., 17 St. Ann's Square, Manchester M2 7 PW, U.K.
  - (10) Includes 84,000 ordinary shares subject to currently exercisable options granted under our stock option plan at an exercise price of \$4.02 per share. The options expire in January 2013.
  - (11) The business address of Mr. Roy Chan is Gearhart Holdings (H.K.) Limited, 2202 Kodak House II, 39 Healthy Street, E. North Point, Hong Kong.

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- (12) Includes 57,333 ordinary shares subject to currently exercisable options granted under our stock option plan at an exercise price of \$4.02 per share. The options expire in January 2013.
- (13) Includes 34,014 ordinary shares issuable upon currently exercisable warrants at an exercise price of \$1.88 per share that were issued in June 2007, and 16,667 ordinary shares subject to currently exercisable options granted under our stock option plans, at an exercise price of \$4.02 per share. Such options expire in January 2013.
- (14) The business address of Mr. Letchinger is 2709 Rittenhouse Street, Washington DC, 20015, USA.

### STOCK OPTION PLANS

#### 1999 STOCK OPTION PLAN

Our 1999 Stock Option Plan, or the 1999 Plan, provides for the issuance of stock options to purchase an aggregate of 108,400 of our ordinary shares. The 1999 Plan, authorizes the issuance of options to key employees and consultants, including officers and directors of our company and its subsidiaries, who, are in position to contribute significantly to our success, in the judgment of the board of directors or, if appointed in the future, a committee which will administer the 1999 Plan. The board of directors or the committee will determine the number of shares covered by each option, and the formulation, within the limitations of the 1999 Plan, of the form of option.

Options granted under the 1999 Plan may be for a maximum term of ten years from the date of grant. The exercise price of an option granted to an employee may not be less than 60% of the fair market value of our ordinary shares on the date of grant of the option. The exercise price of an option to a non-employee director or consultant may not be less than 80% of the fair market value of our ordinary shares on the date of grant of the option. If any option expires without having been fully exercised, the shares with respect to which such option has not been exercised will be available for future grants.

Options may not be transferable by the optionee otherwise than by will or the laws of descent and distribution and during the optionee's lifetime are exercisable only by the optionee. Options terminate before their expiration dates one year after the optionee's death while in our employ, three months after the optionee's retirement for reasons of age or disability or involuntary termination of employment other than for cause, and immediately upon voluntary termination of employment or involuntary termination of employment for cause.

Our board of directors may, at its discretion, modify, revise or terminate the 1999 Plan at any time, except that the aggregate number of shares issuable pursuant to options may not be increased (except in the event of certain changes in our capital structure), the eligibility provisions and minimum option price may not be changed, or the permissible maximum term of options may not be increased without the consent of our shareholders.

The 1999 Plan also contains provisions protecting optionees against dilution of the value of their options in the case of stock splits, stock dividends or other changes in our capital structure, in the event of any proposed reorganization or merger involving our company or in the event of any spin-off or distribution of assets to our shareholders.

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As of March 27, 2008 options to purchase 165,400 ordinary shares were granted at an average exercise price of \$9.63 per share. Of such options, 92,133 have been cancelled or forfeited. 73,267 options are outstanding and currently exercisable.

### 2003 STOCK OPTION PLAN

Our 2003 Stock Option Plan, or the 2003 Plan, provides for the issuance of stock options to purchase an aggregate of 666,667 of our ordinary shares. At the Company's Annual General meeting held in August, 2006, shareholder approve a 500,000 share increase in the number ordinary shares available for grant under the plan. Consequently, 1,166,667 shares are subject to this plan. Options under the 2003 Plan may be issued to employees including officers and directors of our company and its subsidiaries who, in the judgment of the board of directors based on the recommendation of our compensation committee, are in a position to contribute significantly to our success. The provisions of our 2003 Plan are designated to allow for the tax benefits promulgated under the Israeli Income Tax Ordinance [New Version]. Our board of directors has resolved that all options that will be granted to Israeli residents under the 2003 Plan will be taxable under the "capital gains path." Pursuant to this path the profit realized by the employee is taxed as a capital gain (25%) if the options or shares are held by a trustee for at least 24 months from the end of the tax year in which such options were granted. If the shares are sold before the lapse of said 24 months period, the profit is re-characterized as ordinary income. The company is not allowed a corresponding salary expense, even in the event the profit is taxed as ordinary income. Otherwise, the terms of the 2003 Plan are substantially the same as those of the 1999 Plan.

As of March 27, 2008 options to purchase 1,191,000 ordinary shares were granted. Of such options, 51,168 options have been exercised and 104,166 were cancelled expired or forfeited. 1,035,666 options are outstanding. Options to purchase 872,056 ordinary shares are currently exercisable.

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

#### A. MAJOR SHAREHOLDERS

Mr. Howard Yeung is the beneficial holder of 46% of our outstanding shares, and holds currently exercisable warrants to purchase an additional 1,578,947 of our ordinary shares. Accordingly, Mr. Howard Yeung may be deemed to control our company.

The following table sets forth certain information as of March 27, 2008, regarding the beneficial ownership by all shareholders known to us to own beneficially 5% or more of our ordinary shares:

| NAME<br>-----                 | NUMBER OF<br>ORDINARY SHARES<br>BENEFICIALLY OWNED (1)<br>----- | PERCENTAGE OF<br>OWNERSHIP (2)<br>----- |
|-------------------------------|---|---|
| Howard P.L. Yeung (3) (4) (5) | 5,626,465   | 49.2%                                   |

- (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 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

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shares shown as beneficially owned by them.

- (2) The percentages shown are based on 8,705,788 ordinary shares outstanding as of March 27, 2008.
- (3) Of the 5,626,465 ordinary shares, 450,029 shares are held by Horsham Enterprises Ltd., a corporation incorporated in the British Virgin Islands. Messrs. Howard P.L. Yeung and his brother Kenneth Yeung are the beneficial owners, in equal shares, of Horsham Enterprises Ltd. Accordingly, Messrs. Yeung may be deemed to be the beneficial owners of the ordinary shares held by Horsham Enterprises Ltd.

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- (4) Includes 1,578,947 ordinary shares issuable upon the exercise of currently exercisable warrants issued to Mr. Howard P.L. Yeung.
- (5) The address of Messrs. Howard P.L. Yeung is 2202 Kodak House II, 39 Healthy Street, North Point, Hong Kong.

### SIGNIFICANT CHANGES IN THE OWNERSHIP OF MAJOR SHAREHOLDERS

On January 27, 2005, Bank Leumi le-Israel B.M. filed a Schedule 13G with the Securities and Exchange Commission reflecting ownership of 976,399, or 13.7%, of our ordinary shares. In an amendment to the Schedule 13G filed with the Securities and Exchange Commission on June 6, 2005, Bank Leumi le-Israel B.M. reported ownership of 220,000, or 1.9%, of our ordinary shares.

### MAJOR SHAREHOLDERS VOTING RIGHTS

Our major shareholders do not have different voting rights.

### RECORD HOLDERS

Based on a review of the information provided to us by our transfer agent, as of March 27, 2008, there were 258 holders of record of our ordinary shares, of which 234 record holders holding approximately 64% of our ordinary shares had registered addresses in the United States, including banks, brokers and nominees. 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 banks, brokers or other nominees.

### B. RELATED PARTY TRANSACTIONS

On June 22, 2003 we signed a memorandum of agreement with Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M., or the Banks, which agreement was approved by our shareholders at an extraordinary general meeting of shareholders that was held on July 22, 2003. Pursuant to the agreement that was finalized on September 24, 2003, we restructured \$3,451,000 of our outstanding debt to the Banks. We repaid \$1,100,000 on account of our debt the Banks, and the Banks forgave \$1,100,000 of debt and received warrants to purchase 1,260,665 of our ordinary shares, at an exercise price that is equal to the nominal (par) value of our shares, in lieu of \$1,251,000 of our debt. The Banks also agreed to grant us an additional short-term line of credit of \$500,000 to finance our cash flow requirements during 2003. As part of the agreement, our controlling shareholder, Mr. Yeung, agreed to grant the Banks a put option allowing the Banks to require him to purchase the above warrants for the consideration of \$1,251,000, exercisable within a period of 45 days commencing on March 24, 2005 and the Banks granted Mr. Yeung a call option allowing him to require the Banks, during



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a period of 18 months, commencing as of September 24, 2003, and in the event that the Banks do not exercise their put option, during an additional 90 day period commencing as of May 9, 2005, to sell him such warrants at a price that is not lower than \$1,251,000 and not higher than \$1,770,165, depending upon the average close price of our ordinary shares during the 90 business days prior to such exercise. We also granted the Banks warrants to purchase an additional 366,667 ordinary shares at an exercise price of \$6.00 per share, exercisable for five years, commencing as of September 24, 2003.

In May 2005, Mr. Yeung exercised his call option to purchase the warrants from the Banks and in October 2005 exercised these warrants. Upon such exercise, we issued 1,260,665 ordinary shares to Mr. Yeung.

On December 10, 2007 we entered into a loan agreement with Mr. Yeung. Pursuant to such agreement, in consideration for a loan in the amount of \$3.0 million, we issued \$3.0 million principal amount of convertible notes to Mr. Yeung. The convertible notes will mature on December 10, 2010, bear interest at a rate of six month LIBOR plus 3.5% and are convertible into ordinary shares at a conversion price of \$2.09 per share. In addition, Mr. Yeung received warrants exercisable for a period of five years beginning on December 10, 2007 to purchase up to an aggregate of 1,578,947 ordinary shares at an exercise price of \$2.375 per share.

### C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

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## ITEM 8. FINANCIAL INFORMATION

### A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

#### LEGAL PROCEEDINGS

In December 1998, Mr. Haim Nissenson, our former president and chief executive officer, filed a complaint against us and Mr. Herzle Bodinger, chairman of our Board of Directors and our president, in the Regional Labor Court of Tel Aviv (Case No. 3/4074/98 H. NISSENSON V. RADA ELECTRONIC INDUSTRIES LTD. AND OTHERS), seeking approximately NIS 2.0 million (approximately \$440,000) for salary, vacation and severance payments and other benefits that he is allegedly entitled to pursuant to his retirement agreement with us. In addition, Mr. Nissenson is seeking a permanent injunction and a declarative relief, stating that a personal loan that was provided to him by us had been forgiven. Mr. Nissenson is also asserting that Mr. Bodinger caused the breach of the retirement agreement. In response, we filed a statement of defense claiming, among other things, that (i) the retirement agreement is not valid since it was not approved pursuant to the requirements of the applicable law; (ii) Mr. Nissenson was responsible for our company's precarious financial condition at the time he resigned and for the concealment of these facts from our board of directors and our investors; (iii) during the board of directors meeting in which such agreement was discussed and approved, Mr. Nissenson misrepresented our financial and economic condition and the nature and origins of his debt to us; and (iv) by breaching his fiduciary duties Mr. Nissenson caused us damages in amounts that exceed the amount of the complaint, which damages should be offset from any amounts awarded in favor of Mr. Nissenson, if any. In addition, we asserted that in a certificate dated March 23, 1992, Mr. Nissenson assigned to us all his rights to receive employment related benefits other than salaries, including severance and vacation payments for the period up to the certificate

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date. The hearing of this claim was combined with the hearing of our claim for repayment of the loan granted to Mr. Nissenson, as detailed below. The hearing of testimony in this matter was concluded and the oral summations as well as written responses have been heard and filed. Currently, the cases are pending the judgment of the Labour Court. Our management believes that this claim will not have a material adverse effect on our financial condition or results of operations. In addition, the income tax authorities have demanded that we commence payment of the salary tax due in respect of the retirement arrangements of Mr. Nissenson which are the subject matter of this litigation. An agreement was reached with the tax authority whereby the tax liability will be discharged over several years and that in the event that Mr. Nissenson's claim is dismissed, the tax payment will be recovered.

In September 1999, we filed a suit in the District Court of Tel-Aviv against Messrs. Nissenson and Eles Dubronsky (Civil File 2514/99 RADA ELECTRONIC INDUSTRIES LTD. V. H. NISSENON AND OTHERS) seeking damages in the amount of \$1.4 million. In the complaint, we alleged that Messrs. Nissenson and Dubronsky: (i) represented to our board of directors inaccurate and incomplete information, and (ii) failed to disclose, during the course of our board's deliberations to acquire Jetborne International, Ltd., their personal interest in Jetborne International and Mr. Nissenson's involvement in a previous attempt to gain control of Jetborne International several years earlier. We alleged that our board of directors approved the acquisition based on such inaccurate and incomplete information and that the acquisition caused severe losses. We further alleged that in their conduct Messrs. Nissenson and Dubronsky breached their fiduciary duty owed to us and to our shareholders while acting as an executive and members of our board of directors. Our motion to attach the funds deposited by Mr. Nissenson in his pension funds was denied by the Court in May 2000. The suit is still in its preliminary stages.

In January 2000, Vertical Integration Limited filed a claim against us with the District Court of Tel Aviv (Case No. 1120/00 VERTICAL INTEGRATION LIMITED V. RADA ELECTRONIC INDUSTRIES LTD) for the amount of \$250,000. It was alleged that at the beginning of 1997, they entered into an agreement with us, whereby they were entitled to remuneration in the event that they found an investor for our company. The claim was dismissed by the Court and it was held, *inter alia*, that the witnesses for the plaintiffs were not credible. The plaintiffs appealed to the Supreme Court. The matter was heard in February 2008 and the appeal is pending the resolution of the Supreme Court. We believe that there will be no material exposure or adverse effect on our financial condition as a result of this appeal.

In August 2000, we filed a claim against Mr. Nissenson in the Regional Court for Labor Disputes in Tel Aviv (Case No. 7049/00 RADA ELECTRONIC INDUSTRIES LTD. V. NISSENON.) for the amount of NIS 2.0 million (approximately \$440,000) for the repayment of the loan we granted to Mr. Nissenson that allegedly was forgiven by us in Mr. Nissenson's retirement agreement, as mentioned above. The hearings of both Mr. Nissenson's and our claims in the Regional Court for Labor Disputes were joined and the hearing of the cases was recently concluded. The cases are pending resolution of the Labor Court.

In January 2001, we filed a suit against our former controller, Mr. Mordechai Perera in the Regional Court for Labor Disputes in Tel Aviv (Case No. 1672/01 RADA ELECTRONIC INDUSTRIES LTD. V. PERERA) in the amount of approximately \$260,000 for the repayment of a loan provided to him. While Mr. Perera did not deny that he received such amount, he argued that it was promised to him on account of his compensation and was registered as a loan in the books

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of our company for tax purposes. He further claimed that Mr. Nissenson orally promised him that such loan would be forgiven. In March 2001, Mr. Perera filed a counter claim in the amount of approximately \$520,000 for various payments to which he was allegedly entitled in connection with his employment and termination thereof by us, including bonus, severance payments, vacation redemption and overtime payments. In December 2006 a judgment was delivered by the Court, whereby Mr. Perera's counter-claim was dismissed and our claim was allowed in part, as the Court held that we had waived half of Mr. Perera's debt. We have appealed to the National Labor Court and Mr. Perera also filed an appeal. Both appeals were heard in March 2008. At the hearing we reached a settlement agreement with Mr. Perera according to which his claim was completely dismissed and our claim was allowed almost in full.

In February 2001, we filed a suit against Mr. Dubronsky, in the District Court of Tel Aviv (Civil Case 1158/01 RADA ELECTRONIC INDUSTRIES LTD. V. E. DUBRONSKY) seeking approximately \$250,000. We maintain that Mr. Dubronsky is personally responsible for drafting and executing Mr. Nissenson's retirement agreement and that in such capacity he breached his fiduciary duties to our company and should the Labor Court decide that the retirement agreement is valid and enforceable against us, Mr. Dubronsky has to indemnify us for all the damages caused to us as a result of such Court decision. The District Court has issued a stay of the proceedings pending resolution of the Labor Court proceedings detailed above.

In May 2001, Mr. Nissenson filed a suit against us in the District Court of Tel Aviv (Civil Case 1715/01 H. NISSENSON V. RADA ELECTRONIC INDUSTRIES LTD.) for damages allegedly suffered by him as a result the cancellation of an attachment imposed by us on his pension funds in connection with the previously mentioned Jetborne International litigation. The claim is for NIS 1.0 million (approximately \$220,000). In response, we filed a statement of defense denying all of Mr. Nissenson's allegations.

In May 2001, Mr. David Kenig, a former member of our board of directors, filed a claim against us in the District Court of Tel Aviv (Civil Case 1791/01 KENIG V. RADA ELECTRONIC INDUSTRIES LTD.) seeking a declaration that he is entitled to receive options to purchase 200,000 of our ordinary shares (after the reverse split) under the same terms and conditions as those granted by us to other directors in 1999, and an injunction enforcing us to issue such options to him. Based on legal advice, we believe that the claim has no merits. In July 2001 we filed a counter-claim in the amount of NIS 500,000. In the counter-claim we maintain that Mr. Kenig is personally responsible for executing Mr. Nissenson's retirement agreement and that in such capacity he breached his fiduciary and care duties towards us and should the Labor Court decide that the retirement agreement is valid and enforceable against us, then Mr. Kenig has to indemnify us for all the damages caused to us as a result of such Labor Court decision. The District Court has issued a stay of the hearings pending resolution of the Labor Court proceedings detailed above.

In June 2001, we filed a counter claim (within the framework of the said civil case 1715/01) against Mr. Nissenson, his wife and another former director for damages caused us as a result of transfers of funds to third parties that were made in breach of fiduciary duties owed to us by Mr. Nissenson and the other former director. In addition, we are seeking a declaratory judgment stating that Mrs. Nissenson is liable to us for the repayment of the loan provided to Mr. Nissenson, jointly with Mr. Nissenson. We are also seeking a declaration that the transfer of the title to Mr. Nissenson's house and another apartment to his wife without consideration in the beginning of 1997 are void and were made to avoid the repayment of outstanding loans to us.

In August 2004, Mr. Nissenson filed a suit against us, Mr. Bodinger and our former office holders, Messers. Azancot, Agmon, Ronen Stein, Tropp, Sigal and Ms. Snir, in the Magistrate Court of Tel Aviv (CIVIL CASE 56365/04 NISSENSON V.

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RADA ELECTRONIC INDUSTRIES LTD. AND OTHERS), seeking damages in the amount of NIS 1.0 million (approximately \$220,000) and alleging that the description of the claim filed against him and another former director in connection with the acquisition of our formerly owned subsidiary Jetborne International, Ltd. included in our annual reports on Form 20-F and certain press releases contains defamatory allegations with respect to Mr. Nissenson. We believe that we, Mr. Bodinger and our former office holders have valid defenses against these claims. According to Israeli law, the usual award in defamatory claims is low and does not exceed NIS 500,000 (approximately \$110,000).

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In June 2005, Mr. Nissenson filed a suit in the District Court of Tel Aviv against our chairman, Mr. Bodinger (Civil Case No. 1845/05 H. NISSENSON V. H. BODINGER) seeking damages in an amount of NIS 2.6 million (approximately \$565,000 ). In the complaint, which was filed with the court one day before the expiration of the statute of limitations, Mr. Nissenson alleged that Mr. Bodinger committed fraud against him and negligent misrepresentation towards him, as a result of which he was compelled at the time (June 1998), to retire from his position as the chief executive officer of our company. Mr. Nissenson further alleged that Mr. Bodinger represented to our board of directors that Boeing Corporation would not invest in our company unless Mr. Nissenson retired from his position as the chief executive officer. It is further alleged that as a result, Mr. Nissenson retired from his position, losing income equal to the claimed amount of NIS 2.6 million. In response, we filed a statement of defense, claiming among other things, that no representation whatsoever was made by Mr. Bodinger to the board of directors and that Mr. Nissenson was fully aware, at all times, of all the relevant information regarding the possibility of the investment by Boeing Corporation. We further asserted that the allegation raised by Mr. Nissenson in this claim is inconsistent with his allegation in his claim against us in the Regional Court for Labor Dispute (Case No. 3/4074/98) and that there is no sufficient legal basis for his claim. Our management believes that this claim (in respect of which Mr. Bodinger is entitled to indemnity from us), does not carry any material exposure or adverse effect on our financial condition.

In May 2006, Mr. Nissenson filed a suit in the Magistrates Court of Tel-Aviv against our Board Members, Mr. R. K. C. Chan and Mr. A.H. Berg (C.C. 29334/06 NISSENSON VS. CHAN AND BERG) seeking damages in the amount of NIS. 0.5 Million (approx. \$110,000). In essence, this claim is identical to Mr. Nissenson' claim against us and against our officer holders (C.C. 56365/04 in the Magistrates Court of Tel-Aviv) which is described above. A response has not as yet been submitted on behalf of the defendants, since the issue of the competency of the Court has to be decided first.

In 2006, we filed a suit before an Arbitrator seeking to recover \$444,574 from Parado Technologies Ltd., formerly known as Vectop Ltd. ("Vectop"). On the same day Vectop counterclaimed against us seeking an order that we transfer an amount of \$181,492 to a trust account and to provide Vectop an accounting of sales made during 2006. These claims are related to an agreement made with Vectop in 2005 whereby we purchased certain of Vectop's assets. Under the agreement, Vectop is entitled to receive payments contingent upon sales made by us of Vectop's products. According to the agreement, the first \$200,000 due to Vectop should have been transferred to a trust account for the purpose of indemnifying us for possible future damages. In our claim, we assert that we are entitled to compensation because of misrepresentations made by Vectop during the negotiations, in connection with five of the products sold to us by Vectop. We also allege that Vectop breached the agreement by not providing on time financial statements reconciled to US GAAP. We also asserted that we have a

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right of set-off against payments due to Vectop under the Agreement. Vectop alleges that we are obliged to transfer to the trust account the part of the immediate payment from the sales of the year 2005 and that we can only be indemnified from this trust account under a final award of the Arbitrator. The Arbitrator has ordered that we transfer \$170,000 to the trust account until a final award is delivered and additional \$36,000 is due and payable pursuant to the agreement. The hearing of the case has been concluded and it is now pending the Arbitrator's award. We believe that it is reasonable that part of our claim will be allowed.

In March 2007 David Kenig, a former member of our Board of Directors who resigned from our Board in 1999, commenced an action against us in New York State Supreme Court alleging that we failed to provide him certain stock options to which he was entitled as a result of his service on the Board of Directors in the 1990s. Mr. Kenig alleged in his complaint that he was entitled to recover \$1.8 million from us. We moved to dismiss this complaint on several grounds. In December 2007, the court granted our motion to dismiss the action in its entirety. Mr. Kenig has filed a notice of appeal from the dismissal, but has not yet taken steps to perfect or prosecute that appeal.

From time to time we are involved in legal proceedings arising from the operation of our business. Based on the advice of our legal counsel, management believes such other current proceedings will not have a material adverse effect on our financial position or results of operations.

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### DIVIDEND DISTRIBUTION 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 the 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. In the event cash dividends are declared, such dividends will be paid in NIS.

### B. SIGNIFICANT CHANGES

Since the date of the annual consolidated financial statements included in this annual report, no significant changes have occurred.

### 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 National Market or the NASDAQ Capital Market:

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| YEAR | HIGH    | LOW     |
|------|---------|---------|
| ---- | -----   | -----   |
| 2003 | \$ 6.69 | \$ 1.65 |
| 2004 | 10.32   | 3.42    |
| 2005 | 5.64    | 3.18    |
| 2006 | 3.90    | 1.95    |
| 2007 | 3.00    | 1.95    |

### QUARTERLY STOCK INFORMATION

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

| 2006           | HIGH   | LOW    |
|----------------|--------|--------|
| ----           | -----  | -----  |
| First Quarter  | \$3.90 | \$2.79 |
| Second Quarter | 2.85   | 1.95   |
| Third Quarter  | 3.03   | 2.16   |
| Fourth Quarter | 2.67   | 1.98   |
| <br>           |        |        |
| 2007           | HIGH   | LOW    |
| ----           | -----  | -----  |
| First Quarter  | \$2.15 | \$1.74 |
| Second Quarter | 2.20   | 1.42   |
| Third Quarter  | 2.55   | 1.52   |
| Fourth Quarter | 3.00   | 1.95   |

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### MONTHLY STOCK INFORMATION

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

| 2007                           | HIGH   | LOW    |
|--------------------------------|--------|--------|
| ----                           | -----  | -----  |
| October                        | \$2.15 | \$2.00 |
| November                       | 2.15   | 1.74   |
| December                       | 2.03   | 1.89   |
| <br>                           |        |        |
| 2008                           |        |        |
| January                        | \$2.80 | \$2.06 |
| February                       | 2.18   | 2.07   |
| March (through March 26, 2008) | 2.18   | 1.81   |

#### B. PLAN OF DISTRIBUTION

Not applicable.

#### C. MARKETS

Our ordinary shares traded on the NASDAQ National Market under the symbol "RADIF" from 1985 until June 10, 2002 when the listing of our ordinary shares

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was transferred to the NASDAQ Capital Market. On December 13, 2005, we changed our symbol to "RADI.", which symbol was changed for a 22 business day period to RADID after our reverse split on February 14, 2007. On March 15, 2007, we changed our symbol to "RADA."

### D. SELLING SHAREHOLDERS

Not applicable.

### E. DILUTION

Not applicable.

### F. EXPENSE OF THE ISSUE

Not applicable.

## ITEM 10. ADDITIONAL INFORMATION

### A. SHARE CAPITAL

Not applicable.

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### B. MEMORANDUM AND ARTICLES OF ASSOCIATION

#### PURPOSES AND OBJECTS OF THE COMPANY

We are registered with the Israeli Companies Registry and have been assigned company number 52-003532-3. Section 2 of our memorandum of association provides that we were established for the purpose of engaging in the business of providing services of planning, development, consultation and instruction in the electronics field. In addition, the purpose of our company is to perform various corporate activities permissible under Israeli law.

On February 1, 2000, the Israeli Companies Law came into effect and superseded most of the provisions of the Israeli Companies Ordinance (New Version), 5743-1983, except for certain provisions which relate to liens, bankruptcy, dissolution and liquidation of companies. Under the Israeli Companies Law, as recently amended, various provisions, some of which are detailed below, overrule the current provisions of our articles of association.

#### THE POWERS OF THE DIRECTORS

Under the provisions of the Israeli 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 6A. Directors, Senior Management and Employees - 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, retirement of directors from 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.

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### RIGHTS ATTACHED TO SHARES

Our authorized share capital consists of 16,333,333 ordinary shares of a nominal value of NIS 0.015 each. All outstanding ordinary shares are validly issued, fully paid and non-assessable. The rights attached to the ordinary shares are as follows:

The rights attached to the ordinary shares are as follows:

**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. Our articles of association provide that the declaration of a dividend requires approval by an ordinary resolution of the shareholders, which may decrease but not increase the amount proposed by the board of directors. See "Item 8A. Financial Information - Consolidated and Other Financial Information - Dividend Distribution Policy." If after one year a dividend has been declared and it is still unclaimed, the board of directors is entitled to invest or utilize the unclaimed amount of dividend in any manner to our benefit until it is claimed. We are not obligated to pay interest or linkage differentials on an unclaimed dividend.

**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, such as a resolution for the declaration of dividends, requires approval by the holders of a majority of the voting rights represented at the meeting, in person, by proxy or by written ballot and voting on the matter. Under our articles of association, a special resolution, such as amending our memorandum of association or articles of association, approving any change in capitalization, winding-up, authorization of a class of shares with special rights, or other changes as specified in our articles of association, requires 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 written ballot, and voting on the matter.

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Pursuant to our articles of association, our directors are elected at our annual general meeting of shareholders 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. and hold office until the third next annual general meeting of shareholders and until their successors have been elected. All the members of our Board of Directors (except the outside directors) may be reelected upon completion of their term of office. For information regarding the election of outside directors, see "Item 6C. Directors, Senior Management and Employees - Directors and Senior Management - Board Practices - Election of Directors."

**RIGHTS TO SHARE IN THE COMPANY'S 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



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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.

LIABILITY TO CAPITAL CALLS BY THE COMPANY. Under our memorandum of association and the Israeli Companies Law, the liability of our shareholders is limited to the par value of the shares held by them.

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

### CHANGING RIGHTS ATTACHED TO SHARES

According to our articles of association, in order to change the rights attached to any class of shares, unless otherwise provided by the terms of the class, such change must be adopted by a general meeting of the shareholders and by a separate general meeting of the holders of the affected class with a majority of 75% of the voting power participating in such meeting.

### ANNUAL AND SPECIAL GENERAL MEETINGS

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. Depending on the matter to be voted upon, notice of at least 21 days or 35 days prior to the date of the meeting is required. Our board of directors may, in its discretion, convene additional meetings as "special general meetings." In addition, the board must convene a special general meeting upon the demand of two of the directors, 25% of the nominated directors, one or more shareholders having at least 5% of the outstanding share capital and at least 1% of the voting power in the company, or one or more shareholders having at least 5% of the voting power in the company.

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 one third 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 designate in a notice to the shareholders. At the reconvened meeting, the required quorum consists of any two members present in person or by proxy.

### 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 which 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 board's confirmation that there is no reasonable

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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. Generally, under the Israeli Companies Law, our articles of association are deemed to include a requirement that such merger be approved by a special 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 6A. Directors, Senior Management and Employees - Directors and Senior Management - 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 in a stock exchange outside of Israel, as in the case of our company, to disclose its share ownership.

### CHANGES IN OUR CAPITAL

Changes in our capital are subject to the approval of the shareholders at a general meeting by a special majority of 75% of the votes of shareholders participating and voting in the general 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

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

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

### ISRAELI TAX CONSIDERATIONS

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The following is a summary of the current tax structure applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of the material Israeli tax consequences to purchasers of our ordinary shares and Israeli government programs benefiting us. This summary does not discuss all the aspects of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law. Examples of this kind of investor include residents of Israel or traders in securities who are subject to special tax regimes not covered in this discussion. Since some parts of this discussion are based on new tax legislation that has not yet been subject to judicial or administrative interpretation, we cannot assure you that the appropriate tax authorities or the courts will accept the views expressed in this discussion.

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### GENERAL CORPORATE TAX RATE

Israeli companies are subject to income tax on their worldwide income regardless of the territorial source of such income. The applicable rate for 2007 was 29%. The rate will be further reduced to 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter. Capital gains derived after January 1, 2003 (the gains derived from the sale of listed securities that are taxed at the prevailing corporate tax rates) are subject to tax at a rate of 25%.)

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

The Law for the Encouragement of Industry (Taxes), 1969, generally referred to as the Industry Encouragement Law, provides several tax benefits for industrial companies. We believe that we currently qualify as an "Industrial Company" within the meaning of the Industry Encouragement Law. The Industry Encouragement Law defines "Industrial Company" as a company resident in Israel, of which 90% or more of its income in any tax year, other than of income from defense loans, capital gains, interest and dividend, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is defined as an enterprise whose major activity in a given tax year is industrial production activity.

The following corporate tax benefits, among others, are available to Industrial Companies:

- o Amortization of the cost of purchased know-how and patents and/or right to use a patent and know-how which are used for the development or advancement of the company, over an eight-year period;
- o Accelerated depreciation rates on equipment and buildings;
- o Under specified conditions, the company may elect to file consolidated tax returns with other related Israeli Industrial Companies; and
- o Expenses related to a public offering are deductible in equal amounts over three years.

Eligibility for the benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. We cannot assure that we qualify or will continue to qualify as an "Industrial Company" or that the benefits described above will be available in the future.

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

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Under the Law for the Encouragement of Industrial Research and Development, 1984, research and development programs approved by a governmental committee of the Office of the Chief Scientist are eligible for grants, in exchange for payment of royalties from revenues generated by the products developed in accordance with the program. Once a project is approved, the Office of the Chief Scientist will award grants between 20% to 50% of the project's approved budget, in exchange for royalties at a rate of 3% to 6%, depending on the date of approval of the project, of the proceeds from the sales of the products that are developed from projects funded by the Office of the Chief Scientist. These royalties must be paid beginning with the commencement of sales of those products and ending when 100% of the dollar value of the grant was repaid or, for projects approved after January 1, 1999, the dollar amount of the grant plus interest at the rate LIBOR for dollar deposits in a twelve-month period.

The terms of this Israeli governmental participation also require that the products developed with government grants be manufactured in Israel, unless a special governmental committee, in its discretion consents to manufacturing abroad. In addition, in the event that any of the manufacturing rights are transferred out of Israel, if approved by the special governmental committee, we may be required to pay royalties at a higher rate and be liable to an increased aggregate pay back amount depending on the portion of manufacturing performed outside of Israel, up to a maximum of 300% of the dollar amount of the grant, or of the dollar amount plus interest, as applicable. The technology developed pursuant to the terms of these grants may not be transferred outside of Israel, excluding several exceptions, which will be detailed below, and may be transferred to third parties within Israel only with the prior approval of the governmental committee. This approval is not required for the export of any products resulting from that research development. Approval of the transfer of technology within Israel may be granted only if the recipient abides by all of the provisions of this law and the regulations promulgated thereunder, including the restrictions on the transfer of know-how and the obligation to pay royalties in an amount that may be increased. There can be no assurance that this consent, requested at the time of a future transfer of technology, will be granted.

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In June 2005, an amendment to the Research Law became effective, which amendment was intended to make the Research Law more compatible with the global business environment by, among other things, relaxing restrictions on the transfer of manufacturing rights outside Israel and on the transfer of Office of the Chief Scientist-funded know-how outside of Israel.

The amendment permits the Office of the Chief Scientist, among other things, to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of demanding the recipient to pay increased royalties as described above.

The amendment further permits, under certain circumstances and subject to the Office of the Chief Scientist's prior approval, the transfer outside Israel of know-how that has been funded by Office of the Chief Scientist, generally in the following cases: (a) the grant recipient pays to the Office of the Chief Scientist a portion of the consideration paid for such funded know-how (according to certain formulas), (b) the grant recipient receives know-how from a third party in exchange for its funded know-how, or (c) such transfer of funded know-how arises in connection with certain types of cooperation in research and development activities.

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The Research Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and interested parties to notify the Office of the Chief Scientist of any change in control of the recipient or a change in the holdings of the means of control of the recipient that results in a foreign resident becoming an interested party directly in the recipient.

In addition, the rules of the Office of the Chief Scientist may require prior approval of the Office of the Chief Scientist or additional information or representations in respect of certain of such events. For this purpose, "control" is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. "Means of control" refers to voting rights or the right to appoint directors or the chief executive officer. An "interested party" of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors.

Accordingly, any foreign resident who acquires 5% or more of our ordinary shares will be required to notify the Office of the Chief Scientist that it has become an interested party and to sign an undertaking to comply with the Research Law.

Additionally, procedures regulated under the Research Law require the grant recipient to obtain the approval of the Office of the Chief Scientist prior to a change in the holdings of the recipient or change in the holdings of the means of control of the recipient if the recipient's shares are being issued to a foreign person or entity and require the new foreign party to undertake to the Office of the Chief Scientist to comply with the Research Law.

The funds available for grants from the Office of the Chief Scientist were reduced in 1998, however the Israeli authorities have indicated in the past that the government may increase grants from the Office of the Chief Scientist in the future.

In order to meet certain conditions in connection with the grants and programs of the Office of the Chief Scientist, we have made some representations to the Israeli government about our future plans for our Israeli operations. From time to time the extent of our Israeli operations has differed and may in the future differ, from our representations. If, after receiving grants under certain of such programs, we fail to meet certain conditions to those benefits or if there is any material deviation from the representations made by us to the Israeli government, we could be required to refund to the State of Israel tax or other benefits previously received (including interest and consumer price index linkage difference) and would likely be denied receipt of such grants or benefits, and participation of such programs, thereafter.

### TAXATION UNDER INFLATIONARY CONDITIONS

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

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which are material to us, can be generally described as follows:

- o Where a company's equity, as calculated under the Inflationary Adjustments Law, exceeds the depreciated cost of its fixed assets (as defined in the Inflationary Adjustments Law), a deduction from taxable income is permitted equal to the excess multiplied by the applicable annual rate of inflation. The maximum deduction permitted in any single tax year is 70% of taxable income, with the unused portion permitted to be carried forward, based on the change in the consumer price index. The unused portion that is carried forward may be deducted in full in the following year.
- o If the company's depreciated cost of fixed assets exceeds its equity, then the excess multiplied by the applicable annual rate of inflation is added to the company's ordinary income.
- o Subject to certain limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the change in the consumer price index.

The Minister of Finance may, with the approval of the Knesset Finance Committee, determine by decree, during a certain fiscal year (or until February 28th of the following year) in which the rate of increase of the Israeli consumer price index would not exceed or did not exceed, as applicable, 3%, that some or all of the provisions of the Inflationary Adjustments Law shall not apply with respect to such fiscal year, or, that the rate of increase of the Israeli consumer price index relating to such fiscal year shall be deemed to be 0%, and to make the adjustments required to be made as a result of such determination.

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

Under income tax regulations shareholders that are not Israeli residents are generally exempt from Israeli capital gains tax on any gains derived from the sale, exchange or disposition of our ordinary shares, provided that (1) such shareholders did not acquire their shares prior to first initial public offering on a recognized stock exchange outside of Israel, (2) the provisions of the Income Tax Law (inflationary adjustments), 1985 do not apply to such gain, and (3) such gains did not derive from a permanent establishment or business activity of such shareholders in Israel. However, non-Israeli corporations will not be entitled to the foregoing exemptions if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

Under the U.S.-Israel Tax Treaty, the sale, exchange or disposition of our ordinary shares by a shareholder who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) holding the ordinary shares as a capital asset is exempt from Israeli capital gains tax unless either (i) the shareholder holds, directly or indirectly, shares representing 10% or more of our voting capital during any part of the 12-month period preceding such sale, exchange or disposition or (ii) the capital gains arising from such sale are attributable to a permanent establishment of the shareholder located in Israel.

### TAXATION OF FOREIGN RESIDENT HOLDERS OF SHARES

Non-residents of Israel are generally subject to Israeli income tax on the receipt of dividends paid on our ordinary shares at the rate of 20%, which tax will be withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. With respect to a substantial shareholder, the applicable tax rate is at 25%. Under the U.S.-Israel Tax Treaty, the maximum rate of tax withheld in Israel on dividends

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paid to a holder of our ordinary shares who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) is 25%. However, generally, the maximum rate of withholding tax on dividends, not generated by our Approved Enterprise, that are paid to a U.S. corporation holding 10% or more of our outstanding voting capital throughout the tax year in which the dividend is distributed as well as the previous tax year, is 12.5%.

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A non-resident of Israel who receives dividends from which tax was withheld is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer, and the taxpayer has no other taxable sources of income in Israel.

### FOREIGN EXCHANGE REGULATIONS

Dividends (if any) paid to the holders of our ordinary shares, and any amounts payable with respect to our ordinary shares upon dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of the ordinary shares to an Israeli resident, may be paid in non-Israeli currency or, if paid in Israeli currency, may be converted into freely reparable U.S. dollars at the rate of exchange prevailing at the time of conversion, however, Israeli income tax is required to have been paid or withheld on these amounts.

### CONTROLLED FOREIGN CORPORATION

In general, and subject to the provisions of all relevant legislation, an Israeli resident who holds, directly or indirectly, 10% or more of the rights in a foreign corporation whose shares are not publicly traded, in which more than 50% of the rights are held directly or indirectly by Israeli residents, and a majority of whose income in a tax year is considered passive income (generally referred to as a Controlled Foreign Corporation, or CFC), is liable for tax on the portion of his income attributed to holdings in such corporation, as if such income was distributed to him as a dividend.

### SHARE ALLOCATIONS TO EMPLOYEES

In general, the section of the Tax Ordinance that deals with taxation of share allocations to employees and/or officers (excluding controlling members) provides that a company may choose one of three courses of taxation which course must be approved by the assessing officer: (i) work income course for shares held 12 months in trust; (ii) capital gains course for shares held 24 months in trust; and (iii) allocation not through a trustee. Each of these courses has different tax consequences.

As of January 1, 2006, the periods mentioned in the first two courses commence as of the date of grant and not as of the end of the tax year in which the shares were granted.

### STAMP DUTY

Documents signed after January 1, 2006 are not subject to stamp tax.

### 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

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

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

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

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

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

### TAXATION OF DIVIDENDS

Subject to the discussion below under "Passive Foreign Investment Companies," the gross amount of any distributions received with respect to ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes to the extent of our current and accumulated earnings and profits, as determined under U.S. federal income tax principles. You will be required to include this amount of dividends in gross income as ordinary income. Distributions in excess of our current and accumulated earnings and profits will be treated as a non-taxable return of capital to the extent of your tax basis in the ordinary shares and any amount in excess of your tax basis will be treated as gain from the sale of



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ordinary shares. See "-Disposition of Ordinary Shares" below for the discussion on the taxation of capital gains. Dividends will not qualify for the dividends-received deduction generally available to corporations under Section 243 of the Code.

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

Subject to complex limitations, any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with respect to each such class of income. Dividends generally will be treated as foreign-source passive category income or, in the case of certain U.S. Holders, general category income for United States foreign tax credit purposes. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax, see discussion below. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

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

## DISPOSITION OF ORDINARY SHARES

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

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

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

## PASSIVE FOREIGN INVESTMENT COMPANIES

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

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

If we are treated as a PFIC for any taxable year, dividends would not

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qualify for the reduced maximum tax rate, discussed above, and, unless you elect either to treat your investment in ordinary shares as an investment in a "qualified electing fund" (a "QEF election") or to "mark-to-market" your ordinary shares, as described below:

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

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

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

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

### BACKUP WITHHOLDING AND INFORMATION REPORTING

Payments in respect of ordinary shares may be subject to information reporting to the U.S. Internal Revenue Service and to U.S. backup withholding tax at a rate equal to the fourth lowest income tax rate applicable to

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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.

### U.S. GIFT AND ESTATE TAX

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

### F. 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 United States 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 public accounting firm, and we intend to file reports with the Securities and Exchange Commission on Form 6-K containing unaudited financial information for the first three quarters of each fiscal year.

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: 100 F Street, N.E., Room 1580, Washington, D.C. 20549; and on the Securities and Exchange Commission Internet site (<http://www.sec.gov>) and on our website [www.rada.com](http://www.rada.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

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Exchange Act file number for our Securities and Exchange Commission filings is 0-30198.

The documents concerning our company which are referred to in this annual report may also be inspected at our offices located at 7 Giborei Israel Street, Netanya 42504, Israel.

### I. SUBSIDIARY INFORMATION

Not applicable.

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

#### INTEREST RATE RISK

We currently do not invest in, or otherwise hold, for trading or other purposes, any financial instruments subject to market risk. We pay interest on our credit facilities, convertible notes and short-term loans based on Libor, for dollar-denominated loans, and Israeli prime or adjustment differences to the Israeli consumer price index, for some of our NIS-denominated loans. As a result, changes in the general level of interest rates directly affect the amount of interest payable by us under these facilities. However, we expect our exposure to market risk from changes in interest rates to be minimal and not material. Therefore, no quantitative tabular disclosures are required.

A devaluation of the NIS in relation to the U.S. dollar has the effect of reducing the U.S. dollar amount of any of our expenses or liabilities which are payable in NIS (unless such expenses or payables are linked to the U.S. dollar). As of December 31, 2007, we had liabilities payable in NIS which are not linked to the U.S. dollar in the amount of \$2.6 million and cash and receivables in the amount of \$2.0 million denominated in NIS. Accordingly, an increase of 1% of the NIS against the dollar would increase our financing expenses by approximately \$6,000. A devaluation of 1% of the NIS against the dollar would decrease our financing expenses by the same amount. Neither a ten percent increase nor decrease in current exchange rates would have a material affect on our consolidated financial statements. However, the amount of liabilities payable and/or cash and receivables in NIS is likely to change from time to time.

Because exchange rates between the NIS and the U.S. dollar fluctuate continuously (albeit with a historically declining trend in the value of the NIS), exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in our consolidated financial statements in continuing operations.

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### 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

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None.

### ITEM 15. CONTROLS AND PROCEDURES

#### DISCLOSURE CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports 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 is accumulated and communicated to our chief executive officer and chief financial officer to allow timely decisions regarding required disclosure. Our management, including our chief executive officer and chief financial officer, conducted an evaluation of our disclosure controls and procedures, as defined under 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.

#### MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management, including our chief executive officer and chief financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined under Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the our receipts and expenditures are being made only in accordance with appropriate authorizations; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Our management assessed the effectiveness of our internal control over financial reporting as of the end of the period covered by this annual report. Their assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Based on that assessment, our management concluded that as of December 31, 2007, our company's internal control over financial reporting was effective.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial report. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

#### CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

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There was no change in our internal control over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### ITEM 15T. CONTROLS AND PROCEDURES

Not applicable.

### ITEM 16. RESERVED.

### ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that that Mr. Eli Akavia, one of our outside directors, qualifies as an independent director as this term is defined by the rules of the Securities and Exchange Committee and NASDAQ, and meets the definition of an audit committee financial expert, as defined by rules of the Securities and Exchange Commission. For a brief listing of Mr. Akavia's relevant experience, see Item 6.A. "Directors, Senior Management and Employees -- Directors and Senior Management."

### ITEM 16B. CODE OF ETHICS

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

### ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

#### FEES PAID TO INDEPENDENT PUBLIC ACCOUNTANTS

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

|                    | YEAR ENDED DECEMBER 31 |          |
|--------------------|------------------------|----------|
|                    | 2006                   | 2007     |
| SERVICES RENDERED: |                        |          |
| Audit (1)          | 74,000                 | 70,000   |
| Audit-related (2)  | --                     | --       |
| Total              | \$74,000               | \$70,000 |

- (1) Audit fees consist of services that would normally be provided in connection with statutory and regulatory filings or engagements, including services that generally only the independent registered public accounting firm can reasonably provide, such as services preformed in connection with documents filed with the SEC.
- (2) Audit related fees consist of fees for assurance and related services by the independent registered public accounting firm that are reasonably related to the performance of the audit or review of the registrant financial statements.

## 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 accounting firm, Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global. 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. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the Securities and Exchange Committee, and also requires the Audit Committee to consider whether proposed services are compatible with the independence of the public accountants.

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

Not applicable.

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

## ISSUER PURCHASE OF EQUITY SECURITIES

We did not purchase any of our securities during 2006. On December 10, 2007 we entered into a loan agreement with Mr. Yeung, our controlling shareholder. Pursuant to such agreement, in consideration for a loan in the amount of \$3.0 million, we issued \$3.0 million principal amount of convertible notes to Mr. Yeung. The convertible notes will mature on December 10, 2010, bear interest at a rate of six month LIBOR plus 3.5% and are convertible into ordinary shares at a conversion price of \$2.09. In addition, Mr. Yeung received warrants exercisable for a period of five years beginning on December 10, 2007 to purchase up to an aggregate of 1,578,947 ordinary shares at an exercise price of \$2.375 per share.

The following table sets forth, for each of the months indicated, the total number of shares purchased by Mr. Yeung, the average price paid per share, the number of shares purchased as part of our publicly announced repurchase programs, the maximum number of shares that may yet be purchased under the programs.

| Period in 2007<br>----- | Total Number of<br>Shares Purchased<br>----- | Average Price Paid<br>per Share<br>----- | Total Number of<br>Shares Purchased<br>as Part of<br>Publicly<br>Announced Plans<br>or Programs<br>----- | Approxima<br>Value of S<br>May Yet Be<br>Under the<br>Prog<br>----- |
|-------------------------|--|--|--|---|
| December                | 3,014,354                                    | \$2.24                                   | -  |   |

## PART III.

## ITEM 17. FINANCIAL STATEMENTS

Not applicable.

## ITEM 18. FINANCIAL STATEMENTS



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## CONSOLIDATED FINANCIAL STATEMENTS

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| Consolidated Statements of Cash Flows                   | F-7 |
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## ITEM 19. EXHIBITS

### INDEX TO EXHIBITS

| EXHIBIT | DESCRIPTION   |
|---------|---|
| 1.1     | Memorandum of Association of the Registrant*  |
| 1.2     | Articles of Association of the Registrant*  |
| 2.1     | Specimen of Share Certificate*  |
| 4.3     | 1999 Employee Stock Option Plan, as amended*  |
| 4.4     | 2003 Employee Stock Option Plan, as amended**   |
| 4.8     | Memorandum of Agreement dated June 23 2003 between the Registrant and Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M.**  |
| 8       | List of Subsidiaries of the Registrant  |
| 12.1    | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended   |
| 12.2    | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended   |
| 13.1    | Certification of the Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 13.2    | Certification of the Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 23.1    | Consent of Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global, Independent Registered Public Accounting Firm (Israel) with respect to our Registration Statements on Form F-3 and S-8 |

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\* Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2000 and incorporated herein by reference.

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\*\* Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2002 and incorporated herein by reference.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2007

U.S. DOLLARS IN THOUSANDS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE SHAREHOLDERS OF

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

We have audited the accompanying consolidated balance sheets of Rada Electronic Industries Ltd. ("the Company") and subsidiary as of December 31, 2007 and 2006 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence

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supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and subsidiary as of December 31, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2p to the consolidated financial statements, in 2006 the Company adopted Statement Financial Accounting Standards Board No. 123 (revised 2004), "Share-Based Payment".

Tel-Aviv, Israel  
March 27, 2008

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

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

|   | NOTE  | DECEMBER<br>2007 |
|---|-------|------------------|
|   | ----- | -----            |
| ASSETS  |       |                  |
| CURRENT ASSETS:   |       |                  |
| Cash and cash equivalents   |       | \$ 835           |
| Restricted cash   |       | 598              |
| Trade receivables (net of allowance for doubtful accounts of \$ 62 and \$ 34 at December 31, 2007 and 2006, respectively) |       | 4,907            |
| Other accounts receivable and prepaid expenses  |       | 305              |
| Costs and estimated earnings in excess of billings on uncompleted contracts   | 3a    | 701              |
| Inventories   | 4     | 2,609            |
|   |       | -----            |
| TOTAL current assets  |       | 9,955            |
|   |       | -----            |
| LONG-TERM RECEIVABLES AND DEPOSITS:   |       |                  |
| Long-term receivables   | 5     | 983              |
| Leasing deposits  |       | 57               |
| Severance pay fund  |       | 2,038            |
|   |       | -----            |
| TOTAL long-term receivables and deposits  |       | 3,078            |
|   |       | -----            |

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|                                    |   |          |       |
|------------------------------------|---|----------|-------|
| PROPERTY, PLANT AND EQUIPMENT, NET | 6 | 2,745    | ----- |
| OTHER ASSETS:                      | 7 |          |       |
| Intangible assets, net             |   | 1,414    |       |
| Goodwill                           |   | 214      |       |
| Deferred charges, net              |   | -        | ----- |
| TOTAL other assets                 |   | 1,628    | ----- |
| TOTAL assets                       |   | \$17,406 | ===== |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

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

|   | NOTE  | DECEMBER 31, |       |
|---|-------|--------------|-------|
|   | ----- | 2007         | 2008  |
|   |       | -----        | ----- |
| LIABILITIES AND SHAREHOLDERS' EQUITY  |       |              |       |
| CURRENT LIABILITIES:  |       |              |       |
| Short-term bank credit and current maturities of long-term loans            | 8     | \$ 490       | \$ -  |
| Convertible note  | 11a   | -            | 2     |
| Trade payables  |       | 1,472        | 1     |
| Other accounts payable and accrued expenses                                 | 9     | 3,666        | 3     |
| Deferred revenues   |       | 181          |       |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 3b    | 88           |       |
|   |       | -----        | ----- |
| TOTAL current liabilities   |       | 5,897        | 8     |
|   |       | -----        | ----- |
| LONG-TERM LIABILITIES:  |       |              |       |
| Long-term loan  | 8b    | -            |       |
| Loan from shareholders, net   | 8b    | 261          |       |
| Convertible note from a shareholder, net                                    | 11c   | 1,622        |       |
| Accrued severance pay   |       | 2,442        | 2     |
|   |       | -----        | ----- |
| TOTAL long-term liabilities   |       | 4,325        | 2     |
|   |       | -----        | ----- |
| COMMITMENTS AND CONTINGENT LIABILITIES                                      | 10    |              |       |

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|  |    |           |       |
|--|----|-----------|-------|
| MINORITY INTEREST  |    | 459       |       |
|  |    | -----     | ----- |
| SHAREHOLDERS' EQUITY:                                    | 11 |           |       |
| Share capital -  |    |           |       |
| Ordinary shares of NIS 0.015 par value - Authorized:     |    |           |       |
| 16,333,333 shares at December 31, 2007 and 2006; Issued  |    |           |       |
| and outstanding: 8,705,788 at December 31, 2007 and 2006 |    | 116       |       |
| Additional paid-in capital                               |    | 68,968    | 67    |
| Accumulated deficit                                      |    | (62,359)  | (61   |
|  |    | -----     | ----- |
| TOTAL shareholders' equity                               |    | 6,725     | 6     |
|  |    | -----     | ----- |
| TOTAL liabilities and shareholders' equity               |    | \$ 17,406 | \$ 17 |
|  |    | =====     | ===== |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA

|                                    |       | YEAR ENDED DECEMBER |           |
|------------------------------------|-------|---------------------|-----------|
|                                    | NOTE  | 2007                | 2006      |
|                                    | ----- | -----               | -----     |
| Revenues:                          | 15    |                     |           |
| Products                           |       | \$ 11,704           | \$ 10,984 |
| Services                           |       | 2,317               | 2,053     |
|                                    |       | -----               | -----     |
|                                    |       | 14,021              | 13,037    |
|                                    |       | -----               | -----     |
| Cost of revenues:                  |       |                     |           |
| Products                           |       | 9,501               | 9,517     |
| Services                           |       | 1,180               | 1,482     |
|                                    |       | -----               | -----     |
|                                    |       | 10,681              | 10,999    |
|                                    |       | -----               | -----     |
| Gross profit                       |       | 3,340               | 2,038     |
|                                    |       | -----               | -----     |
| Operating costs and expenses:      |       |                     |           |
| Research and development           |       | 324                 | 181       |
| Marketing and selling              |       | 1,213               | 1,316     |
| General and administrative         |       | 2,190               | 1,794     |
|                                    |       | -----               | -----     |
| TOTAL operating costs and expenses |       | 3,727               | 3,291     |

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|  |    |          |          |
|--|----|----------|----------|
| Operating loss                                       |    | 387      | 1,253    |
| Financial expenses, net                              | 13 | 629      | 775      |
| Other income, net                                    |    | -        | 45       |
|  |    | 1,016    | 1,983    |
| Minority interest in losses (earnings) of subsidiary |    | (62)     | (17)     |
| Net loss   |    | \$ 1,078 | \$ 2,000 |
| Net loss per share:                                  |    |          |          |
| Basic and diluted net loss per share                 |    | \$ 0.12  | \$ 0.23  |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. DOLLARS IN THOUSANDS, EXCEPT SHARE DATA

|  | NUMBER OF<br>ORDINARY<br>SHARES | SHARE<br>CAPITAL | ADDITIONAL<br>PAID-IN<br>CAPITAL |
|--|---------------------------------|------------------|----------------------------------|
| Balance at January 1, 2005                           | 6,793,400                       | \$ 110           | \$ 64,074                        |
| Issuance of Ordinary shares and warrants,<br>net *)  | 321,978                         | 1                | 1,005                            |
| Exercise of warrants, net **)                        | 1,563,688                       | 5                | 1,794                            |
| Exercise of options                                  | 12,889                          | ***)-            | 27                               |
| Net loss   | -                               | -                | -                                |
| Balance at December 31, 2005                         | 8,691,955                       | 116              | 66,900                           |
| Exercise of options                                  | 13,833                          | ***)-            | 28                               |
| Share-based compensation for employees               | -                               | -                | 221                              |
| Issuance expenses related to stamp tax<br>provision  | -                               | -                | 90                               |
| Net loss   | -                               | -                | -                                |
| Balance at December 31, 2006                         | 8,705,788                       | 116              | 67,239                           |
| Share-based compensation for employees               | -                               | -                | 175                              |
| Issuance of warrants                                 | -                               | -                | 986                              |
| Beneficial conversion feature on convertible<br>note | -                               | -                | 568                              |
| Net loss   | -                               | -                | -                                |

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|                              |           |        |           |
|------------------------------|-----------|--------|-----------|
|                              | -----     | -----  | -----     |
| Balance at December 31, 2007 | 8,705,788 | \$ 116 | \$ 68,968 |
|                              | =====     | =====  | =====     |

\*) Net of issuance expenses of approximately \$ 85 for the years ended December 31, 2005.

\*\*\*) Net of issuance expenses of approximately \$ 148.

\*\*\*\*) Represents an amount lower than \$ 1.

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

-----  
U.S. DOLLARS IN THOUSANDS

|  | YEAR ENDED DEC |            |
|--|----------------|------------|
|  | 2007           | 2006       |
|  | -----          | -----      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                |            |
| Net loss   | \$ (1,078)     | \$ (2,000) |
| Adjustments required to reconcile net loss to net cash provided by (used in) operating activities: |                |            |
| Depreciation and amortization  | 1,227          | 1,300      |
| Amortization expense on convertible note   | 142            | 200        |
| Amortization expense on loans  | 37             | 0          |
| Minority interest in earnings (losses) of subsidiary   | 62             | 0          |
| Share-based compensation for employees   | 175            | 200        |
| Severance pay, net   | 2              | 0          |
| Decrease (increase) in trade receivables, net  | (611)          | 600        |
| Decrease (increase) in other accounts receivable and prepaid expenses                              | (105)          | (100)      |
| Decrease (increase) in costs and estimated earnings in excess of billings, net                     | (230)          | 600        |
| Decrease (increase) in inventories   | 104            | (500)      |
| Decrease in trade payables   | (139)          | (100)      |
| Increase (decrease) in other accounts payable and accrued expenses                                 | 199            | 100        |
| Increase (decrease) in deferred revenues   | 97             | 0          |
|  | -----          | -----      |
| Net cash provided by (used in) operating activities  | (118)          | 700        |
|  | -----          | -----      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                |            |
| Cash paid in conjunction with the acquisition of certain assets and liabilities of Vectop, net (a) | -              | 0          |
| Change in restricted cash  | 106            | 300        |
| Purchase of property, plant and equipment  | (353)          | (200)      |
| Decrease (increase) in leasing deposits  | 21             | 0          |

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|   |         |       |       |
|---|---------|-------|-------|
| Loans repaid by employees                                   | -       | ----- | ----- |
| Net cash provided by (used in) investing activities         | (226)   | ----- | ----- |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                |         |       |       |
| Proceeds from issuance of Ordinary shares and warrants, net | -       |       |       |
| Proceeds from issuance of loan and warrants                 | 400     |       |       |
| Proceeds from issuance of convertible loan and warrants     | 3,000   |       |       |
| Proceeds from short-term loans                              | -       |       |       |
| Proceeds from long-term loans                               | -       |       | 2     |
| Proceeds from bridge loan                                   | -       |       | 6     |
| Repayment of bridge loan                                    | -       |       | (6)   |
| Repayments of current maturities of long-term loans         | (306)   |       | (5)   |
| Repayments of long-term convertible note                    | (3,000) |       |       |
| Short-term bank credit, net                                 | 95      |       |       |
| Exercise of warrants, net                                   | -       |       |       |
| Exercise of options   | -       |       |       |
| Net cash provided by (used in) financing activities         | 189     | ----- | (1)   |
| Increase (decrease) in cash and cash equivalents            | (155)   |       | 6     |
| Cash and cash equivalents at the beginning of the year      | 990     | ----- | 3     |
| Cash and cash equivalents at the end of the year            | \$ 835  | ===== | \$ 9  |
| <b>NON-CASH TRANSACTIONS:</b>                               |         |       |       |
| Goodwill in respect of Vectop (royalties payable)           | \$ 48   | ===== | \$ 1  |
| Issuance expenses related to stamp tax provision            | \$ -    | ===== | \$    |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

YEAR ENDED  
DECEMBER 31,  
2005  
-----

(a) CASH PAID IN CONJUNCTION WITH THE ACQUISITION  
OF CERTAIN ASSETS AND LIABILITIES OF VECTOP,  
NET (SEE ALSO NOTE 1D):

|                      |        |
|----------------------|--------|
| Working capital, net | \$ 844 |
| Equipment            | (62)   |



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|                   |          |
|-------------------|----------|
| Intangible assets | (1,263)  |
| Deferred revenues | 130      |
|                   | -----    |
|                   | \$ (351) |
|                   | =====    |

|   | YEAR ENDED DECEMBER 31, |        |        |
|---|-------------------------|--------|--------|
|   | 2007                    | 2006   | 2005   |
|   | -----                   | -----  | -----  |
| (b) SUPPLEMENTAL DISCLOSURES OF CASH FLOW ACTIVITIES: |                         |        |        |
| Net cash paid during the year for:                    |                         |        |        |
| Income taxes  | \$ 15                   | \$ 14  | \$ 3   |
|   | =====                   | =====  | =====  |
| Interest  | \$ 308                  | \$ 307 | \$ 396 |
|   | =====                   | =====  | =====  |
| (c) Non-cash transactions                             |                         |        |        |
| Transfer of equipment to inventory                    | \$ 245                  | \$ -   | \$ -   |
|   | =====                   | =====  | =====  |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 1:- GENERAL

- a. Rada Electronic Industries Ltd. an Israeli corporation ("the Company"), is involved in the military and commercial aerospace industries. The Company is engaged in the development, manufacture and sale of avionics systems (Digital Video Recorders, Ground Debriefing Stations, Stores Management Systems, Flight Data Recorders, Inertial Navigation Systems), Trainers Upgrades, Avionics systems for the UAV market, and Electro optic cameras for airplanes and armored vehicles.
- b. As reflected in the consolidated financial statements as of December 31, 2007, the Company has an accumulated deficit of \$ 62,359. Based on continued financial support from the Company's shareholders, existing and anticipated orders in 2008, management believes that the anticipated cash flows from operations, as well as financial support up to \$1,500 (in the form of long term loans) in 2008 from the Company's controlling shareholder in respect of a new technology developed by the Company, will enable the Company to finance its operations at least through December 31, 2008.
- c. The Company operates a test and repair shop using its Automated Test

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Equipment ("ATE") products in Beijing, China through its 80% owned Chinese subsidiary, Beijing Huari Aircraft Components Maintenance and Services Co. Ltd. ("CACs" or "subsidiary"). CACS was established with a third party, which owns the remaining 20% equity interest.

- d. On February 13, 2005, the Company purchased certain assets and assumed certain liabilities related to the operations of Vectop Limited ("Vectop") in order to increase its customer base. Vectop is an Israeli company specializing in the design, development, marketing and sale of electro-optic equipment and debriefing systems. Vectop's assets also include know-how, patents and intellectual property to produce off-the-shelf products such as cameras and video recorders, which are currently operational onboard aircraft and tanks in Israel and other countries. The Company purchased Vectop's net assets for \$ 381 in cash and additional future royalties based on revenues derived from Vectop projects five years from the date of the agreement up to \$ 500. The net assets purchased are considered to be a business, in accordance with EITF 98-3, "Determining Whether a Non-monetary Transaction Involves Receipt of Productive Assets or Business". The acquisition was accounted for under the purchase method of accounting in accordance with FAS 141, "Business Combinations", and the results of Vectop operations have been included from the acquisition date (February 2005). The purchase price related to the acquisition of Vectop was allocated to the fair market value of tangible and intangible assets acquired and liabilities assumed at the date of acquisition, as detailed below.

|  |               |
|--|---------------|
| Cash and cash equivalents                      | \$ 30         |
| Trade receivables                              | 601           |
| Other current assets                           | 347           |
| Equipment                                      | 62            |
| Customer relationships (five-year useful life) | 1,263         |
|  | -----         |
| <b>TOTAL assets acquired</b>                   | <b>2,303</b>  |
|  | -----         |
| Short-term bank credit and loans               | 933           |
| Trade payables                                 | 810           |
| Other accounts payable and accrued expenses    | 49            |
| Deferred revenues                              | 130           |
|  | -----         |
| <b>TOTAL liabilities assumed</b>               | <b>1,922</b>  |
|  | -----         |
| <b>Net assets acquired</b>                     | <b>\$ 381</b> |
|  | =====         |

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 1:- GENERAL (CONT.)

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Customer relationships were determined by Company's management using the discounted cash flows approach and is being amortized on a straight-line basis over the expected useful life of five years (see also Note 7).

- e. As for major customers, see Note 15.

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are as follows:

- a. Use of estimates:

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

- b. Financial statements in U.S. dollars:

Most of the revenues of the Company are generated in U.S. dollars ("dollar"). In addition, a substantial portion of the costs of the Company is incurred in dollars. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company operates. Thus, their functional and reporting currency is the dollar. The financial statements of the Company's subsidiary are in the local currency.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of the Financial Accounting Standard Board No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All the Company's transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statement of operations as financial income or expenses, as appropriate, in the period in which the currency exchange rate changes. The translation adjustments of the subsidiary are reported as accumulated other comprehensive income (loss) in shareholders' equity. The representative exchange rate at December 31, 2007 was U.S. \$ 1.00 = NIS 3.846, December 31, 2006 was U.S. \$ 1.00 = NIS 4.225 and December 31, 2005 - NIS 4.603.

- c. Basis of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiary. Inter-company transactions and balances have been eliminated upon consolidation.

- d. Cash equivalents and restricted cash:

All highly liquid investments that are readily convertible to cash and are not restricted as to withdrawal or use and the period to maturity of which did not exceed three months at time of deposit, are considered cash equivalents.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

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

Restricted cash is invested in a short-term bank deposit (less than three months), which is mainly used as security for the Company's guarantees to customers. The deposit is in U.S. dollars and bears interest at an average rate of 3.95%.

#### e. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, excess inventories and for market prices lower than cost, See also Note 4.

Cost is determined as follows:

Raw materials and components - using the "first-in, first-out" cost method.

Work in progress and finished goods - represents the cost of manufacturing with the addition of allocable indirect manufacturing costs.

Amounts related to long-term contracts as determined by the percentage of completion method of accounting are recorded as "Costs and estimated earnings in excess of billings."

#### f. Property, plant and equipment:

Property plant and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets. Annual rates of depreciation are as follows:

|                                | %           |
|--------------------------------|-------------|
| Factory and other buildings    | 2.5 - 4     |
| Machinery and equipment        | 10 - 15, 33 |
| Office furniture and equipment | 6 - 15      |

Leasehold improvements are depreciated over the shorter of the estimated useful life or the lease period.

Assets, in respect of which investment grants have been received, are presented at cost less the related grant amount. Depreciation is based on net cost.

#### g. Intangible assets:

Capitalized software costs are amortized by the greater of the amount computed using: (i) the ratio of current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product. The Company assesses

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the recoverability of these intangible assets on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold.

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

At each balance sheet date, the unamortized capitalized costs of the software products are compared to the net realizable value of the product. If the unamortized capitalized costs of a computer software product exceed the net realizable value of the product, such excess is written off. The net realizable value is calculated as the estimated future gross revenues from the product reduced by the estimated future costs of completing and disposing of that product, including the costs of performing maintenance and customer support required to satisfy the Company's responsibility set forth at the time of the sale.

A customer relationships asset (intangible asset) has been recorded as a result of the acquisition of Vectop and is amortized over the expected useful life of five years.

As for impairment charges included in these financial statements, see Note 7.

#### h. Goodwill

Goodwill represents excess of the costs over the net assets of businesses acquired. Under SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), goodwill acquired in a business combination should not be amortized. SFAS No. 142 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required. In 2007 and 2006, the Company recorded goodwill in respect of additional consideration payable in connection with the acquisition of Vectop relating to royalties due based on actual revenues derived from Vectop projects. The Company determines fair value of goodwill using market capitalization and is tested for impairment by comparing the fair market value with its carrying amount. As of December 31, 2007, no impairment losses have been identified.

#### i. Impairment of long-lived assets:

The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to the future undiscounted cash flows expected to be generated by the assets. If

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such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2007, no impairment losses have been identified.

j. Research and development costs:

Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("SFAS No. 86"), requires capitalization of certain software development, costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a working model.

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Research and development costs incurred in the process of developing product masters and the Company's Test System Programs Sets ("TPSS") software library, integrated with the Company's test station, are charged to expenses as incurred.

Costs incurred by the Company between completion of the working model and the point at which the product is ready for general release, have been capitalized.

k. Income taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS 109"). This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax based assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

On January 1, 2007, the Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109" (FIN 48). FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. The adoption of FIN 48 did not

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result in a change in the Company's accumulated deficit.

1. Severance pay:

The Company's liability for severance pay is calculated pursuant to Israel's Severance Pay Law, based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its Israeli employees is partly provided by monthly deposits for insurance policies and/or pension funds and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet. The deposited funds of the Company's employees include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements.

The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance expense recorded in the statement of operations is net of interest and other income accumulated in the deposits. Severance expense for the years ended December 31, 2007, 2006 and 2005 amounted to \$ 21, \$ 43 and \$ 57, respectively.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

m. Fair value of financial instruments:

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

The carrying amount of cash and cash equivalents, restricted cash, trade receivables, short-term bank credit and trade payables approximate their fair value due to the short-term maturity of these instruments.

The fair value of the convertible notes and long-term loans are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. The carrying amount of the convertible notes and long-term loans approximate their fair value.

n. Concentrations of credit risk:

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

The Company's cash and cash equivalents and restricted cash are mainly

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held in U.S. dollars with major banks in Israel. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are derived from sales to large and solid organizations located mainly in the United States, Europe and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to these amounts that the Company has determined to be doubtful of collection. The allowance is computed for specific debts and the collectibility is determined based upon the Company's experience.

The Company granted loans in prior years to its former CEO and a former officer amounting to approximately \$ 983 as of December 31, 2007 and 2006. These loans are partly unsecured and the Company is currently in litigation with these officers regarding such loans (see also Note 10 for subsequent event). If not paid, the Company will incur a loss equal to the amount of the loan, net of a provision recorded against the loan.

The Company has no off-balance sheet credit risks.

o. Warranty:

In connection with the sale of its products, the Company provides product warranties for periods between one to two years. Based on past experience and engineering estimates, the liability from these warranties is immaterial at balance sheet date.

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

p. Share-based compensation:

At December 31, 2007, the Company has three stock-based employee compensation plans, which are described in Note 11b. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of APB 25, "Accounting for Stock Issued to Employees", and related Interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). In general, as the exercise price of options granted under these plans was equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost was recognized in the statements of operations for the years ended December 2005 and 2004.

Effective January 1, 2006, the Company adopted FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), and related Securities and Exchange Commission rules included in Staff Accounting Bulletin No. 107, on a modified prospective basis. Under this method,



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compensation cost recognized in 2006 includes costs related to 1) all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123 and 2) all share-based payments granted subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statements of operations. Results for prior periods have not been restated.

The Company had unvested options granted to employees upon its adoption of SFAS 123(R) on January 1, 2006. The impact of the adoption of SFAS 123(R) on January 1, 2006 was an increase of approximately \$ 75 on the Company's net loss and \$ 0.01 basic and diluted net loss per share for the years ended December 31, 2007 and 2006.

The following table illustrates the effect on net loss and net loss per share, assuming that the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company's stock options plans in 2005, prior to the adoption of SFAS 123(R). For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes-Merton option-pricing model and amortized to expense over the options' vesting periods.

|   | YEAR ENDED<br>DECEMBER 31,<br>2005<br>----- |
|---|---|
| Net loss, as reported   | \$ 2,329                                    |
| Deduct - total stock-based employee compensation expense under fair value based methods | 136<br>-----                                |
| Pro forma net loss  | \$ 2,465<br>=====                           |
|   |   |
| Net loss per share:   |   |
| Basic and diluted net loss per share as reported  | \$ 0.31                                     |
| Pro forma basic and diluted net loss per share  | \$ 0.33                                     |

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

The Company estimates the fair value of stock options on the grant date using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions:

YEAR ENDED DECEMBER 31,

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|                         | 2007    | 2006    | 2005    |
|-------------------------|---------|---------|---------|
| Expected term           | 4 years | 4 years | 4 years |
| Dividend yield          | 0%      | 0%      | 0%      |
| Expected volatility     | 43%     | 54%     | 66%     |
| Risk-free interest rate | 4.7%    | 4.7%    | 4.4%    |
| Estimated forfeitures   | 10-20%  | 10%     | -       |

The risk-free interest rate assumption is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term as of the Company's employee stock options. The dividend yield assumption is based on the Company's historical and expectation of future dividend payouts and may be subject to substantial change in the future. The expected term of the options represents the period of time that the options are expected to be outstanding and is based on the Company's historical information, with respect to employee options exercised. The Company used its historical stock price movement over the most recent periods ended on the date of grant equal to the expected option term for calculating volatility in accordance with SFAS 123 (R). Estimated forfeitures are based on actual historical pre-vesting forfeitures.

q. Revenue recognition:

The Company generates revenues mainly from the development, manufacture and sale of avionics systems, trainers' upgrades, and avionics and electro optic cameras for airplanes and armored vehicles. In addition, the Company leases ATE to customers and provides manufacturing, development and product support services.

PRODUCT REVENUES:

The Company recognizes revenue from sales of products in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition". Product revenue is recognized when there is persuasive evidence of an arrangement, the fee is fixed or determinable, delivery of the product to the customer has occurred and the Company has determined that collection of the fee is probable. If the product requires specific customer acceptance, revenue is deferred until customer acceptance occurs or the acceptance provisions lapse, unless the Company can objectively and reliably demonstrate that the criteria specified in the acceptance provisions are satisfied.

Revenues from long-term fixed price contracts are recognized in accordance with Statement of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" ("SOP 81-1"), using contract accounting on a percentage of completion method in accordance with the "Input Method". The percentage of completion is determined based on the ratio of actual costs incurred to total costs estimated to be incurred over the duration of the contract. With regard to contracts for which a loss is anticipated, a provision is made for the entire amount of the estimated loss at the time such loss becomes evident. As of December 31, 2007, the provision for estimated losses identified is \$ 26.

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit or loss are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

The Company believes that the use of the percentage of completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases, the Company expects to perform its contractual obligations and its licensees are expected to satisfy their obligations under the contract.

According to SOP 81-1, costs that are incurred and are directly associated with a specific anticipated contract are being deferred, subject to evaluation of their probable recoverability, and recorded as unbilled contract costs.

Revenues from certain arrangements may include multiple elements within a single contract. The Company's accounting policy complies with the provisions of Emerging Issues Task Force Issue 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"), relating to the separation of multiple deliverables into individual accounting units with determinable fair value. The Company's arrangements are accounted for as separate units of accounting when it is possible to determine objective and reliable evidence of fair value of the undelivered elements in order to separate the fees among the elements. Revenue is recognized when the element is delivered and all other criteria for revenue recognition are met.

The Company accounts for software sales (TPSs) in accordance with Statement of Position No. 97-2, "Software Revenue Recognition" ("SOP No. 97-2"), as amended. Revenue from software arrangements is recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectability is probable. Arrangements with payment terms extending beyond customary payment terms are considered not to be fixed or determinable. If the fee is considered not to be fixed or determinable, revenue is deferred and recognized when payment becomes due from the customer or are actually collected when collectability is not probable, providing that all other revenue recognition criteria have been met.

#### SERVICE REVENUES:

Revenues from services are recognized as the services are performed.

Revenue under operating leases of equipment are recognized ratably over the lease period, in accordance with Statement of Financial Accounting Standard No. 13, "Accounting for Leases" ("SFAS No. 13").

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Deferred revenues include unearned amounts received from customers, but not yet recognized as revenues.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

r. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year in accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share". For the years ended December 31, 2007, 2006 and 2005, all outstanding options, convertible notes and warrants have been excluded from the computation of diluted net loss per share, since their effect is anti-dilutive.

s. Recently issued Accounting Standards:

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for the Company beginning January 1, 2008. The FASB issues a FASB Staff Position (FSP) to defer the effective date of SFAS No. 157 for one year for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company has not yet determined the effect that the adoption of SFAS No. 157 will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. The provisions of SFAS No. 159 are effective for the Company beginning January 1, 2008. The Company has not yet determined the effect that the adoption of SFAS No. 159 will have on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141R"). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non controlling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141R is effective for fiscal

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years beginning after December 15, 2008. Earlier adoption is prohibited. The Company does not expect the adoption of SFAS 141R will have material impact on its consolidated results of operations and financial condition.

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

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

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51". SFAS No. 160 establishes accounting and reporting standards that require that the ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity; the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; and changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the adoption of SFAS No. 160 will have significant impact on its consolidated financial statement.

#### NOTE 3:- CONTRACTS IN PROGRESS

Amounts included in the financial statements, which relate to costs and estimated earnings in excess of billings on uncompleted contracts are classified as current assets. Billings in excess of costs and estimated earnings on uncompleted contracts are classified as current liabilities. Summarized below are the components of the amounts:

- a. Costs and estimated earnings in excess of billings on uncompleted contracts:

|   | DECEMBER 31, |          |
|---|--------------|----------|
|   | 2007         | 2006     |
| Costs incurred on uncompleted contracts | \$ 5,152     | \$ 6,758 |
| Estimated earnings (expenses)           | 790          | (1,612)  |
|   | 5,942        | 5,146    |
| Less - billings and progress payments   | 5,241        | 4,478    |
|   | \$ 701       | \$ 668   |

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b. Billings in excess of costs and estimated earnings on uncompleted contracts:

|   |          |          |
|---|----------|----------|
| Costs incurred on uncompleted contracts | \$ 1,040 | \$ 3,706 |
| Estimated earnings                      | -        | 2,005    |
|   | -----    | -----    |
|   | 1,040    | 5,711    |
| Less - billings and progress payments   | 1,128    | 5,996    |
|   | -----    | -----    |
|   | \$ (88)  | \$ (285) |
|   | =====    | =====    |

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 4:- INVENTORIES

|                              | DECEMBER 31, |         |
|------------------------------|--------------|---------|
|                              | 2007         | 2006    |
|                              | -----        | -----   |
| Raw materials and components | \$1,349      | \$1,852 |
| Work in progress             | 767          | 523     |
| Finished goods               | 493          | 93      |
|                              | -----        | -----   |
|                              | \$2,609      | \$2,468 |
|                              | =====        | =====   |

Write-offs of inventories for the years ended December 31, 2007, 2006 and 2005 amounted to \$ 134, \$ 29 and \$ 342, respectively. The write-offs in 2007, 2006 and 2005 were due to slow-moving items and excess inventories and were presented as cost of revenues.

NOTE 5:- LONG-TERM RECEIVABLES

|  | DECEMBER 31, |       |
|--|--------------|-------|
|  | 2007         | 2006  |
|  | -----        | ----- |
| Loan to former chief executive officer | \$705        | \$705 |
| Loan to a former officer               | 278          | 278   |
|  | -----        | ----- |
|  | \$983        | \$983 |
|  | =====        | ===== |

See also Note 10a.

NOTE 6:- PROPERTY, PLANT AND EQUIPMENT

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|                                | DECEMBER 31, |          |
|--------------------------------|--------------|----------|
|                                | 2007         | 2006     |
| Cost:                          |              |          |
| Factory building               | \$ 1,940     | \$ 1,940 |
| Other buildings                | 1,042        | 1,042    |
| Machinery and equipment        | 13,332       | 14,001   |
| Office furniture and equipment | 582          | 541      |
| Leasehold improvements         | 25           | 23       |
|                                | -----        | -----    |
|                                | 16,921       | 17,547   |
|                                | -----        | -----    |
| Accumulated depreciation:      |              |          |
| Factory building               | 1,391        | 1,320    |
| Other buildings                | 359          | 310      |
| Machinery and equipment        | 11,977       | 12,140   |
| Office furniture and equipment | 426          | 396      |
| Leasehold improvements         | 23           | 22       |
|                                | -----        | -----    |
|                                | 14,176       | 14,188   |
|                                | -----        | -----    |
| Depreciated cost               | \$ 2,745     | \$ 3,359 |
|                                | =====        | =====    |

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 6:- PROPERTY, PLANT AND EQUIPMENT (CONT.)

The Company's factory building in Beit-She'an, Israel is located on land leased from the Israel Lands Administration until 2034.

Depreciation expense amounted to \$ 722, \$ 808 and \$ 825 for the years ended December 31, 2007, 2006 and 2005, respectively.

As for charges, see Note 10e.

NOTE 7:- INTANGIBLE ASSETS, NET AND GOODWILL

| USEFUL<br>LIFE<br>-----<br>(YEARS) | DECEMBER 31, 2007                    |                                      |                               | DECEMBER 31, 2006                    |                                      |
|------------------------------------|--------------------------------------|--------------------------------------|-------------------------------|--------------------------------------|--------------------------------------|
|                                    | GROSS<br>CARRYING<br>AMOUNT<br>----- | ACCUMULATED<br>AMORTIZATION<br>----- | AMORTIZED<br>BALANCE<br>----- | GROSS<br>CARRYING<br>AMOUNT<br>----- | ACCUMULATED<br>AMORTIZATION<br>----- |
|                                    |                                      |                                      |                               |                                      |                                      |

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|                              |        |         |           |         |         |       |
|------------------------------|--------|---------|-----------|---------|---------|-------|
| Amortized intangible assets: |        |         |           |         |         |       |
| Test System                  |        |         |           |         |         |       |
| Programs Sets                | 5 - 10 | \$8,275 | \$*)7,391 | \$ 884  | \$8,275 | \$*)  |
| Customer relationships       | 5      | 1,263   | 733       | 530     | 1,263   |       |
|                              |        | -----   | -----     | -----   | -----   | ----- |
| Total                        |        | \$9,538 | \$ 8,124  | \$1,414 | \$9,538 | \$    |
|                              |        | =====   | =====     | =====   | =====   | ===== |

\*) Includes impairment charges of \$ 19.

Amortization expense was \$ 492, \$ 544 and \$ 503 for the years ended December 31, 2007, 2006 and 2005, respectively. The expected amortization expense over the next 5 years is approximately as follows:

|      |         |
|------|---------|
| 2008 | \$ 413  |
| 2009 | 413     |
| 2010 | 235     |
| 2011 | 177     |
| 2012 | 176     |
|      | -----   |
|      | \$1,414 |
|      | =====   |

The weighted average useful life of the intangible assets is five years. Impairment of TPSs was \$ 0, \$ 19 and \$ 0 for the years ended December 31, 2007, 2006 and 2005, respectively and included in cost of revenues. The impairment of \$ 19 was recorded in 2006 since the Company does not anticipate future revenues on certain specific TPSs.

In 2007 and 2006, the Company recorded \$ 48 and \$ 166 of goodwill in respect of additional consideration payable in connection with the acquisition of Vectop relating to royalties due based on actual revenues derived from Vectop projects.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 8:- SHORT-TERM BANK CREDIT AND LOANS

a. Short-term bank credit:

|                       |              |       |
|-----------------------|--------------|-------|
|                       | DECEMBER 31, |       |
|                       | -----        | ----- |
|                       | 2007         | 2006  |
|                       | ----         | ----  |
| Bank credit in NIS *) | \$333        | \$238 |
|                       | =====        | ===== |



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- \*) The interest rate at December 31, 2007 is 8.6% (December 31, 2006 - 8.85%).

The revolving line of credit is due in December 2008 and will be renewed on an annual basis.

As for charges, see Note 10e.

b. Long-term loans:

|   | DECEMBER 31, |       |
|---|--------------|-------|
|   | 2007         | 2006  |
|   | ----         | ----  |
| Loan in NIS (1)                           | \$ -         | \$288 |
| Loan in U.S. dollars (2)                  | -            | 175   |
| Loan in U.S. dollars from shareholder (3) | 261          | -     |
|   | ----         | ----  |
|   | \$261        | \$463 |
|   | =====        | ===== |
| <br>Current maturities                    |              |       |
| Loan in NIS (1)                           | \$157        | \$146 |
| Loan in U.S. dollars (2)                  | -            | 175   |
|   | ----         | ----  |
|   | \$157        | \$321 |
|   | =====        | ===== |

- (1) The principal of the loan is due in 21 monthly installments from March 2007 until November 2008 and the interest is payable monthly from February 2007. The interest rate at December 31, 2007 is 8.6%.
- (2) The principal of the loan is due in 15 monthly installments from January 2006 until April 2007 and the interest is payable monthly from March 2005. The interest rate for the period ended December 31, 2007 and as of December 31, 2006 is 5.1%.
- (3) In July 2007, the Company received a loan from shareholders in the amount of \$ 400. The loan bears an annual interest rate of 8%. The loan is due in one installment in June, 2010. See also Note 11(c).

The Company's line of credit (including loans) is \$ 1,466, which all was utilized at December 31, 2007.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 9:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

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|  | DECEMBER 31, |         |
|--|--------------|---------|
|  | 2007         | 2006    |
| Payroll and related accruals                           | \$1,112      | \$ 953  |
| Provision for legal proceedings                        | 617          | 561     |
| Accrued royalties                                      | 911          | 861     |
| Accrued commissions                                    | 254          | 294     |
| Contracts in progress - provision for estimated losses | 26           | 104     |
| Accrued expenses                                       | 582          | 401     |
| Other  | 164          | 245     |
|  | -----        | -----   |
|  | \$3,666      | \$3,419 |
|  | =====        | =====   |

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES

- a. As of December 31, 2007, the Company was a party to various legal proceedings, including the following:

1. In June 1998, the Company's Board accepted the resignation of the Company's former CEO. In December 1998, the former CEO commenced legal proceedings against the Company in the Tel-Aviv Labor Court, claiming approximately \$ 440 in respect of salary, severance pay, vacation pay and other fringe benefits. The former CEO also claimed that a personal loan that was provided to him by the Company had been forgiven and that the Company has to bear the tax in respect thereof. In August 2000, the Company filed in the same Court a lawsuit against the former CEO in the amount of approximately \$ 440 regarding the repayment of the loan provided to him. This claim was joined with the former CEO's claim. In addition, in 2001, the Company filed a claim against a former director claiming that in the event that the former CEO's claim in the Labor Court is accepted by the Court, damages in the amount of \$ 250 should be covered by the former director. In December 2007 and January 2008 - after completion of the testimony - the Tel-Aviv Labor Court heard the parties' oral summations which were followed by written summation in response. The court is expected to give its judgment in both of the claims within the next six months.

In September 1999, the Company filed a lawsuit against the former CEO and the former director with the District Court of Tel-Aviv in the amount of \$ 1,400 for damages caused to the Company in the purchase of a subsidiary and negligence of management. In May 2001, the former CEO filed in the Tel-Aviv District Court an additional claim against the Company, of approximately \$ 220, for damages allegedly caused to him as a result of attachment imposed on certain of his assets by the Company (an attachment that was subsequently cancelled by the Court). The Company filed in the said Court a counter claim against the former CEO and a former director in the amount of \$ 260 for funds that they allegedly transferred from the Company to a third party. All of the claims were joined and transferred to the District Court Central Region.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

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

Management believes, based on the advice of its legal counsel, that the Company has a strong defense against all claims made against it.

2. In 1999 and 2000, the former CEO and his son filed a number of complaints against the Company's president and are seeking damages for alleged slander by him in the amount of approximately \$ 750. The claim by the former CEO was withdrawn and replaced by a new claim filed in 2004, for an amount of NIS 1 million (approximately \$ 260 at December 31, 2007) while his son's claim was dismissed and an appeal to the Supreme Court was withdrawn. Management believes, based on the advice of its legal counsel, that the Company has a strong defense against the allegations and, accordingly, did not record any provision.
3. In 2001, a former employee and officer of the Company filed a claim against the Company with the Tel-Aviv Labor Court claiming approximately \$ 520 in respect of severance pay, vacation pay and other fringe benefits. This claim was filed as a counter-claim to a claim filed by the Company in 2000, in the amount of approximately \$ 260 in respect of the repayment of a personal loan that was provided to the former employee. In December 2006 a judgment was delivered by the Court, whereby the former-employee's counter-claim was dismissed entirely and the Company's claim was allowed in part. Appeals on this judgment were filed by both of the parties with the National Labor Court. In March 2008, a settlement was reached with the former-employee, according to which his counter-claim was dismissed and the Company's claim was allowed almost in its entirety.
4. In 2001, a former director filed a claim against the Company, claiming that he is entitled to 200,000 options (after the reverse split) to purchase Ordinary shares of the Company. Management believes, based on the advice of its legal counsel, that the claim does not have any merit and, accordingly, did not record any provision.
5. In 2000, a claim was filed by an Israeli firm against the Company, claiming that it served as a broker in an agreement signed by the Company and a potential investor and is entitled to commissions (or finder's fee) in the amount of approximately \$ 260. The claim was dismissed by the Court, and the plaintiff appealed to the Supreme Court. Management believes, based on the advice of its legal counsel, that there is no merit to the appeal.
6. In 2005, the former CEO of the Company filed a claim against the Chairman of the Company (in respect of which the Chairman is entitled to indemnification) alleging that the Chairman committed fraud and negligent misrepresentation of him. The former CEO claims that, as a result, he was compelled to retire from his position, resulting in a loss of a salary and benefits in the aggregate amount of approximately \$ 620. Management believes, based on the advice of its legal counsel, that there is no merit to the claim and that the Company has a strong defense against the allegations and, accordingly, did not record any provision.

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

7. In 2006, the former CEO filed a claim against two of the Board members seeking damages in the amount of NIS 0.5 million (approximately \$ 130 at December 31, 2007). In essence, this claim is identical to the claim against the Company and against its Chairman, which is described in 6 above. A response has not as yet been submitted on behalf of the defendants, since the issue of the competency of the Court has to be decided first.
8. In 2006, the Company filed a suit before an arbitrator seeking to recover \$ 445 from Parado Technologies Ltd., formerly known as Vectop Ltd. ("Vectop"). Consequently, Vectop filed a counter claim seeking an order that the Company will transfer an amount of \$ 181 to a trust account with respect to royalties due to Vectop for 2005 and 2006.

In accordance with the agreement with Vectop (see Note 1d), Vectop is entitled to receive payments contingent upon sales made by the Company of Vectop's products. According to the agreement, the first \$ 200 due to Vectop should have been transferred to a trust account for the purpose of indemnifying the Company for possible future damages.

In the claim against Vectop, the Company asserts that it is entitled to compensation because of misrepresentations made by Vectop during the negotiations, in connection with five of the products sold by Vectop. It is alleged that Vectop breached the agreement, by not providing timely financial statements reconciled to U.S. GAAP. The Company asserts that it has a right of off-set against payments due to Vectop under the agreement.

Vectop alleges that the Company is obliged to transfer to the trust account the part of the immediate payment of royalties due from the 2005 sales and that it can only be indemnified from this trust account under a final decision of the arbitrator. The Company believes that there is a possibility that the arbitrator will order the transfer of said amount to the trust account until a final award is made. As for the outcome of the arbitration, management believes, based on the advice of its legal counsel, that the matter is still in its early stages and it is therefore not possible to assess the risk involved in Vectop's claim.

9. The Company is involved periodically in various legal claims in the ordinary course of business, including claims by agents and others for commissions, royalties and others. The Company has provided an amount which it believes is sufficient to cover damages, if any that may result from these claims. The Company's management, based on the advice of its legal counsel, believes that such claims will not have a material adverse effect on the financial position or results of operations of the Company.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

- b. The Company's research and development efforts have been partially financed through royalty-bearing programs sponsored by the Office of the Chief Scientist of Israel's Ministry of Industry, Trade and Labor ("OCS"). In return for the OCS's participation, the Company is committed to pay royalties at a rate ranging from 3% to 5% of sales of the products whose research was supported by grants received from the OCS, up to 100% of the amount of such participation received linked to the U.S. dollar. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales, no payment is required. The Company's total obligation for royalties, net of royalties paid or accrued, totaled approximately \$ 883 as of December 31, 2007. The total amount of royalties charged to operations for the years ended December 31, 2007, 2006 and 2005 was approximately \$ 10, \$ 17 and \$ 27, respectively.
- c. Research and development projects undertaken by the Company were partially financed by the Binational Industrial Research and Development Fund ("BIRD") Foundation. The Company is committed to pay royalties to the BIRD Foundation at a rate of 5% of sales proceeds generating from projects for which the BIRD Foundation provided funding up to 150% of the sum financed by the BIRD Foundation. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales, no payment is required. The Company's total obligation for royalties, net of royalties paid or accrued, totaled approximately \$ 2,064 as of December 31, 2007. The total amount of royalties charged to operations for the years ended December 31, 2007, 2006 and 2005 was approximately \$ 7, \$ 14 and \$ 12, respectively.
- d. The Company's offices in Netanya are rented under a non-cancelable operating lease expiring January 31, 2010. In addition, the Company's motor vehicles are rented under operating leases. Annual minimum future rental commitments under these leases, at exchange rates in effect on December 31, 2007, are approximately as follows:

|      |       |
|------|-------|
| 2008 | \$350 |
| 2009 | 344   |
| 2010 | 126   |
|      | ----  |
|      | \$820 |
|      | ====  |

Lease expense for the years ended December 31, 2007, 2006 and 2005 was \$ 619, \$ 656 and \$ 476, respectively.

- e. Floating charges have been recorded on all of the Company's assets and specific charges have been recorded on certain assets in respect of the Company's liabilities to its banks and other creditors.
- f. The Company provides bank guarantees to its customers and others in the ordinary course of business. The guarantees which are provided to

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customers are to secure advances received at the commencement of a project or to secure performance of operational milestones. The total amount of bank guarantees provided to customers and others as of December 31, 2007 is approximately \$ 816.

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

#### NOTE 11:- SHAREHOLDERS' EQUITY

a. Share capital:

Ordinary shares confer upon their holders voting rights, the right to receive cash dividends and the right to share in excess assets upon liquidation of the Company.

In February 2007, the Company effected a 3 to 1 reverse stock split with respect to its Ordinary shares. All shares, stock options, warrants and net loss per share amounts in these financial statements have been restated for all prior periods to reflect the reverse stock split.

In April 2005, the Company completed a private placement to institutional investors. The Company issued 321,978 Ordinary shares for total proceeds of \$ 1,091 (\$ 1,006 net of issuance expenses) and warrants to purchase up to an aggregate of 625,000 Ordinary shares at an exercise price of \$ 6.30 per share. At the same time, the investors exercised additional investment rights to purchase 303,022 of the Company's Ordinary shares at an exercise price of \$ 6.30 per share, for total amount of \$ 1,909 (\$ 1,761 net of issuance expenses) (see also c. below).

In July 2004, the Company issued 600,000 shares, an aggregate of \$ 3,000 principal amount of convertible notes, additional investment rights to purchase up to an aggregate of 366,667 Ordinary shares at an exercise price of \$ 6.30 per share, (with a term of two years commencing six months following the closing) and warrants to purchase up to an aggregate of 312,500 Ordinary shares at an exercise price of \$ 7.50 per share (for a term of five years commencing six months following the closing) to investors in a private placement for a total consideration of \$ 5,880 (\$ 5,712 net of issuance expenses) (see also c. below).

The consideration was allocated based on the relative fair values of the Ordinary shares, notes, additional investment rights and warrants in accordance with APB No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants" ("APB No. 14"). The convertible notes bear interest at a rate of six-month LIBOR plus 2.5% in quarterly installments. The principal was repaid in July 2007, see also (Note 11(c)) below. In connection with the issuance of the notes, additional investment rights and warrants, \$ 180 was recorded as a beneficial conversion feature in accordance with EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" ("EITF 98-5").

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The total amount of the deemed discount on the notes as a result of the allocated proceeds attributable to the warrants, additional investment rights and the beneficial conversion feature amounting to \$ 760, was amortized over the term of the notes using the interest method. The fair value of the warrants and additional investment rights was based on a valuation prepared using the Black-Scholes-Merton option-pricing model, assuming a risk free interest of 2.64% and 3.69%, respectively, a volatility factor of 0.67 and 0.68, respectively, dividend yield of 0% and contractual life of two years and five years, respectively. In addition, the valuation considered that the warrants and additional investment rights were restricted for the first six months, the warrants were not traded on the market at any time, and the underlying asset had a low marketability. The valuation result was judged to be reasonable by comparison to benchmarks in similar circumstances. The Company's management is responsible for the valuation.

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

#### NOTE 11:- SHAREHOLDERS' EQUITY (CONT.)

Costs incurred with respect to the issuance of the convertible notes of \$ 69 have been recorded as deferred charges and are amortized as financial expenses over the term of the notes using the interest method.

b. Stock option plans:

In 1996, 1999 and 2003, the Company's Board approved the adoption of Employee Stock Option Plans ("the Plans"), which authorized the grant of options to purchase up to an aggregate of 80,000, 346,667 and 1,166,667 Ordinary shares (in 2006 the Company's Board approved an increase in the 2003 plan by an additional 500,000 options), respectively, to officers, directors, consultants and key employees of the Company and its subsidiary. Options granted under the Plans expire within a maximum of ten years from adoption of the plan. One third of the options granted under the Company's Plans vest immediately on the grant date and the remaining two third vests ratably over two years. Compensation expense is recognized by the straight-line method.

The exercise price of an option granted to an employee may not be less than 60% of the fair market value of the Ordinary shares on the date of grant of the option. The exercise price of an option granted to a non-employee director or consultant may not be less than 80% of the fair market value of the Ordinary shares on the date of grant of the option. Any options that are cancelled or forfeited before expiration become available for future grants. At December 31, 2007, 114,966 options were available for grant under the Plans described above. Upon exercise of options by employees, the Company satisfies the requirements by issuing newly issued shares.

Transactions related to the above Plans (including warrants to

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directors) during the year ended December 31, 2007 were as follows:

| YEAR ENDED DECEMBER 31, 2007                     |                      |  |   |                                 |
|--|----------------------|--|---|---------------------------------|
|  | AMOUNT OF<br>OPTIONS | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE | WEIGHTED<br>AVERAGE<br>REMAINING<br>CONTRACTUAL<br>TERM<br>(IN YEARS) | AGGREGATE<br>INTRINSIC<br>VALUE |
|  |                      |  |   |                                 |
| Options outstanding at beginning of year         | 1,057,467            | \$ 3.31                                  | 4.85  |                                 |
| Granted  | 83,333               | \$ 2.91                                  | 5.08  |                                 |
| Forfeited  | (31,867)             | \$ 3.11                                  | 4.80  |                                 |
|  |                      |  |   |                                 |
| Options outstanding at end of year               | 1,108,933            | \$ 3.28                                  | 4.87  | \$ -                            |
|  |                      |  |   |                                 |
| Vested and expected to vest at December 31, 2007 | 1,056,572            | \$ 3.33                                  | 4.86  | \$ -                            |
|  |                      |  |   |                                 |
| Exercisable options at end of year               | 945,322              | \$ 3.42                                  | 4.84  | \$ -                            |
|  |                      |  |   |                                 |

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### RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

#### NOTE 11:- SHAREHOLDERS' EQUITY (CONT.)

Share based compensation for the year ended December 31, 2007 and 2006 was \$175 and \$ 221, respectively. No share-based employee compensation expense was recorded for the year ended December 31, 2005 under APB 25.

The weighted-average grant-date fair value of options granted during the years ended December 31, 2007, 2006 and 2005 was \$ 2.91, \$ 0.34 and \$ 0.55, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on December 31, 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2007. Total intrinsic value of options exercised for the years ended December 31, 2006 and 2005 was \$ 13 and \$ 98, respectively. As of December 31, 2007, there was \$ 79 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a weighted-average period of two years.



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### c. Warrants:

As of December 31, 2007, warrants to purchase 3,020,698 Ordinary shares were outstanding.

On December 10, 2007, in connection with a convertible note in the amount of \$ 3,000 issued to a shareholder, the Company issued warrants to purchase up to an aggregate of 1,578,947 Ordinary shares at an exercise price of \$ 2.38 per share for a term of five years. The convertible notes bear an interest at a rate of six-month LIBOR plus 3.5%. The principal is due in December 2010 and the interest is payable in quarterly installments until December 2010. The notes are convertible to Ordinary shares at a conversion price of 2.09 per share.

The consideration was allocated based on the relative fair values of the convertible loan and warrants in accordance with APB No. 14. In connection with the issuance of the convertible note, \$ 568 was recorded as a beneficial conversion feature in accordance with EITF 98-5. The total amount of the deemed discount on the convertible note as a result of the allocated proceeds attributable to the warrants and the beneficial conversion feature amounting to \$ 1,410, was amortized over the term of the note using the interest method. The fair value of the warrants was based on the Black-Scholes-Merton option-pricing model, assuming a risk free interest of 3.49%, a volatility factor of 47%, dividend yield of 0% and contractual life of five years.

In July 2007, the Company received a loan in the amount of \$ 400 from certain shareholders, See also Note 8(b). These shareholders had warrants to purchase 762,585 Ordinary shares which expired on the same date of the issuance of the loan. In connection with the issuance of the loan the warrants to purchase 606,803 Ordinary shares were extended for a term of three years and repriced to an exercise price of \$ 1.88 per share. Warrants to purchase the remaining 155,782 Ordinary shares were extended for an additional three years. The extended and repriced warrants were accounted for as modification accounting in accordance with FASB 123(R).

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 11:- SHAREHOLDERS' EQUITY (CONT.)

The consideration was allocated based on the relative fair values of the loan and warrants (extended and repriced) in accordance with APB No. 14. The fair value of the warrants was based on the Black-Scholes-Merton option-pricing model, assuming a risk free interest of 5%, a volatility factor of 43%, dividend yield of 0% and contractual life of three years.

The total amount of the deemed discount on the loan of \$ 158, is amortized over the term of the loan using the interest method.

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Subsequent to balance sheet date, the Company repaid \$ 300 of the loan to the shareholders in consideration for 152,765 Ordinary shares.

In July 2004, in connection with the issuance of Ordinary shares and convertible notes described in a. above, the Company granted the investors additional investment rights to purchase up to an aggregate of 366,667 Ordinary shares at an exercise price of \$ 6.30 per share, (with a term of two years commencing six months following the closing) and warrants to purchase up to an aggregate of 312,500 Ordinary shares at an exercise price of \$ 7.50 per share (for a term of five years commencing six months following the closing). In April 2005, 303,022 additional investment rights were exercised.

In April 2005, in connection with the issuance of Ordinary shares described in a. above, the Company granted the purchasers of the Ordinary shares, warrants to purchase up to an aggregate of 625,000 Ordinary shares at \$ 6.30 per share, which expire on the later of (i) 24 months from the date of the grant, and (ii) 24 months from the date of the shareholder approval, ratifying the issuance of the Ordinary shares and the warrants under the Securities Purchase Agreement to the selling shareholders and authorizing the increase of the Company's authorized Ordinary shares from 15,000,000 Ordinary shares to no less than 15,833,333 Ordinary shares.

- d. According to registration rights agreements with various security holders listed under registration statements filed in connection with private placements for issuance of shares, convertible notes and warrants issued, should the Company fail to maintain and file the effectiveness of those registration statements for the periods stated in the respective agreements, the Company risks having imposed on it unlimited liquidated damages as defined in those agreements.

In accordance with EITF 00-19, the warrants are classified as permanent equity. If at any time payment of liquidated damages becomes probable, the Company will recognize a liability, and a charge to expense, for the probable damages in accordance with SFAS No. 5, "Accounting for Contingencies".

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. DOLLARS IN THOUSANDS

NOTE 12:- TAXES ON INCOME

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

Results for tax purposes are measured and adjusted in accordance with the change in the CPI. As explained in Note 2b, the consolidated financial statements are presented in U.S. dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate cause a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on this

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difference between the financial reporting basis and the tax bases of assets and liabilities.

- b. Tax benefits under the Law for the Encouragement of Industry (Taxes), 1969:

The Company is an "Industrial Company" under the Law for the Encouragement of Industry. The principal benefit from the above law is the deduction of expenses in connection with a public offering.

- c. Tax rates applicable to income of companies in Israel:

In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the "Knesset" (Israeli parliament) and on July 25, 2005, another law was passed, the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2005 - 34%, 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

- d. As of December 31, 2007, the net operating tax loss carryforward relating to the Company in Israel amounted to approximately \$ 62,690, including a carryforward capital loss amounting to approximately \$ 3,688. Carryforward losses in Israel may be carried forward indefinitely and may be offset against future taxable income.

As the Company believes that it is more likely than not that the tax assets in respect of these carryforward losses amounting to approximately \$ 16,926 will not be utilized, the Company recorded a valuation allowance for the entire balance of the deferred tax asset relating to the carryforward losses.

- e. The main reconciling items between the statutory tax rate of the Company and the effective tax rate is the valuation allowance recorded in respect of the tax assets relating to net operating loss carryforwards and other temporary differences due to the uncertainty of the realization of such tax assets.

- f. Income (loss) before income taxes:

|          | YEAR ENDED DECEMBER 31, |           |           |
|----------|-------------------------|-----------|-----------|
|          | 2007                    | 2006      | 2005      |
| Domestic | \$(1,386)               | \$(2,085) | \$(2,254) |
| Foreign  | 308                     | 85        | (75)      |
|          | \$(1,078)               | \$(2,000) | \$(2,329) |
|          | =====                   | =====     | =====     |

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U.S. DOLLARS IN THOUSANDS

### NOTE 13:- FINANCIAL EXPENSES, NET

|  | YEAR ENDED DECEMBER 31, |        |        |
|--|-------------------------|--------|--------|
|  | 2007                    | 2006   | 2005   |
| Income:  |                         |        |        |
| Foreign currency exchange differences                          | \$ 26                   | \$ 96  | \$ 164 |
| Interest on cash equivalents and restricted cash               | 105                     | 56     | 20     |
|  | -----                   | -----  | -----  |
|  | 131                     | 152    | 184    |
|  | -----                   | -----  | -----  |
| Expenses:  |                         |        |        |
| Interest on convertible note                                   | 116                     | 231    | 181    |
| Amortization expense on convertible note and deferred expenses | 193                     | 323    | 234    |
| Foreign currency exchange differences                          | 207                     | 240    | 156    |
| Interest on loans and other credit balances                    | 192                     | 35     | 68     |
| Bank commissions   | 52                      | 98     | 100    |
| Others   | -                       | -      | 69     |
|  | -----                   | -----  | -----  |
|  | 760                     | 927    | 808    |
|  | -----                   | -----  | -----  |
|  | \$ 629                  | \$ 775 | \$ 624 |
|  | =====                   | =====  | =====  |

### NOTE 14:- RELATED PARTY TRANSACTIONS

There were no related party balances as of December 31, 2006, and no related party transactions for the years ended December 31, 2006 and 2005. For the year ended December 31, 2007 the Company recognized revenues in the amount of \$ 870 from a related party (a company controlled by the major shareholder).

See also Note 11(c) for transactions with Company's shareholders.

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## RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

### NOTE 15:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

- a. In accordance with Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information", the Company is organized and operates as one business segment, which develops, manufactures and sells ATE products, avionics equipment and aviation data acquisition and debriefing systems (see Note 1a).

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b. Revenues by geographic areas:

Revenues are attributed to geographic area based on the location of the end customers as follows:

|               | YEAR ENDED DECEMBER 31, |          |          |
|---------------|-------------------------|----------|----------|
|               | 2007                    | 2006     | 2005     |
|               | -----                   | -----    | -----    |
| North America | \$ 3,403                | \$ 4,666 | \$ 5,096 |
| Europe        | 1,792                   | 792      | 586      |
| Israel        | 5,479                   | 4,265    | 5,546    |
| Others        | 3,347                   | 3,314    | 2,193    |
|               | -----                   | -----    | -----    |
| Total         | \$14,021                | \$13,037 | \$13,421 |
|               | =====                   | =====    | =====    |

c. Major customers:

Revenues from single customers that exceed 10% of the total revenues in the reported years as a percentage of total revenues are as follows:

|            | YEAR ENDED DECEMBER 31, |       |       |
|------------|-------------------------|-------|-------|
|            | 2007                    | 2006  | 2005  |
|            | -----                   | ----- | ----- |
|            | %                       |       |       |
|            | -----                   | ----- | ----- |
| Customer A | *)                      | *)    | 12    |
| Customer B | 17                      | 20    | 14    |
| Customer C | 17                      | 38    | 21    |
| Customer D | *)                      | *)    | 12    |
| Customer E | 10                      | *)    | *)    |
| Customer F | 14                      | *)    | *)    |

\*) Less than 10%.

d. Long-lived assets by geographic areas:

|        | DECEMBER 31, |         |
|--------|--------------|---------|
|        | 2007         | 2006    |
|        | -----        | -----   |
| Israel | \$3,207      | \$4,518 |
| China  | 1,166        | 926     |
|        | -----        | -----   |
|        | \$4,373      | \$5,444 |
|        | =====        | =====   |

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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.

RADA ELECTRONIC INDUSTRIES LTD.

By: /s/ Zvika Alon

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Zvika Alon

Chief Executive Officer

Dated: March 27, 2008