

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2009

U.S. DOLLARS IN THOUSANDS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors 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, 2009 and 2008 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, 2009. 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 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, 2009 and 2008, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel
March 25, 2010

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

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2009	2008
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 987	\$ 964
Restricted cash	760	793
Trade receivables (net of allowance for doubtful accounts of \$ 78 and \$ 60 at December 31, 2009 and 2008, respectively)	4,675	3,434
Other accounts receivable and prepaid expenses	604	597
Costs and estimated earnings in excess of billings on uncompleted contracts	1,291	2,210
Inventories	5,685	4,409
<u>Total current assets</u>	14,002	12,407
LONG-TERM RECEIVABLES AND DEPOSITS	602	209
PROPERTY, PLANT AND EQUIPMENT, NET	3,268	3,699
OTHER ASSETS:		
Intangible assets, net	530	972
Goodwill	587	557
<u>Total other assets</u>	1,117	1,529
<u>Total assets</u>	\$ 18,989	\$ 17,844

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

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

	December 31,	
	2009	2008
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term loans	\$ 184	\$ 162
Trade payables	2,590	2,760
Convertible note from a shareholder, net	2,482	-
Other accounts payable and accrued expenses	3,458	3,210
Billings in excess of costs and estimated earnings on uncompleted contracts	515	43
	9,229	6,175
LONG-TERM LIABILITIES:		
Long-term bank loan	-	33
Loans from shareholders, net	1,410	1,546
Convertible note from a shareholder, net	-	1,980
Accrued severance pay and other long term liability	489	558
	1,899	4,117
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 0.015 par value - Authorized: 16,333,333 shares at December 31, 2009 and 2008; Issued and outstanding: 8,868,857 and 8,858,553 shares at December 31, 2009 and December 31, 2008, respectively	119	119
Additional paid-in capital	69,578	69,495
Accumulated other comprehensive income	316	317
Accumulated deficit	(62,722)	(62,935)
	7,291	6,996
Total RADA Electronic Industries shareholders' equity	7,291	6,996
Non-controlling interests	570	556
	7,861	7,552
Total equity	7,861	7,552
Total liabilities and equity	\$ 18,989	\$ 17,844

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

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands, except per share data

	Year ended December 31,		
	2009	2008	2007
Revenues:			
Products	\$ 16,010	\$ 15,543	\$ 11,704
Services	2,432	2,338	2,317
	<u>18,442</u>	<u>17,881</u>	<u>14,021</u>
Cost of revenues:			
Products	11,291	12,472	9,501
Services	1,140	1,214	1,180
	<u>12,431</u>	<u>13,686</u>	<u>10,681</u>
Gross profit	<u>6,011</u>	<u>4,195</u>	<u>3,340</u>
Operating costs and expenses:			
Research and development	1,616	686	324
Marketing and selling	1,399	1,496	1,213
General and administrative	1,937	1,837	2,190
<u>Total operating costs and expenses</u>	<u>4,952</u>	<u>4,019</u>	<u>3,727</u>
Operating profit (loss)	1,059	176	(387)
Financial expenses, net	832	734	629
Net income (loss)	227	(558)	(1,016)
Net income attributable to noncontrolling interest	(14)	(18)	(62)
Net income (loss) attributable to RADA Electronic Industries shareholders	<u>\$ 213</u>	<u>\$ (576)</u>	<u>\$ (1,078)</u>
Net income (loss) per share:			
Basic and diluted net income (loss) per share attributable to RADA Electronic Industries shareholders	<u>\$ 0.02</u>	<u>\$ (0.07)</u>	<u>\$ (0.12)</u>
Weighted average number of Ordinary shares used for computing basic and diluted net income (loss) per share	<u>8,862,544</u>	<u>8,855,205</u>	<u>8,705,788</u>

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

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

	Number of Ordinary shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income (loss)	Accumulated deficit	Non controlling interest (**)	Total equity
Balance at January 1, 2007	8,705,788	\$ 116	\$ 67,239	\$ -	\$ (61,281)	\$ 397	\$ 6,471
Share-based compensation for employees	-	-	175	-	-	-	175
Issuance of warrants	-	-	986	-	-	-	986
Beneficial conversion feature on convertible note	-	-	568	-	-	-	568
Net loss	-	-	-	-	(1,078)	62	(1,016)
Balance at December 31, 2007	8,705,788	116	68,968	-	(62,359)	459	7,184
Share-based compensation for employees	-	-	131	-	-	-	131
Conversion of loan into shares	152,765	3	396	-	-	-	399
Foreign currency translation adjustment, net	-	-	-	317	-	79	396
Net loss	-	-	-	-	(576)	18	(558)
Balance at December 31, 2008	8,858,553	119	69,495	317	(62,935)	556	7,552
Share-based compensation for employees	-	-	62	-	-	-	62
Exercise of options	5,304	*)	12	-	-	-	12
Exercise of warrants	5,000	*)	9	-	-	-	9
Foreign currency translation adjustment, net	-	-	-	(1)	-	-	(1)
Net income	-	-	-	-	213	14	227
Balance at December 31, 2009	8,868,857	\$ 119	\$ 69,578	\$ 316	\$ (62,722)	\$ 570	\$ 7,861

*) Represents an amount lower than \$ 1.

**) Effective January 1, 2009, the Company reclassified noncontrolling interest in the equity.

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

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2009	2008	2007
<u>Cash flows from operating activities:</u>			
Net income (loss)	\$ 213	\$ (576)	\$ (1,078)
Non-controlling interests in earnings of subsidiary	14	97	62
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,176	1,154	1,227
Amortization expense on a convertible note	502	358	142
Amortization expense on loans	15	114	37
Loss due to extinguishment of a loan	-	100	-
Share-based compensation for employees	62	131	175
Severance pay, net	(25)	35	2
Decrease (increase) in trade receivables, net	(1,241)	1,502	(611)
Increase in other accounts receivable and prepaid expenses	(30)	(250)	(105)
Decrease (increase) in costs and estimated earnings in excess of billings, net	854	(1,554)	(230)
Decrease (increase) in inventories	(1,315)	(2,214)	104
Increase (decrease) in trade payables	(170)	950	(139)
Increase (decrease) in other accounts payable and accrued expenses	267	(163)	296
Net cash provided by (used in) operating activities	<u>322</u>	<u>(316)</u>	<u>(118)</u>
<u>Cash flows from investing activities:</u>			
Cash paid in conjunction with the acquisition of certain assets and liabilities of Vectop, net	(93)	(235)	-
Change in restricted cash	33	(195)	106
Purchase of property, plant and equipment	(261)	(498)	(353)
Increase (decrease) in long-term receivables and deposits	(9)	1	21
Net cash used in investing activities	<u>(330)</u>	<u>(927)</u>	<u>(226)</u>
<u>Cash flows from financing activities:</u>			
Proceeds from long-term loan from a shareholder	-	1,500	-
Proceeds from long-term receivables	173	158	-
Proceeds from issuance of loan and warrants	-	-	400
Proceeds from issuance of convertible loan and warrants	-	-	3,000
Proceeds from long-term loans from banks, net	-	165	-
Repayments of current maturities of long-term loans	(132)	(157)	(306)
Repayments of long-term convertible note	-	-	(3,000)
Repayment of long term loan from a shareholder	(30)	-	-
Short-term bank credit, net	-	(333)	95
Exercise of options and warrants	21	-	-
Net cash provided by financing activities	<u>32</u>	<u>1,333</u>	<u>189</u>
Effect of exchange rate changes on cash and cash equivalents	(1)	39	-
Increase (decrease) in cash and cash equivalents	23	129	(155)
Cash and cash equivalents at the beginning of the year	<u>964</u>	<u>835</u>	<u>990</u>
Cash and cash equivalents at the end of the year	<u>\$ 987</u>	<u>\$ 964</u>	<u>\$ 835</u>

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

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2009	2008	2007
(b) <u>Supplemental disclosures of cash flow activities:</u>			
Net cash paid during the year for:			
Income taxes	\$ 9	\$ 22	\$ 15
Interest	\$ 240	\$ 216	\$ 308
(c) Non-cash transactions			
Transfer of inventory to equipment	\$ -	\$ 429	\$ 245
Goodwill in respect of Vectop (royalties payable)	\$ 30	\$ 93	\$ 48
Purchase of fixed assets	\$ -	\$ 486	\$ -
Conversion of loan into shares	\$ -	\$ 399	\$ -

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 1:- GENERAL

- a. Rada Electronic Industries Ltd. ("the Company"), is an Israeli corporation involved in the military and commercial aerospace industries. The Company is engaged in the development, manufacture and sale of defense electronics: Data Recording & Management, Inertial Navigation Systems, UAV Avionics and avionics solutions and their supporting ground systems (automated testers, data debriefing stations). The Company also provides test and repair services using its CATS testers and test program sets for commercial aviation electronic systems mainly through its Chinese subsidiary.
- b. As reflected in the consolidated financial statements as of December 31, 2009, the Company has an accumulated deficit of \$ 62,722. Based on continued financial support from the Company's shareholders and existing and anticipated orders in 2010, management believes that the anticipated cash flows from operations, as well as financial support from the Company's controlling shareholders, will enable the Company to finance its operations at least through December 31, 2010.
- c. The Company operates a test and repair shop using its Automated Test 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.

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 amounts reported 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, its functional and reporting currency is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with ASC 830 (originally issued as "SFAS 52"). All 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The financial statements of the Company's foreign subsidiary, whose functional currency is not the U.S. dollar, have been translated into dollars. All balance sheet amounts have been translated using the exchange rates in effect at balance sheet date. Statement of operation amounts have been translated using the average exchange rate prevailing during the year. Such translation adjustments are reported as a component of accumulated other comprehensive income (loss) in shareholders' equity.

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. Reclassifications:

Certain amounts in prior years' financial statements have been reclassified to conform to the current year's presentation.

e. Cash and cash equivalents:

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.

f. Restricted cash:

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 a variable interest of up to 1%.

g. 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 FIFO cost method.

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

Costs incurred on long-term contracts in progress include direct labor, material, subcontractors, other direct costs and an allocation of overheads, which represent recoverable costs incurred for production.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

h. 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	4
Machinery and equipment	7 - 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.

i. 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 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.

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 being amortized over the expected useful life of five years. See also Note 7.

No impairment charges were recorded for the years ended December 31, 2009, 2008 and 2007.

j. Impairment of long-lived assets:

The Company's long-lived assets are reviewed for impairment in accordance with ASC 360 ("Formerly 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 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, 2009, no impairment losses have been identified.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Goodwill

Goodwill represents excess of the costs over the net assets of businesses acquired. Under ASC 350 (Formerly "SFAS No. 142"), goodwill acquired in a business combination should not be amortized. ASC 350 requires goodwill to be tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired. In 2009 and 2008, 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 operates in one segment, and this segment comprises its only reporting unit, as required under ASC 350.

ASC 350 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment while the second phase (if necessary) measures impairment. In the first phase of impairment testing, goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. The Company determines its fair value according to the Company's market capitalization and the goodwill was tested for impairment by comparing the fair market value with its carrying amount. As of December 31, 2009, no impairment losses have been identified. As a result, step two was not required.

l. Research and development costs:

Research and development costs, net of participation grants, include costs incurred for independent research and development and are expensed as incurred.

The Company received royalty-bearing grants, from the Israeli Chief Scientist's Office ("OCS") for the purpose of partially funding research and development projects. The grants are recognized as a deduction from research and development costs or capitalized costs on the basis of costs incurred. See also note 10(b).

Statement of ASC 985 (Formerly "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.

Research and development costs incurred in the process of developing product masters and the Company's Test System Programs Sets ("TPS") 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 has been capitalized.

m. Income taxes:

The Company accounts for income taxes in accordance with ASC 740 (Formerly "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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

On January 1, 2007, the Company adopted ASC 740-10 (Formerly "FIN 48"). ASC 740-10 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with ASC 740. 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 ASC 740-10 did not result in a change in the Company's accumulated deficit. The Company did not record any provision in connection with ASC 740-10 as of December 31, 2008 and 2009.

n. Severance pay:

The Company's agreements with most of its employees are in accordance with section 14 of the Severance Pay Law -1963, under which the Company's contributions for severance pay shall be instead of severance compensation. Upon release of the policy to the employee, no additional liability exists between the parties regarding the matter of severance pay and no additional payments shall be made by the Company to the employee.

The Company's liability for severance pay for the employees that are not under section 14 is calculated pursuant to Israel's Severance Pay Law, based on the most recent salary of the employees as of the balance sheet date less monthly deposits for insurance policies and/or pension funds. Employees are entitled to one month's salary for each year of employment or a portion thereof.

The carrying value of deposited funds includes profits (losses) accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligations pursuant to Israeli severance pay law or labor agreements.

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, 2009, 2008 and 2007 amounted to \$ 433, \$ 505 and \$ 313, respectively.

o. Fair value of financial instruments:

The carrying amount of cash and cash equivalents, restricted cash, trade receivables, other accounts receivable, current maturities of long term loans, trade payables and other accounts payable approximate their fair value due to the short-term maturity of these instruments.

The fair value of the convertible note 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 note and long-term loans approximate their fair value.

Effective January 1, 2008, the Company adopted ASC 820 (Formerly "SFAS 157").

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ASC 820 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

- Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - Include other inputs that are directly or indirectly observable in the marketplace.
- Level 3 - Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The adoption of ASC 820 did not result in a change in the Company's accumulated deficit. The Company did not record any provision in connection with ASC 820 as of December 31, 2008 and 2009.

p. 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 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, low, 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, Asia 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 collectability is determined based upon the Company's experience.

The Company has no off-balance sheet credit risks.

q. Comprehensive income (loss):

The Company accounts for comprehensive income (loss) in accordance with ASC 220 (Formerly "SFAS No. 130"). This statement establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income (loss) generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, stockholders. The other comprehensive income (loss) relates to gain and loss on foreign currency translation adjustments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

r. 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 as of December 31, 2008 and 2009.

s. Share-based compensation:

At December 31, 2009, the Company has one stock-based employee compensation plan, which is described in Note 11b.

The Company accounts for stock-based compensation under ASC 718, "Compensation – Stock Compensation", (formerly SFAS No. 123(R)), which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors.

ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. 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 statements of operations.

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. No options were granted in 2009:

	<u>Year ended December 31,</u>	
	<u>2008</u>	<u>2007</u>
Expected term	3 years	4 years
Dividend yield	0%	0%
Expected volatility	53%	43%
Risk-free interest rate	2.7%	4.7%

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 changes 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 simplified method, as allowed under ASC 718-10, which is the midpoint between the vesting dates and end of the contractual of the option. 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 ASC 718. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

t. Revenue recognition:

The Company generates revenues mainly from the sale of products and from long-term fixed price contracts of defense electronics: Data Recording & Management, Inertial Navigation Systems, UAV Avionics and avionics solutions and their supporting ground systems. In addition, the Company leases ATE to customers and provides manufacturing, development and product support services.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands**

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)*Product revenues:*

The Company recognizes revenue from sales of products in accordance with ASC 605-10 "Revenue Recognition" (Formerly "Staff Accounting Bulletin ("SAB") No. 104"). 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 which provide a substantial level of development efforts are recognized in accordance with ASC 605-35 (Formerly "Statement of Position No. 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, 2009 and 2008, the provision for estimated losses identified is \$ 170 and \$ 106, respectively.

Revenues under long-term fixed-price contracts that involve both development and production are recorded using the cost-to-cost method (development phase) and units-of-delivery method (production phase) as applicable to each phase of the contract, as the basis to measure progress toward completion.

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 customers are expected to satisfy their obligations under the contract.

Revenues from certain arrangements may include multiple elements within a single contract. The Company's accounting policy complies with the provisions of ASC 605-25 (Formerly "Emerging Issues Task Force Issue 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Service revenues:

Revenues from services are recognized as the services are performed.

Revenue under operating leases of equipment is recognized ratably over the lease period, in accordance with ASC 840 (Formerly "SFAS No. 13").

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

u. Basic and diluted net income (loss) per share:

Basic net income (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net income (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 ASC 260 (Formerly "SFAS No. 128"). For the year ended December 31, 2009, 2008 and 2007, all the outstanding options, convertible note and warrants have been excluded from the computation of diluted net loss per share, since their effect is anti-dilutive.

v. Derivatives and hedging:

The Company accounts for derivatives and hedging based on ASC 815 ("SFAS No. 133"), as amended and related Interpretations. ASC 815 requires the Company to recognize all derivatives on the balances sheet at fair value. If a derivative meets the definition of a hedge and is so designated, depending on the nature of the hedge, changes in the fair value of the derivative will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings (for cash flow hedge transactions) or recognized in other comprehensive income until the hedged item is recognized in earnings (for fair value hedge transactions).

The ineffective portion of a derivative's change in fair value is recognized in earnings. If a derivative does not meet the definition of a hedge, the changes in the fair value are included in earnings. Cash flows related to such hedges are classified as operating activities.

The Company enters into forward exchange contracts in order to limit the exposure to exchange rate fluctuation associated with payroll expenses mainly incurred in NIS. Any gain or loss derived from such instruments, which are not defined as hedging instruments, is recognized immediately as financial expenses, net.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

As of December 31, 2009, the fair value of the outstanding forward contracts is \$ 14 which was recorded in other liabilities against financial expenses.

w. Recently issued Accounting Standards:

In June 2009, the FASB issued ASU No. 2009-01, Topic 105 — Generally Accepted Accounting Principles amendments based upon Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles — a replacement of FASB Statement 162 ("ASU 2009-01"). ASU 2009-01 establishes the FASB ASC as the single source of authoritative accounting principles to be applied to financial statements of nongovernmental entities in conformity with U.S. GAAP. ASU 2009-01 was effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company's adoption of ASU 2009-01 did not affect its consolidated results of operations or financial condition.

In October 2009, the FASB issued an update to ASC 605-25, "Revenue recognition – Multiple-Element Arrangements", that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

Require an entity to allocate revenue in an arrangement using estimated selling prices ("ESP") of deliverables if a vendor does not have vendor-specific objective evidence of selling price ("VSOE") or third-party evidence of selling price ("TPE"); and
- Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.
- Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. The Company is currently evaluating the impact on its consolidated results of operations and financial condition.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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,	
	2009	2008
Costs incurred on uncompleted contracts, net(*)	\$ 9,290	\$ 6,036
Estimated earnings (loss)	(157)	732
	9,133	6,768
Less - billings and progress payments	7,305	4,558
Costs and estimated earnings in excess of billings on uncompleted contracts	1,828	2,210
Less: Long-term portion	(537)	-
Current portion	\$ 1,291	\$ 2,210

(*) Net of OCS grants in the amount of \$382 (see Note 10b)

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

Costs incurred on uncompleted contracts	\$ 1,996	\$ 835
Estimated earnings (loss)	1,066	(118)
	3,062	717
Less - billings and progress payments	3,577	760
	\$ (515)	\$ (43)

NOTE 4:- INVENTORIES

Raw materials and components	\$ 2,449	\$ 2,320
Work in progress	2,831	1,933
Finished goods	405	156
	\$ 5,685	\$ 4,409

Write-offs of inventories for the years ended December 31, 2009, 2008 and 2007 amounted to \$ 310, \$ 191 and \$ 134, respectively. The write-offs were due to slow-moving items and excess inventories and were recorded as cost of revenues.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5:- LONG –TERM RECEIVABLES AND DEPOSITS

	December 31,	
	2009	2008
Costs and estimated earnings in excess of billings on uncompleted contracts (see also Note 3)	\$ 537	\$ -
Long term receivable to former officers, net (see also Note 10a)	-	153
Leasing deposits	65	56
	\$ 602	\$ 209

NOTE 6:- PROPERTY, PLANT AND EQUIPMENT

Cost:		
Factory building	\$ 1,988	\$ 1,987
Other buildings	1,226	1,222
Machinery and equipment (*)	10,525	11,959
Office furniture and equipment	366	342
Leasehold improvements	50	50
	14,155	15,560
Accumulated depreciation:		
Factory building	1,500	1,419
Other buildings	466	414
Machinery and equipment (*)	8,650	9,789
Office furniture and equipment	244	215
Leasehold improvements	27	24
	10,887	11,861
Depreciated cost	\$ 3,268	\$ 3,699

(*) Write-offs of machinery and equipment (cost and accumulated depreciation) for the year ended December 31, 2009 and 2008 amounted to a gross amount of \$ 1,816 and \$ 3,063, net of depreciated cost of \$ 0. The write-offs in 2009 and 2008 were due to fully depreciated assets that are no longer in use.

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 \$ 734, \$ 712 and \$ 722 for the years ended December 31, 2009, 2008 and 2007, respectively.

As for charges, see Note 10f.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 7:- OTHER ASSETS

a. Intangible assets, net:

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. 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. 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.

	December 31, 2009			December 31, 2008			
	Useful life (Years)	Gross carrying amount	Accumulated amortization	Amortized balance	Gross carrying amount	Accumulated amortization	Amortized balance
Amortized intangible assets:							
Test Systems Programs Sets ("TPS")	5 - 10	\$ 8,275	\$ 7,745	\$ 530	\$ 8,275	\$ 7,568	\$ 707
Customer relationships	5	1,263	1,263	-	1,263	998	265
Total		<u>\$ 9,538</u>	<u>\$ 9,008</u>	<u>\$ 530</u>	<u>\$ 9,538</u>	<u>\$ 8,566</u>	<u>\$ 972</u>

Amortization expense was \$ 442, \$ 442 and \$ 492 for the years ended December 31, 2009, 2008 and 2007, respectively. The expected amortization expense over the next four years is approximately as follows:

2010	\$ 177
2011	177
2012	176
	<u>\$ 530</u>

The weighted average useful life of the intangible assets is five years. No impairment of TPSs was recorded in 2009, 2008 and 2007.

b. Goodwill:

In 2009 and 2008, the Company recorded \$ 30 and \$ 343, respectively, 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 8:- LOANS

a. Current maturities

	December 31,	
	2009	2008
Loan from bank in NIS (1)	\$ 33	\$ 132
Loan in U.S. dollars from shareholder, net (2)	91	-
Loan in U.S. dollars from shareholder (3)	60	30
	\$ 184	\$ 162

b. Long-term loans:

Loan from bank in NIS (1)	\$ -	\$ 33
Loan in U.S. dollars from shareholder, net (2)	-	76
Loan in U.S. dollars from shareholder (3)	1,410	1,470
	\$ 1,410	\$ 1,579

- (1) In March 2008, the Company received a loan from the bank in the amount of approximately \$260. The principal of the loan is due in 24 monthly installments from March 2008 until March 2010. The interest rate at December 31, 2009 and 2008 was 5.35% and 6.1% respectively.
- (2) 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. In January 2008, the shareholders entered into an agreement with the Company whereby \$ 300 of the loan was converted into shares. The conversion of the loan was treated as an extinguishment of debt in accordance with ASC470-50 (Formerly "EITF 96-19" and "EITF 06-6"). See also Note 11(c).
- (3) In July 2008, the Company entered into a \$ 1.5 million loan agreement with its controlling shareholder. The loan was provided mainly in order to facilitate the development of the Company's inertial navigation systems technology ("INS Technology"). The loan was drawn down in July (\$1.0 million) and in December 2008 (\$ 0.5 million). The loan bears interest of 3% + LIBOR payable at the beginning of every quarter. Principal payments equal to \$ 90 are payable in six equal installments commencing July 1, 2009 on a quarterly basis and the remaining principal amount will be payable in eight equal installments, commencing April 1, 2011. In addition, the controlling shareholder received a non-exclusive license to sell the INS Technology for non-military/commercial purposes. The non-exclusive license granted under this agreement will automatically convert into an exclusive license should the Company default on any of its obligations under the loan agreement. The fair value of the non-exclusive license at the transaction date is deemed de minimus.

The Company's line of credit from the bank (including guarantees and loans) is \$ 2,750, from which \$ 2,450 was utilized at December 31, 2009. See also Note 10(g).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2009	2008
Payroll and related accruals	\$ 1,404	\$ 1,239
Accrued expenses	664	660
Accrued royalties	450	794
Accrued commissions	254	254
Tax authorities	287	-
Deferred revenues	102	36
Contracts in progress - provision for estimated losses	170	106
Others	127	121
	\$ 3,458	\$ 3,210

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES

a. As of December 31, 2009, the Company was a party to various legal proceedings, including the following:

1. Since 1998 the Company was engaged in litigation with Mr. Haim Nissenson, its former president and chief executive officer in connection with payments that were allegedly due to him in connection with his employment with the Company and the termination thereof (Case No. 3/4074/98 H. Nissenson v. RADA Electronic Industries Ltd. and others, in the Regional Labor Court in Tel Aviv). In addition, Mr. Nissenson also sought a permanent injunction and declarative relief, stating that a personal loan that was provided to him by the Company had been forgiven.

In August 2000, the Company filed a claim against Mr. Nissenson in the Regional Labor Court in Tel Aviv (Case No. 7049/00 RADA Electronic Industries Ltd. v. Nissenson.) for the repayment of the loan granted to Mr. Nissenson in the amount of NIS 2.0 million that allegedly was forgiven by the Company in Mr. Nissenson's retirement agreement, as mentioned above. In February 2009, the Regional Labor Court determined that Mr., Nissenson is required to repay the \$ 485 of loans he received from the Company together with accrued interest and linkage differences as provided by law. The Regional Court also denied all of Mr. Nissenson's claims and allegations against Mr. Herzle Bodinger, the current Chairman of the Board of Directors of the Company, as well as substantially all of Mr. Nissenson's claims against the Company. The Regional Court found that the retirement agreement between the Company and Mr. Nissenson is null and void since it was not legally approved, tainted with misleading information provided by Mr. Nissenson and included provisions that were not properly approved by the Company's Board of Directors. Mr. Nissenson appealed to the National Labor Court in Jerusalem and on January 2010, the National Court approved the arrangement between the parties according to which the judgment of the Regional Labor Court remains in full force and effect. In addition, based on the authorization given to the National Labor Court by the parties to rule by way of settlement, the National Court has determined that the Company shall pay Mr. Nissenson, on account of social benefits due to him in connection with his employment as our CEO, a gross amount of 760,000 NIS (\$ 201).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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

The Company and Mr. Nissenson reached an agreement with respect to the repayment of the loan pursuant to which 600,000 NIS (\$159) was paid in December 2009, additional 300,000 NIS (\$80) will be paid until May 1, 2010 and the remaining balance will be paid in 50 equal, consecutive monthly installments commencing on January 15, 2010. The amounts due to Mr. Nissenson in accordance with the judgment of the National Labor Court will be paid to him proportionately to these installments. The decision of the National Labor Court brought to an end the dispute between Mr. H. Nissenson and the Company and any proceeding connected thereto.

2. 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.

- b. The Company's research and development efforts have been partially financed through royalty-bearing programs sponsored by the 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 \$ 410 as of December 31, 2009. The total amount of royalties charged to operations for the years ended December 31, 2009, 2008 and 2007 was approximately \$ 14, \$ 13 and \$ 10, 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 \$ 2,066 as of December 31, 2009. The total amount of royalties charged to operations for the years ended December 31, 2009, 2008 and 2007 was approximately \$ 0, \$ 0 and \$ 7, respectively.

- d. The Company's offices in Netanya are rented under a non-cancelable operating lease expiring January 31, 2012. 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, 2009, are approximately as follows:

2010	\$	842
2011		695
2012		145
		145
		\$ 1,682

Lease expense for the years ended December 31, 2009, 2008 and 2007 was \$ 796, \$ 719 and \$ 619, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

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

- e. During 2008, the Company entered in to a lease agreement to purchase a machine in the amount of approximately \$ 224, which was accounted for as a capital lease under ASC 840(Formerly "SFAS 13"). The total amount of the lease liability was \$ 104 and \$ 147 as of December 31, 2009 and 2008 respectively.
- f. 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.
- g. The Company provides bank guarantees to its customers and others in the ordinary course of business. The guarantees which are provided to 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, 2009 is approximately \$ 2,417.

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 January 2008, the Company repaid \$ 300 of the \$ 400 loan received in June 2007 in consideration for 152,765 Ordinary shares (see also Note 8).

- b. Stock option plans:

In 1999 and 2003, the Company's Board approved the adoption of Israeli Employee Stock Option Plans ("the Plans"), which authorized the grant of options to purchase up to an aggregate of 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 thirds vest 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, 2009, 340,832 options were available for grant under the 2003 Israeli Stock Option Plan. Upon exercise of options by employees, the Company satisfies the requirements by issuing newly issued shares.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

In May 2008, the Company granted under the 2003 Israeli Stock Option Plan to four of its directors options to purchase a total of 261,000 ordinary shares for an exercise price of \$ 2.14 per share in exchange for 258,000 options that were granted to those directors in 2003 for an exercise price of \$ 4.02 per share and additional 3,000 new options. Those new options granted were fully vested and there was no compensation expense related to those options. The options will vest as follows: 25% of the options granted to each of our directors will vest on January 1, 2009, additional 40% shall vest in four equal installments of 10% each on the last date of each calendar quarter commencing on March 31, 2009 and the balance of 35% shall vest in two equal installments of 17.5% each on March 31, 2010 and June 30, 2010, respectively.

The Company accounted for the exchange of options under the provisions of ASC 718 (Formerly "SFAS 123(R)") as a modification. A modification to the terms of an award should be treated as an exchange of the original award for a new award with total compensation cost equal to the grant-date fair value of the original award plus the incremental value measured at the same date. Under ASC 718, the calculation of the incremental value is based on the excess of the fair value of the (modified) award based on current circumstances over the fair value of the original option measured immediately before its terms are modified based on current circumstances. That is, the original (pre-modification) option will be valued based on current assumptions, without regard to the assumptions made on the grant date. As a result of the modification, the Company will record incremental compensation cost of \$ 123 to be recognized over the new service period beginning on the modification date. In 2009 and 2008, \$ 45 and \$ 48 were recorded, respectively, due to this modification.

Transactions related to the above Plans (including warrants to directors) during the year ended December 31, 2009 were as follows:

	Year ended December 31, 2009			
	Amount of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Options outstanding at beginning of year	877,266	\$ 2.86	3.83	\$ -
Exercised	(5,304)	\$ 2.15	3.07	
Expired	(62,600)	\$ 8.19	-	
Forfeited	(40,000)	\$ 2.74	2.56	
Options outstanding at end of year	<u>769,362</u>	<u>\$ 2.44</u>	<u>3.07</u>	<u>\$ 41,463</u>
Vested and expected to vest at December 31, 2009	<u>769,362</u>	<u>\$ 2.44</u>	<u>3.07</u>	<u>\$ 41,463</u>
Exercisable options at end of year	<u>678,013</u>	<u>\$ 2.48</u>	<u>3.07</u>	<u>\$ 33,242</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**U.S. dollars in thousands****NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)**

Share based compensation for the years ended December 31, 2009, 2008 and 2007 was \$ 62, \$ 131 and \$ 175 respectively.

The weighted-average grant-date fair value of options granted during the years ended December 31, 2008 and 2007 was \$ 0.81 and \$ 2.91, respectively. No options were granted in 2009. 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, 2009 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, 2009. As of December 31, 2009, 281,983 options were in-the-money. As of December 31, 2009 and 2008, there was \$ 31 and \$ 93, respectively 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 in 2010.

c. Warrants:

As of December 31, 2009, warrants to purchase 2,649,032 Ordinary shares were outstanding.

On December 10, 2007, in connection with the issuance of convertible note in the amount of \$ 3,000 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 note bears interest at a rate of six-month LIBOR plus 3.5%. The principal is due in October 2010 and the interest is payable in quarterly installments until October 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 ASC 470 (Formerly "APB No. 14"). In connection with the issuance of the convertible note, \$ 568 was recorded as a beneficial conversion feature in accordance with ASC 470-20 (Formerly "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. As of December 31, 2009, the net deemed discount is \$ 530.

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 re-priced warrants were accounted for as modification accounting in accordance with ASC 718.

The consideration was allocated based on the relative fair values of the loan and warrants (extended and repriced) in accordance with ASC 470. 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

The total amount of the deemed discount on the loan of \$ 158, is amortized over the term of the loan using the interest method. In January 2008, the shareholders entered in to an agreement with the Company in order to convert \$ 300 of the loan into shares. As of December 31, 2009, the net deemed discount is \$ 9. (See also Note 11a).

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 ASC 740 (Formerly "SFAS No. 109"), the Company has not provided deferred income taxes on this 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: 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26% and 2010 - 25%.

- d. Reduction in Israeli tax rates (cont.):

During July 2009, an additional reduction to the corporate tax rate was approved in the Israeli parliament ("the Knesset"), according to it the corporate tax rate is scheduled to decrease as follows: 24% - 2011, 23% - 2012, 22% - 2013, 21% - 2014, 20% - 2015 and 18% - 2016 tax year and thereafter.

- e. As of December 31, 2009, the net operating tax loss carryforward relating to the Company in Israel amounted to approximately \$ 61,105, including a carryforward capital loss amounting to approximately \$ 3,516. 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 deferred tax assets in respect of these carryforward losses amounting to approximately \$ 14,400 will not be utilized, the Company recorded a valuation allowance for the entire balance of the deferred tax asset relating to the carryforward losses.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME (Cont.)

- f. 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 deferred tax assets relating to net operating loss carryforwards and other temporary differences due to the uncertainty of the realization of such tax assets.
- g. Income (loss) before income taxes:

	Year ended December 31,		
	2009	2008	2007
Domestic	\$ 140	\$ (647)	\$ (1,386)
Foreign	73	71	308
	\$ 213	\$ (576)	\$ (1,078)

NOTE 13:- FINANCIAL EXPENSES, NET

Income:			
Foreign currency exchange differences	\$ 58	\$ 190	\$ 26
Interest on cash equivalents and restricted cash	9	63	105
Others	10	-	-
	77	253	131
Expenses:			
Interest on convertible note and loans from shareholders	215	246	269
Amortization expense on a convertible note and loans from shareholders	517	473	193
Loss due to extinguishment of a loan	-	100	-
Foreign currency exchange differences	63	-	207
Interest on loans from banks and other credit balances	22	37	39
Bank commissions	92	131	52
	909	987	760
	\$ 832	\$ 734	\$ 629

NOTE 14:- RELATED PARTY TRANSACTIONS

- a. For the year ended December 31, 2009, the Company incurred \$ 215 in respect of interest on loans received from its shareholders.
- b. 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 Notes 8b (3), 10(a) and 11(c) for transactions with Company's shareholders.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

- a. In accordance with Statement of ASC 280 (Formerly "FAS. 131"), 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 also Note 1a).

- 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,		
	2009	2008	2007
Israel	\$ 6,461	\$ 8,032	\$ 5,654
Asia	4,435	5,642	2,980
North America	3,756	3,662	4,519
South & Latin America	3,208	244	192
Europe	582	301	676
	\$ 18,442	\$ 17,881	\$ 14,021

- 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,		
	2009	2008	2007
	%		
Customer A	6	15	*)
Customer B	12	11	17
Customer C	12	16	17
Customer D	*)	*)	10
Customer E	15	29	14
Customer F	11	*)	-

*) Less than 10%

- d. Long-lived assets by geographic areas:

	December 31,	
	2009	2008
Israel	\$ 3,615	\$ 4,353
China	770	875
	\$ 4,385	\$ 5,228
