

ELTEK LTD  
Form 20-F  
April 28, 2008

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UNITED STATES  
**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 0-28884

**ELTEK LTD.**

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

**Israel**

(Jurisdiction of incorporation or organization)

**4 Drezner Street, Sgoola Industrial Zone, P.O. Box 159, Petach Tikva 49101, Israel**

(Address of principal executive offices)

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

Title of each class

Name of each exchange on which registered

Commission file number 0-28884

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Ordinary Shares, NIS 0.6 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:

**6,609,807 Ordinary Shares, par value NIS 0.6 per share (as of December 31, 2007)**

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

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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.

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 Annual Report on Form 20-F is incorporated by reference into our Registration Statement on Form S-8, File No. 333-123559.

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**INTRODUCTION**

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

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For periods prior to December 31, 2006, our consolidated financial statements were prepared in New Israeli Shekels, or NIS, and in accordance with generally accepted accounting principles in Israel with a reconciliation to generally accepted accounting principles in the United States, or U.S. GAAP. Effective as of January 1, 2007, our consolidated financial statements appearing in this annual report are prepared in accordance with U.S. GAAP and our reporting currency is U.S. dollars. Our functional currency continues to be NIS. The consolidated financial statements for all prior periods presented have been restated and are presented in accordance with U.S. GAAP. See Notes 1B and 1C to the consolidated financial statements. The consolidated financial statements appearing in this annual report are translated into U.S. dollars at the representative rate of exchange under the current rate method. Under such method, the income statement and cash flow statement items for each year (or period) stated in this report are translated into U.S. dollars using the average exchange rates in effect at each period presented, and assets and liabilities are translated using the exchange rate as of December 31, 2007 (\$1.00= NIS 3.846, as published by the Bank of Israel), except for equity accounts, which are translated using the rates in effect at the date of the transactions. All resulting exchange differences that do not affect our earnings are reported in the accumulated other comprehensive income as a separate component of shareholders' equity.

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 registration statement or annual report that we previously filed, you may read the document itself for a complete description 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, 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 and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3.D. Key Information- Risk Factors.

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**PART I**

**ITEM 1.      IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION****A. SELECTED FINANCIAL DATA**

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

Effective as of January 1, 2007, our consolidated financial statements appearing in this annual report are prepared in accordance with U.S. GAAP and our reporting currency is U.S. dollars. Our functional currency continues to be NIS. The consolidated financial statements for all prior periods presented have been restated and are presented in accordance with U.S. GAAP. See Notes 1B and 1C to the consolidated financial statements.

The selected consolidated financial data as of December 31, 2006 and 2007 and for each of the three years ended December 31, 2005, 2006 and 2007 have been prepared in accordance with U.S. GAAP, and are derived from our audited consolidated financial statements and accompanying notes included in Item 18, Financial Statements. The selected consolidated financial data as of December 31, 2003, 2004 and 2005 and for each of the two years ended December 31, 2003 and 2004 have been prepared in accordance with Israeli GAAP, which were reconciled to U.S. GAAP for presentation purposes in the following table to conform to the presentation of the subsequent years, and have been derived from our previously published audited consolidated financial statements, which are not included in this annual report. You should read the selected consolidated financial data set forth below together with Item 5. Operating and Financial Review and Prospects as well as our consolidated financial statements and accompanying notes appearing elsewhere in this annual report.

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**STATEMENT OF CONSOLIDATED OPERATIONS DATA:**

|  | Year Ended December 31,                  |                     |           |           |           |
|--|--|---------------------|-----------|-----------|-----------|
|  | 2003 <sup>(1)</sup>                      | 2004 <sup>(1)</sup> | 2005      | 2006      | 2007      |
|  | (\$ in thousands, except per share data) |                     |           |           |           |
| Revenues   | \$ 24,108                                | \$ 27,913           | \$ 32,177 | \$ 39,045 | \$ 37,476 |
| Cost of revenues   | (22,504)                                 | (24,269)            | (25,638)  | (30,557)  | (31,879)  |
| Gross profit   | 1,604                                    | 3,644               | 6,539     | 8,488     | 5,597     |
| Research and development income (expenses), net                              | 4  | --                  | (144)     | (154)     | (74)      |
| Selling, general and administrative expenses                                 | (3,319)                                  | (4,096)             | (4,409)   | (5,580)   | (5,683)   |
| Impairment loss on goodwill  | --                                       | --                  | --        | (473)     | --        |
| Operating profit (loss)  | (1,711)                                  | (452)               | 1,986     | 2,281     | (160)     |
| Financial expenses, net  | (516)                                    | (658)               | (592)     | (538)     | (145)     |
| Profit (loss) before other income (expenses), net                            | (2,227)                                  | (1,110)             | 1,394     | 1,743     | (305)     |
| Other income (expenses), net   | (3)                                      | 11                  | 23        | 5         | 8         |
| Profit (loss) before tax benefit (income tax expenses) and minority interest | (2,230)                                  | (1,099)             | 1,417     | 1,748     | (297)     |
| Income tax benefit (expense)   | (43)                                     | 159                 | --        | (158)     | --        |
| Profit (loss) before minority interest                                       | (2,273)                                  | (940)               | 1,417     | 1,590     | (297)     |

**STATEMENT OF CONSOLIDATED OPERATIONS DATA:**

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|   | Year Ended December 31, |        |       |       |        |
|---|-------------------------|--------|-------|-------|--------|
|   | 26                      | 41     | 49    | 60    | (4)    |
| Minority interest   |                         |        |       |       | (4)    |
| Net profit (loss)   | (2,247)                 | (899)  | 1,466 | 1,650 | (301)  |
| Basic net earnings (loss) per ordinary share  | (0.46)                  | (0.16) | 0.26  | 0.29  | (0.05) |
| Diluted net earnings (loss) per ordinary share  | (0.46)                  | (0.16) | 0.22  | 0.24  | (0.05) |
| Weighted average number of ordinary shares used to compute basic net earnings (loss) per ordinary share   | 4,886                   | 5,478  | 5,575 | 5,617 | 6,247  |
| Weighted average number of ordinary shares used to compute diluted net earnings (loss) per ordinary share | 4,886                   | 5,478  | 6,785 | 6,954 | 6,247  |

(1) Reconciled to U.S. GAAP to conform with subsequent years presentation, see Notes 1B and 1C to the consolidated financial statements.

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**CONSOLIDATED BALANCE SHEETS DATA:**

|  | As at December 31,  |                     |                     |        |        |
|--|---------------------|---------------------|---------------------|--------|--------|
|  | 2003 <sup>(1)</sup> | 2004 <sup>(1)</sup> | 2005 <sup>(1)</sup> | 2006   | 2007   |
|  | (\$ in thousands)   |                     |                     |        |        |
| Working capital (deficit)                          | (2,311)             | (2,542)             | (983)               | 1,689  | 733    |
| Total assets                                       | 20,465              | 19,381              | 20,012              | 24,108 | 29,182 |
| Long-term liabilities excluding current maturities | 3,994               | 2,477               | 2,635               | 4,255  | 5,631  |
| Shareholders' equity                               | 4,004               | 3,481               | 4,978               | 7,285  | 8,074  |

(1) Reconciled to U.S. GAAP to conform with subsequent years presentation, see Notes 1B and 1C to the consolidated financial statements.

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**B. CAPITALIZATION AND INDEBTEDNESS**

Not applicable.

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

**CONSOLIDATED BALANCE SHEETS DATA:**

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 Relating to Our Business and Market**

*We have had a history of operating losses and we may not be able to sustain profitable operations.*

In 2007 and in each year during the three-year period ended December 31, 2004, we incurred operating losses, and we may not be able to achieve and sustain profitable operations in the future. Even if we return to profitability, we cannot assure that our future net income will offset our cumulative losses. To the extent that we incur operating losses in the future, we may not have sufficient working capital to fund our operations. If we do not generate sufficient cash from operations, we will be required to obtain additional financing or reduce our level of expenditure. Such financing may not be available in the future, or, if available, may not be on terms favorable to us.

*Rapid changes in the Israeli and international electronics industries and recessionary pressure may adversely affect our business.*

Our principal customers include manufacturers of medical, defense, aerospace, industrial, telecom and networking equipment, as well as contract electronic manufacturers. These industry segments, as well as the electronics industry as a whole, are subject to rapid technological changes and products obsolescence. Discontinuance or modification of products containing printed circuit boards, or PCBs, manufactured by us could have a material adverse effect on us. In addition, the electronics industry, particularly the defense and aerospace and medical equipment industries, which accounted for approximately 39% and 19%, respectively, of our sales in the year ended December 31, 2007, is subject to sharp economic cycles. Increased or excess production capacity by our competitors in the PCB industry and recessionary pressure in major electronics industry segments may result in intensified price competition and reduced margins. As a result, our financial condition and results of operations may be adversely affected. A weakness in the Israeli and international electronic markets may adversely affect our operating results and financial condition in the future.

*Because competition in the PCB market is intense, our business, operating results and financial condition may be adversely affected.*

The global PCB industry is highly fragmented and intensely competitive. It is characterized by rapidly changing technology, frequent new product introductions and rapidly changing customer requirements. We compete principally in the market for complex, flex-rigid and rigid multi-layer PCBs. In the Israeli market we mainly compete with Melta Ltd. and PCB Technologies Ltd., as well as with major international PCB exporters, mainly from Asia, Europe and the United States. In the European market we mainly compete with Advanced Circuit Boards NV (Belgium), Cirep (France), Invotec (UK), Printca (Denmark), Ruwel Werke GmbH (Germany) and certain other German companies. In the United States market we mainly compete with DDI Corp, Teledyne and TTM Technologies Inc. Many of these competitors have significantly greater financial and marketing resources than us. Our current competition in the rigid PCB segment is mainly from PCB manufacturers in the Far-East (mainly in China), which have substantially lower production costs than us. Continued competitive pressures could cause us to lose market share.

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*Our quarterly operating results fluctuate significantly.*

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

- the size and timing of significant orders and their fulfillment;
- demand for the products produced by our customers;
- competition with our products;

plant utilization;

fluctuations in foreign currency exchange rates, primarily the NIS against the U.S. dollar and the Euro;

yields in the manufacturing process;

timing of expenditures based on projections of future sales;

availability of raw materials;

timing to repair or replace any malfunctioning manufacturing equipment;

the length of our sales cycles;

changes in our strategy;

the number of working days in the quarter; and

changes in seasonal trends and general domestic and international economic and political conditions.

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

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

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

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***Our results of operations may be harmed by currency fluctuations.***

Our reporting currency is U.S. dollars, however our functional currency is NIS. Our revenues are primarily denominated in the U.S. dollar, while our expenses are primarily denominated in NIS, U.S. dollars, Euros, dollar-linked NIS and Euro-linked NIS. As a result, fluctuations in rates of exchange between NIS and non-NIS currencies may affect our operating results and financial condition. The NIS value of our U.S. dollar revenues are adversely affected by the appreciation of the NIS against the U.S. dollar. In addition, the U.S. dollar value of our expenses other than those paid in NIS or Euros are negatively impacted by the devaluation of the U.S. dollar against the NIS and Euro. In 2006 and 2007, the NIS appreciated against the U.S. dollar by 8.2% and 9.0%, respectively, and the Euro appreciated against the U.S. dollar by 11.3% and 11.7%, respectively, which had a significant adverse effect on our results of operations.

If we were to determine that it is in our best interests to enter into any other hedging transactions in the future in order to protect ourselves in part from currency fluctuation and inflation risks, we may not be able to do so, or such transactions, if entered into, may not materially reduce

the effect of fluctuations in foreign currency exchange rates on our results of operations and may result in additional expenses.

***We may encounter difficulty in realizing the potential financial or strategic benefits of future business acquisitions and investments.***

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

difficulty in combining the technology, operations or work force of the acquired business;

adverse effects on our reported operating results due to the amortization or write-down of intangible assets associated with acquisitions;

diversion of management attention from running our existing business; and

increased expenses, including compensation expenses resulting from newly-hired employees.

***Our results may be adversely affected by product liability claims.***

The sale and support of our products may entail the risk of product liability claims, which are likely to be substantial in light of the use of our products in business-critical applications. Over the years we have been involved in claims or litigations relating to allegedly defective products. If such suits are brought against us in the future, our business, results of operations and financial condition may be adversely affected.

***Technological change may adversely affect the market acceptance of our products.***

Technological change in the PCB industry is rapid and continual. To satisfy customers' needs for increasingly complex products, PCB manufacturers must continue to develop improved manufacturing processes, provide innovative solutions and invest in new facilities and equipment. To the extent we determine that new technologies and equipment are required to remain competitive, the acquisition and implementation of such technologies and equipment are likely to require significant capital investment. This capital may not be available to us in the future for such purposes and any new manufacturing processes developed by us may not become or remain commercially viable. As a result, we may not be able to maintain our current technological position. Furthermore, the PCB industry may in the future encounter competition from new technologies that may reduce demand for PCBs or may render existing technology less competitive or obsolete. Our future process development efforts may not be successful or the emergence of new technologies, industry standards or customer requirements may render our technology, equipment or processes obsolete or uncompetitive.

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***We depend on our 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.***

In the years ended December 31, 2005, 2006 and 2007, our ten largest customers accounted for 64%, 61% and 52% of our revenues, respectively, of which one customer accounted for 30.4%, 25.3% and 8.9% of our total revenues, respectively, and another customer accounted (consisting of two affiliated companies) for 12.9%, 11.7% and 15.2% of our total revenues, respectively. In June 2007, our then-largest customer notified us that it would cease production of the PCB for its principal product. As a result, the volume of sales to such customer has declined significantly and the customer is no longer considered a key customer. We expect that a significant portion of our future revenues will continue to be dependent on a small number of customers. If we are unable to retain our key customers or if we are unable to attract sufficient new business to compensate for the loss of any of our key customers, our results of operations and financial condition would be adversely affected.

***We may require additional capital in the future, which may not be available to us.***

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

the timing of orders and deliveries;

the purchase of new equipment;

the build-up of inventories;

the payment terms offered to our customers;

the payment terms offered by our suppliers; and

approval of the current or additional lines of credit and long-term loans from our banks.

As of December 31, 2007, we had revolving lines of credit aggregating \$3.6 million with our banks, all of which was utilized as of such date. As of December 31, 2007, we also had \$5.7 million of long-term loans. These credit facilities may not remain available to us in the future. Furthermore, under certain circumstances our banks may require us to accelerate the repayment of our credit facilities. All of our assets are pledged as security for our liabilities to our banks, whose consents are required for any future pledge of such assets.

Financial covenants in respect of our credit facilities and long-term debt with one of our banks require us to maintain the higher of shareholders' equity, excluding intangible assets, of NIS 24.0 million (\$6.24 million) or 23% of our total assets (on a non consolidated basis). With another bank, the financial covenants require us to maintain the higher of tangible shareholders' equity of NIS 17.5 million (\$4.55 million) or 17% of our consolidated total assets. For these purposes, shareholders' equity excludes prepaid expenses (except insurance). The foregoing NIS amounts have been translated for convenience into U.S. dollars at the representative rate of exchange on December 31, 2007 of \$1.00= NIS 3.846, as published by the Bank of Israel. As of December 31, 2007, we were in compliance with such covenants. We may not be able to maintain compliance with such covenants in the future.

To the extent that the funds generated from our operations and from our existing capital resources are insufficient to fund our operating and financial requirements, we may be required to raise additional funds through public or private financing or other sources. Such additional financing may not be available to us or, if available, may not be obtained on terms favorable to us. Any equity financing may cause dilution to our then current shareholders. If additional funds are raised through the issuance of equity securities, the percentage ownership of then current shareholders will be diluted. We do not have any committed sources of additional financing, and additional financing, if necessary, may not be available on commercially reasonable terms, if at all. If adequate funds are not available on terms acceptable to us, we may be required to delay, scale back or eliminate certain aspects of our operations, and our business, financial condition and results of operations would be materially adversely affected.

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***Our operating margins might be affected as a result of price increases for our principal raw materials.***

In recent years, the significant increase in oil and energy costs and commodity prices (such as copper, gold and glass fibers) put pressure on our suppliers to increase their prices for most of our principal raw materials, and we expect these conditions to continue through 2008. During 2005, 2006 and 2007, price negotiations with our suppliers resulted in lower price increases than requested by our suppliers, however, we may not continue to be successful in such negotiations in the future. We have also faced pressure to raise our prices for our products to compensate for these price increases and maintain our operating margins, and although we have managed to date to maintain our sales volume with moderate price increases, we may not be able to do so in the future. Future price changes in raw materials may materially affect our future profitability.

***We are dependent upon a select number of suppliers of key raw materials and the loss of one or more of these suppliers would adversely affect our manufacturing ability. If these suppliers delay or discontinue the manufacture or supply of these raw materials, we may experience delays in production and shipments, increased costs and cancellation of orders for our products.***

We currently obtain our key raw materials from a select number of suppliers. We do not have long-term supply contracts with our suppliers and our principal suppliers may not continue to supply raw materials to us at current levels or at all. Any delays in delivery of or shortages in these raw materials could interrupt and delay manufacturing of our products and may result in the cancellation of orders for our products. In addition, these suppliers could discontinue the manufacture or supply of these raw materials at any time. During the year ended December 31, 2007, one supplier accounted for 17.5% of our total consolidated materials and non-manufactured products purchase costs. We may not be able to identify and integrate alternative sources of supply in a timely fashion. Any transition to alternate suppliers may result in delays in production and shipment and increased expenses and may limit our ability to deliver products to our customers. Furthermore, if we are unable to identify an alternative source of supply, we may have to modify our products or a large portion of our production process to use a substitute raw material, which may cause delays in production and shipments, increased design and manufacturing costs and increased prices for our products.

***We may encounter difficulties with our international operations and sales that may have a material adverse effect on our sales and profitability.***

We are based in Israel and Germany and generate a large percentage of our sales in Europe. Our sales in Europe in the years ended December 31, 2005, 2006 and 2007 accounted for 50.6%, 46.0% and 36.3% of our consolidated revenues, respectively, of which 12.9%, 11.7% and 10.5% was generated in Germany, respectively. We intend to pursue market share in the United States, including the U.S. military, however contracts with U.S. military agencies are subject to certain regulatory restrictions and approvals, which we may not be able to comply with or obtain. We may not be able to maintain or increase international market demand for our products. To the extent that we cannot do so, our business, operating results and financial condition may be adversely affected.

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

- the impact of possible recessionary environments in multiple foreign markets;
- changes in regulatory requirements and complying with a wide variety of foreign laws;
- tariffs and other trade barriers;
- the imposition of exchange or price controls or other restrictions on the conversion of foreign currencies;
- difficulties and costs of staffing and managing foreign operations; and
- political and economic instability.

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***If we are found to be in violation of environmental laws, we could be liable for damages and costs of remedial actions or our production may be subject to stop orders, which may adversely affect our business, operating results and financial condition.***

We use certain materials in our manufacturing processes that are classified as hazardous substances. Proper waste disposal and environmental regulations are major considerations for PCB manufacturers because metals and chemicals classified as hazardous substances are used in the manufacturing process. Since May 2003, our environmental management system has been ISO 14001 certified. This certification was based on successful implementation of environmental management requirements and includes ongoing monitoring of our processes, raw materials and products. The certification is subject to periodic compliance audits conducted by the Israeli Institute of Standards. If, in the future, we are found to be in violation of environmental laws, we could be liable for damages and costs of remedial actions and could also be subject to revocation of permits necessary to conduct our business or any part thereof. Any such revocation could require us to cease production, which could have a material adverse effect on our financial condition and results of operations. We are also subject to laws relating to the storage, use and disposal of hazardous materials, as well as air quality regulations. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with a violation. For example, environmental regulations enacted in Israel in September 2000 provide that a company that is found to have discharged water containing contaminants will be liable for quadruple the amount normally charged for its water consumption. Moreover, according to the same regulations, manufacturing plants were required to reduce the quantity of the wastewater discharged by them by 90% within four years. To be exempted from such legislation, a plant would have to show the Israeli Ministry of the Environment that a partial or complete decrease in the quantity of wastewater is not feasible. We may not sufficiently comply in the future with the September 2000 regulations or other regulations that may be adopted in the future.

***We may fail to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, which 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.***

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 for the year ended December 31, 2007, have resulted in increased general and administrative expenses and a diversion of management time and attention, and we expect these efforts to require the continued commitment of significant resources. We may identify 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 investigations 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 continue to be susceptible to significant market price and volume fluctuations in the future.*

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

quarterly variations in our operating results;

operating results that vary from the expectations of securities analysts and investors;

changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

announcements of technological innovations or new products by us or our competitors;

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announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

changes in the status of our intellectual property rights;

announcements by third parties of significant claims or proceedings against us;

announcements by governmental or regulatory authorities of significant investigations or proceedings against us;

additions or departures of key personnel;

changes in our cost structure due to factors beyond our control, such as new laws or regulations relating to environmental matters and employment;

future sales of our ordinary shares;

general stock market price and volume fluctuations; and

devaluation of the dollar against the NIS.

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, interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

*We do not expect to distribute dividends.*

We have never declared or paid any cash dividends on our ordinary shares. We currently intend to retain our current and any future earnings to finance operations and expand our business and, therefore, do not expect to pay any dividends in the foreseeable future. According to the Israeli Companies Law, a company may distribute dividends out of its profits (within the meaning of the Israeli Companies Law), provided that there is no reasonable concern that such dividend distribution will prevent the company from paying all its current and foreseeable obligations, as they become due. The declaration of dividends is subject to the discretion of our Board of Directors and would 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. 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 Operations 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 executive offices, principal production facilities 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.

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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. The election of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council in January 2006 resulted in an escalation in violence among Israel, the Palestinian Authority and other groups. In July 2006, extensive hostilities began along Israel's northern border with Lebanon and to a lesser extent in the Gaza Strip. Since June 2007, when Hamas effectively took control of the Gaza Strip, there have been extensive hostilities along Israel's border with 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.

Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

***Our results of operations may be negatively affected by the obligation of our personnel to perform military reserve service.***

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

***Service and enforcement of legal process on us and our directors and officers may be difficult to obtain.***

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

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

***Provisions of Israeli law may delay, prevent or make difficult an acquisition of us, which could prevent a change of control and therefore impact the price of our shares.***

Provisions of Israeli corporate and tax laws may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain

control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

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*The rights and responsibilities of our shareholders are governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.*

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

#### **ITEM 4. INFORMATION ON THE COMPANY**

##### **A. HISTORY AND DEVELOPMENT OF THE COMPANY**

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

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

We design and develop innovative manufacturing solutions pursuant to complex interconnect requirements of original equipment manufacturers, and provide our customers with a wide range of custom designed PCBs, including complex rigid, double-sided and multi-layer PCBs as well as flexible circuitry (flex and flex-rigid boards) made of several types of high-performance base material. To complement our quick-turnaround, prototype, pre-production and low to medium volume production capability and provide our customers with single source

service, we also act as an agent for the importation of PCBs from the Far East when customers require high volume production runs.

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In July 2000, we adopted a plan to create the capacity and capability to offer our customers the new state-of-the-art PCB technology known as high density interconnect, or HDI. This technology enables manufacturers to produce PCBs with line width and spaces as narrow as 3-4 mils and hole diameters of 8 to 10 mils (1 mil=0.001 inch). We began to supply PCBs utilizing the HDI technology to select customers in August 2000 and since such time, have focused our efforts on HDI PCBs. In 2007, we continued to focus on the sale of flex-rigid HDI PCBs and PCBs made with high performance base materials. Such products accounted for approximately \$26.9 million or 71.7% of our total sales in the year ended December 31, 2007 as compared to approximately of \$27.4 million or 70.2% of our total sales in the year ended December 31, 2006.

In June 2002, we acquired 76% of Kubatronik, a privately held German PCB manufacturer, for approximately Euro 2.6 million (\$2.4 million as of the date of acquisition). The remaining 24% of Kubatronik is held by Mr. Alois Kubat, its founder and General Manager at that time. Kubatronik specializes in manufacturing short run and prototype boards, including multi-layer, flex-rigid and HDI boards. Its customers include companies engaged in the production of industrial, defense, aerospace, telecom, networking, computer and data storage equipment, as well as contract electronic manufacturers. This acquisition facilitated our entry into the German market, while complementing our other relationships throughout the rest of Europe.

In November 2006, we entered into a license agreement with Stablcor, Inc., under which we were granted the first license to use the STABLCOR® technology, an advanced thermal management solution for PCB fabrication, outside the United States. The STABLCOR technology enables PCB manufacturers, such as our company, to produce smaller electronic products while eliminating the thermal, mechanical and reliability concerns that currently challenge the semiconductor industry. We intend to work with the STABLCOR technology to design and develop new and unique solutions for our high-end customers and believe that this license will expand our opportunities in the high-end PCB market. However, we cannot predict the market acceptance of a PCB product using the STABLCOR technology.

During the three years ended December 31, 2007, we invested approximately \$8.0 million in the expansion of our facilities and infrastructures and purchase of equipment.

## **B. BUSINESS OVERVIEW**

### **Industry Overview**

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

*Rigid PCBs.* Rigid PCBs are the core product of the industry and can be found in virtually every electronics device. The layer count of these products generally ranges from two to thirty-two layers.

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

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

PCB manufacturers can generally be classified based on two parameters, product sophistication and service sophistication. Product sophistication is evident in the capability of a PCB manufacturer to offer products with higher layer counts and more complex construction, as well as in the line width and the spacing of lines on the circuit boards. The new state-of-the-art HDI technology enables manufacturers to produce PCBs with line width and spaces as narrow as 3-4 mils and hole diameters of 8 to 10 mils.

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## Manufacturing and Engineering Processes

In the PCB industry, significant investments in equipment are necessary to maintain technological competitiveness. During the three years ended December 31, 2007, we invested approximately \$7.2 million in machinery and equipment for that purpose (not including the acquisition of Kubatronik).

*Manufacturing Capabilities.* We have the capability to manufacture PCBs with layer counts in excess of 30 layers, blind and buried vias and designs using materials as thin as 0.001 inches. We established our HDI advanced capabilities after a two-year period of research and development, followed by a significant investment in HDI production capacity. In August 2000, we began to supply HDI products to selected customers. We are able to produce short runs of five to thirty PCBs within three to five working days, and a few hundred units within ten working days and are capable of producing such number of boards within five working days when production line scheduling permits. During 2007, we developed new technologies, enabling us to manufacture via-in-pad multilayer PCBs, microvia filling, through hole via filling and copper overplating. These technologies enable us to offer our customers new solutions and participate in bids in which we were not able to participate in the past. In the year ended December 31, 2007, approximately 29% of our manufactured products were ordered for delivery in less than 20 working days, of which approximately 7% were ordered for delivery within six to ten working days and approximately 5% in five or less working days.

*Computer Aided Design/Computer Aided Manufacturing (CAD/CAM).* We utilize a state-of-the-art CAD system developed by Frontline PCB Solutions Ltd., an Israeli based company jointly owned by Orbotech Ltd. and Valor Ltd., and can receive CAD data by electronic data transmission. Our CAD workstations perform design rule checks on transmitted designs, incorporate any customer-specific design modifications and perform manufacturability enhancements that increase PCB quality.

*Advanced Finishing Capabilities for Dense Packaging Designs.* We provide a wide assortment of alternative surface finishes, including hot air solder leveling, electroless gold over nickel, tin immersion, silver immersion and Entek, which is produced by Enthone-Omi Inc., for the attachment of components to PCBs.

*Other Advanced Process Capabilities.* We provide fabrication of dense multi-layer PCBs. We use an advanced inner-layer production line, a laser direct imaging system, drilling equipment and clean room environments (ISO-7) to produce technologically advanced products.

*Quality, Environmental and Safety Standards.* Our quality management system has been ISO 9001:2000 certified since July 2002 (and prior to such date, was ISO 9002 certified from January 1995). This certification is based on successful implementation of quality assurance requirements and includes ongoing monitoring of our business and periodic compliance audits conducted by the Israeli Institute of Standards. We have obtained United States Department of Defense Qualified Product List approval (MIL-PRF-55110F and MIL-P-50884D) for our products. Since 1976, our Rigid Glass Epoxy (FR4 & FR5) & Flex-Rigid Boards have been UL 94V-0 certified by Underwriters Laboratories Inc. (a standards organization that offers product safety testing and certification of product safety). Our environmental management system has been ISO 14001:2004 certified since 2005 (and prior to such date was ISO 14001 certified from 2003). We are OHSAS 18001 certified for occupation health and safety management systems since December 2007. We are currently in the process of AS9100 Aerospace Standard certification, which we expect to complete during 2008.

## Sales, Customers and Marketing

*Sales.* In the years ended December 31, 2005, 2006 and 2007, the primary industries for which we produced PCBs were medical equipment (37%, 35% and 19% of production, respectively), defense and aerospace equipment (26%, 25% and 39% of production, respectively), industrial equipment (11%, 11% and 15% of production, respectively) and telecom and networking equipment (5%, 7% and 5% of production, respectively) as well as for contract electronic manufacturers (12%, 16% and 16% of production, respectively).

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*Customers.* During the year ended December 31, 2007, we provided PCBs to approximately 175 customers in Israel and approximately 313 customers outside of Israel (including Kubatronik's customers). Our customers outside of Israel are located primarily in Germany, France, Italy, the Netherlands, Scandinavia and the United States. Sales to non-Israeli customers were \$18.6 million (57.7% of revenues) for the year ended December 31, 2005, \$21.2 million (54.2% of revenues) for the year ended December 31, 2006 and \$19.0 million (50.6% of revenues) for the year ended December 31, 2007.

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In the years ended December 31, 2005, 2006 and 2007, our ten largest customers accounted for 64%, 61% and 52% of our revenues, respectively, of which one customer accounted for 30.4%, 25.3% and 8.9% of our total revenues, respectively, and another customer (consisting of two affiliated companies) accounted for 12.9%, 11.7% and 15.2% of our total revenues, respectively. In June 2007, our then-largest customer notified us that it would cease production of the PCB for its principal product. As a result, the volume of sales to such customer has declined significantly and the customer is no longer considered a key customer. We expect that a significant portion of our future revenues will continue to be dependent on a small number of customers.

*Marketing.* We market and sell our products primarily through our direct sales personnel, sales agents and agreements with PCB trading and manufacturing companies. Our sales personnel currently consist of 26 persons, of which 14 are in Israel, three are in the United States employed by our U.S. subsidiary, Eltek USA Inc., two are in Europe and seven persons are employed by our German subsidiary, Kubatronik, and we also have sales agents in France, Germany, Sweden and Switzerland. In the Netherlands and Italy PCB trading and manufacturing companies act as distributors of our products. In the United States we market and sell our products through our U.S. subsidiary, which is supported by three representatives, as well as through a PCB manufacturing company. In India we market our products through a local sales agent. We maintain technical support services for our customers world-wide. We also maintain customer service support centers that handle all logistical matters relating to delivery and maintenance arrangements and receive and handle complaints relating to delivered products.

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

### **Materials and Supplies**

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

Our suppliers decreased their prices in 2002, 2003 and 2004 for the principal raw materials we use in the manufacture of PCBs. During 2005 and 2006, the significant increase in oil and energy costs and commodity prices (such as copper, gold and glass fibers) put pressure on our suppliers to increase their prices for most of our principal raw materials. During 2007, the prices stabilized, however there is no assurance that prices will remain stable during 2008. During recent years, price negotiations with our suppliers resulted in lower price increases than requested by our suppliers, however we may not continue to be successful in such negotiations in the future. We have also faced pressure to raise our prices for our products to compensate for these price increases and although we have managed to date to maintain our sales prices with moderate price increases, however we may not be able to do so in the future. Although to date our profitability has not been significantly affected by such price changes, future price changes in raw materials may materially affect our future profitability.

### **Competition**

The global PCB industry is highly fragmented and intensely competitive, trends that we believe will continue. It is characterized by rapidly changing technology, frequent new product introductions and rapidly changing customer requirements. We compete principally in the market for complex, flex-rigid multi-layer PCBs. In the Israeli market we mainly compete with PCB Technologies Ltd. and Melta Ltd., as well as with major PCB exporters, mainly from the United States, Europe and Asia. In the European market we mainly compete with Advanced Circuit Boards NV (Belgium), Cirep (France), Invotec (UK), Printca (Denmark), Ruwel Werke GmbH (Germany) and certain other German companies. In the United States market we mainly compete with DDI Corp, Teledyne and TTM Technologies Inc. Many of these competitors have significantly greater financial, technical and marketing resources than us. Although capital requirements are a significant barrier to entry for manufacturing complex PCBs, the basic interconnect technology is generally not protected by patents or copyrights. Our current competition in the rigid PCB segment is mainly from PCB manufacturers in the Far-East (mainly in China), which have substantially lower production costs than us. Continued competitive pressures could cause us to lose market share.

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### **Environmental Matters**

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

PCB manufacturing requires the use of metals and chemicals classified as hazardous substances. Water used in the manufacturing process must be treated to remove metal particles and other contaminants before it can be discharged into the local sewer systems. Environmental regulations enacted in Israel in September 2000 provide that a company, which is found discharging water containing contaminants, will be liable to pay quadruple the amount normally charged for its water consumption. We operate and maintain effluent water treatment systems and use approved testing procedures at our manufacturing facilities. There is no assurance, however, that violations will not occur in the future. We are also subject to environmental laws and regulations relating to the storage, use and disposal of chemicals, solid waste and other hazardous materials, as well as air quality regulations. Environmental laws and regulations could become more stringent over time, and the costs of compliance with more stringent laws could be substantial. According to the September 2000 regulations, manufacturing plants are required to reduce the quantity of the wastewater discharged by them by 90% within four years. To be exempted from such legislation, an owner of a plant would have to show the Israeli Ministry of the Environment that a partial or complete decrease in the quantity of wastewater is not feasible. Since 1996, we have undertaken various actions to reduce the use of water in our manufacturing facilities. We believe that we have materially complied with the September 2000 regulations, but no assurance can be given that such compliance will be sufficient in the future. In 2008, we began to invest in improving our effluent wastewater treatment system to lower the amounts of inorganic salts in the discharged water.

### **Intellectual Property Rights**

Our success depends in part on our proprietary techniques and manufacturing expertise, particularly in the area of complex multi-layer and flex-rigid PCBs. Like many companies in the PCB industry, we do not hold any patents and rely principally on trade secret protection of our intellectual property. However, we have applied for two patents in Israel in the field of opto-electronic circuits. We believe that, because of the rapid pace of technological change in the electronics industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of support services that we provide. We are devoting resources to the development of new manufacturing technology that we believe will allow us to enhance our product offerings.

### **C. ORGANIZATIONAL STRUCTURE**

In May 2002, we established En-Eltek Netherlands 2002 B.V., a wholly-owned subsidiary organized in the Netherlands, in connection with our acquisition of a 76% interest in Kubatronik. We currently intend to transfer our entire holdings in Kubatronik from En-Eltek Netherlands 2002 B.V. to our company. Kubatronik is a PCB manufacturer that specializes in short run and prototype boards, including multi-layer, flex-rigid and HDI boards. Its customers include companies engaged in the production of industrial equipment, defense and aerospace equipment, telecom and networking equipment, and computer and data storage equipment as well as contract electronic manufacturers. Mr. Alois Kubat, Kubatronik's founder, holds the remaining 24% interest in Kubatronik. Mr. Kubat has the right to require us to purchase, and we have the right to require him (or his permitted transferee) to sell to us, his remaining interest in Kubatronik. See Item 5B. Operating and Financial Review and Prospects – Liquidity and Capital Resources.

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In July 2007, we established Eltek USA Inc., a wholly-owned subsidiary incorporated in Delaware to manage our marketing activities in the North American market. Eltek USA Inc. commenced operations in 2008.

### **D. PROPERTY, PLANTS AND EQUIPMENT**

#### **Leased Facilities**

Our executive offices, as well as our design, production, storage and shipping facilities, aggregating approximately 90,000 square feet, are located in an industrial building in the Sgoola Industrial Zone of Petach Tikva, Israel. The lease for such facilities expires in February 2017 and we have an option to extend the lease for an additional five year term upon six months prior notice. In the year ended December 31, 2007, we paid \$618,000 in rent for these premises. The foregoing amount has been translated for convenience into U.S. dollars from NIS at the respective rate of exchange on December 31, 2007.

Kubatronik's executive offices as well as its design, production, storage and shipping facilities, aggregating approximately 15,000 square feet, are located in an industrial building in Geislingen, Germany. The lease for their facilities expires on June 30, 2008 and our intention is to request an extension of the lease for an additional period. A lease for an adjoining 8,000 square feet parking area expires on December 31, 2010. In the year ended December 31, 2007, Kubatronik paid an aggregate of \$107,000 in rent for these premises. The foregoing amounts have been translated for convenience into U.S. dollars from Euro at the respective rate of exchange on December 31, 2007.

## Leased Equipment

We lease manufacturing equipment under two operating lease agreements, pursuant to which as of December 31, 2007 we were obligated to pay a total amount of \$556,000 through March 2010. Our monthly lease expense under these two agreements is \$14,250.

Kubatronik leases manufacturing equipment under three operating lease agreements, which as of December 31, 2007 required us to pay a total of 183,000 Euros (\$270,000) through November 2012. Our monthly lease expense under these three agreements is approximately 6,033 Euros (\$9,877). The foregoing amounts have been translated for convenience into U.S. dollars from Euro at the respective rate of exchange on December 31, 2007.

## Investment in Equipment and Infrastructure

In 2005, we invested approximately \$2.8 million in capital expenditures. Of such amount, \$2.7 million was used to purchase production and manufacturing equipment and \$81,000 was used for leasehold improvements.

In 2006, we invested approximately \$1.9 million in capital expenditures. Of such amount, approximately \$1.5 million was used to purchase production and manufacturing equipment and \$0.4 million was used for leasehold improvements.

In 2007, we invested approximately \$3.3 million in capital expenditures. Of such amount, approximately \$1.9 million was used to purchase production and manufacturing equipment and \$1.4 million was used for leasehold improvements.

In 2008, we intend to invest approximately \$2.0 million in capital expenditures, including approximately \$1.5 million in manufacturing equipment and approximately \$0.5 million in leasehold improvements for the expansion of our production facilities.

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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 were incorporated under the laws of the State of Israel in 1970. Kubatronik, our European manufacturing and marketing subsidiary located in Geislingen Germany, is our only active subsidiary.

We develop, manufacture, market and sells PCBs, including high density interconnect (HDI) multi-layered and flex-rigid boards for the telecommunications, defense and aerospace and medical technology industries. Our principal customers include manufacturers of medical equipment, defense and aerospace equipment, industrial equipment, and telecom and networking equipment, as well as contract electronic manufacturers.

For periods prior to December 31, 2006, our consolidated financial statements were prepared in NIS and in accordance with generally accepted accounting principles in Israel with a reconciliation to generally accepted accounting principles in the United States, or U.S. GAAP. Effective as of January 1, 2007, our consolidated financial statements appearing in this annual report are prepared in accordance with U.S.

GAAP and our reporting currency is U.S. dollars. Our functional currency continues to be NIS. The consolidated financial statements for all prior periods presented have been restated and are presented in accordance with U.S. GAAP. See Notes 1B and 1C to the consolidated financial statements. The consolidated financial statements appearing in this annual report are translated into U.S. dollars at the representative rate of exchange under the current rate method. Under such method, the income statement and cash flow statement items for each year (or period) stated in this report are translated into U.S. dollars using the average exchange rates in effect at each period presented, and assets and liabilities are translated using the exchange rate as of December 31, 2007 (\$1.00= NIS 3.846, as published by the Bank of Israel), except for equity accounts, which are translated using the rates in effect at the date of the transactions. All resulting exchange differences that do not affect our earnings are reported in the accumulated other comprehensive income as a separate component of shareholders' equity.

### **Critical Accounting Policies**

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

The significant accounting policies described in Note 1 of our consolidated financial statements, which we believe to be most important to fully understand and evaluate our financial condition and results of operation under U.S. GAAP, are discussed below.

#### ***Revenue Recognition***

We recognize revenues when products are shipped and the customer takes ownership and assumes risk of loss, collection of the relevant receivable is probable, persuasive evidence of an arrangement exists and the sale price is fixable or determinable. Commission income is accounted for on the accrual basis.

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#### ***Inventories***

Inventories are recorded at the lower of cost or market value. Cost is determined on the weighted average basis for raw materials and finished goods, and on the basis of actual manufacturing costs for work-in-progress.

#### ***Provision for doubtful accounts receivable***

The allowance for doubtful accounts receivable is calculated on the basis of specific identification of customer balances. The allowance is determined based on management's estimate of the aged receivable balance considered uncollectible, based on historical experience, aging of the receivable and information available about specific customers, including their financial condition and the volume of their operations.

#### ***Fixed assets***

Assets are recorded at cost. Depreciation on property and equipment is calculated on the straight-line method over the estimated useful lives of the assets. Machinery and equipment purchased under capital lease arrangements are recorded at the present value of the minimum lease payments at lease inception. Such assets and leasehold improvements are depreciated and amortized respectively, using the straight-line method over the shorter of the lease term or estimated useful life of the asset.

#### ***Impairment in Value of Assets***

We account for long-lived assets and certain intangible assets in accordance with the provisions of the Financial Accounting Standards Board, or the FASB, Statements of Financial Accounting Standards, or SFAS, No. 144, *Accounting for the Impairment of or Disposal of Long-Lived Assets*, or SFAS 144. SFAS 144 requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset or asset group to the undiscounted future net cash flows expected to be generated by the asset or the asset group. 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, 2007, no impairment losses have been identified.

#### ***Goodwill***

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Goodwill represents the excess of the aggregate purchase price over the fair value of the net assets acquired in a purchase business combination. Goodwill is reviewed for impairment at least annually in accordance with the provisions of FASB SFAS No. 142, *Goodwill and Other Intangible Assets*. The goodwill impairment test is a two-step test. Under the first step, the fair value of the reporting unit is compared with its carrying value. An indication any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, in accordance with FASB SFAS No. 141, *Business Combinations*. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. If the fair value of the reporting unit exceeds its carrying value, step two does not need to be performed.

In 2006, following our annual impairment test of goodwill, based on our projections and using expected future discounted cash flows, we determined that goodwill in the amount of \$473,000 of the \$1.3 million goodwill relating to our investment in Kubatronik had been impaired. As a result, we recorded an impairment loss in the amount of \$473,000 for the year ended December 31, 2006. We have not identified and did not record any impairment of goodwill for the year ended December 31, 2007.

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### Results of Operations

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

|   | Year Ended December 31, |        |        |
|---|-------------------------|--------|--------|
|   | 2005                    | 2006   | 2007   |
| Revenues  | 100.0%                  | 100.0% | 100.0% |
| Cost of revenues  | (79.7)                  | (78.3) | (85.1) |
| Gross profit  | 20.3                    | 21.7   | 14.9   |
| Research and development expenses, net                    | (0.4)                   | (0.4)  | (0.2)  |
| Selling, general and administrative expenses              | (13.7)                  | (14.3) | (15.1) |
| Impairment loss on goodwill                               | --                      | (1.2)  | --     |
| Operating profit (loss)                                   | 6.2                     | 5.8    | (0.4)  |
| Financial expenses, net                                   | (1.8)                   | (1.4)  | (0.4)  |
| Other income, net   | *                       | *      | *      |
| Profit (loss) before tax expenses and minority interest   | 4.4                     | 4.4    | (0.8)  |
| Income tax expense  | --                      | (0.4)  | --     |
| Profit (loss) after tax expenses before minority interest | 4.4                     | 4.0    | (0.8)  |
| Minority interest   | 0.2                     | 0.2    | *      |
| Net profit (loss)   | 4.6                     | 4.2    | (0.8)  |

\* Less than 0.1%

*Year Ended December 31, 2007 Compared with Year Ended December 31, 2006*

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*Revenues.* Revenues decreased by 4.0% to \$37.5 million in the year ended December 31, 2007 from \$39.0 million in the year ended December 31, 2006. This decrease in revenues is primarily attributable to reduced sales to our former largest customer, which notified us at the end of the second quarter of 2007 that it was terminating production of its principal product. As a result of the change in the U.S. dollar/NIS exchange rate, from the beginning of 2008 we have been in discussions with many of our Israeli customers in an attempt to increase our U.S. dollar linked prices or to agree to use a higher U.S. dollar/NIS exchange rate for our U.S. dollar linked prices, and we have also been in discussions to increase our offshore U.S. dollar prices.

*Cost of Revenues.* Cost of revenues increased by 4.3 % to \$31.9 million in the year ended December 31, 2007 from \$30.6 million in the year ended December 31, 2006. This increase in cost of revenues is primarily due to the appreciation of the NIS against the U.S. dollar in 2007, which adversely affected the U.S. dollar value of NIS denominated expenses (primarily salaries and other domestic expenses), a higher consumption of raw material due to the replacement of a high volume of revenue from one major customer with many smaller orders, causing additional challenges in our production efficiency, and an increase in energy costs. Cost of revenues as a percentage of revenues increased to 85.1% in the year ended December 31, 2007 from 78.3 % in the year ended December 31, 2006. This increase in cost of revenues as a percentage of revenues is primarily attributable to the same reasons explained above. We expect that our expenses as a percentage of revenue will increase in 2008 as result of the continued appreciation of the NIS against the U.S. dollar during the first half of 2008, which adversely affects the U.S. dollar value of our NIS denominated expenses (primarily salaries and other domestic expenses). In addition, if energy and commodity prices increase in 2008, our costs may increase at a higher level than anticipated.

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*Gross Profit.* Gross profit decreased by 34.1% to \$5.6 million in the year ended December 31, 2007 from \$8.5 million in the year ended December 31, 2006. This decrease in gross profit is primarily due to the reduction in sales and the increase in cost of revenues, for the reasons explained above. Gross profit as a percentage of revenues decreased to 14.9% in the year ended December 31, 2007 from 21.7% in the year ended December 31, 2006. This decrease in gross profit as a percentage of revenues is primarily attributable to the reduction in sales and the increase in cost of revenues, for the reasons explained above. We expect that our expenses as a percentage of revenue will increase in 2008 as result of the continued appreciation of the NIS against the U.S. dollar during the first half of 2008, which adversely affects the U.S. dollar value of our NIS denominated expenses (primarily salaries and other domestic expenses). In addition, if energy and commodity prices increase in 2008, our gross profit as a percentage of revenues may decrease at a higher level than anticipated.

*Research and Development Expenses, Net.* We generally do not engage in significant research and developments efforts. In 2006 and 2007, we incurred \$326,000 and \$167,000, respectively, in research and development expenses in connection with our membership in OptiPac, a consortium within the framework of the MAGNET program of the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel, or the OCS. Of such total expenses in 2006 and 2007, \$172,000 and \$93,000, respectively, were reimbursed to us by the OCS in accordance with the terms of the OptiPac consortium. The OptiPac program was completed in July 2007.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased by 1.8 % to \$5.7 million in the year ended December 31, 2007 from \$5.6 million in the year ended December 31, 2006. This increase in selling, general and administrative expenses is primarily attributable to the expansion of our sales and marketing force in Europe and the United States (including the establishment of a new sales and marketing office in New Hampshire), and increased commission expenses as a result of an increase in sales made through our sales representatives as opposed to direct sales. The increase was offset in part by a reduction in liability that we recorded in connection with the put/call option agreement with the former owner of Kubatronik as a result of the extension of the term of the option and the amendment of other provisions relating to the put/call option. We expect that our selling, general and administrative expenses will increase in 2008 as we intend to increase the number of our sales personnel, as well as due to an anticipated increase in commissions to sales representatives as a result of an increase in sales made through our sales representatives and increased export and delivery expenses as a result of the anticipated increase in our export revenues.

*Impairment loss on goodwill.* For the year ended December 31, 2006, following our annual impairment test of goodwill, we recorded an impairment loss of \$473,000 relating to our investment in Kubatronik. We did not record any impairment of goodwill for the year ended December 31, 2007.

*Operating profit (loss).* As a result of the foregoing, our operating loss was \$160,000 in the year ended December 31, 2007 compared to an operating profit of \$2.3 million in the year ended December 31, 2006.

*Financial Expenses, Net.* Financial expenses, net decreased to \$145,000 in the year ended December 31, 2007 from \$538,000 in the year ended December 31, 2006. These financial expenses were primarily attributable to interest paid on short-term debt and long-term debt as well as exchange rate expenses, net. This decrease in financial expenses is attributable to gain on currency hedging transactions.

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*Other Income, Net.* We had other income, net of \$8,000 in the year ended December 31, 2007 and \$5,000 in the year ended December 31, 2006. Other income, net in the years ended December 31, 2007 and 2006 was attributable to the gain we recorded on the disposal of fixed assets.

*Income tax expense.* We did not record any current tax expenses in the years ended December 31, 2006 in respect of our profits in Israel, as we utilized our tax loss carryforwards to offset such profits. Despite our accumulated profits in Israel during the years ended December 31, 2006 and 2007, we did not record a net deferred tax asset and related tax benefit in 2006 or 2007 with respect to our net operating losses generated in Israel due to uncertainty about our ability to utilize such losses in the foreseeable future. Such uncertainty is primarily due to the appreciation of the NIS against the U.S. dollar, the replacement of a high volume of revenue from our former largest customer with many smaller orders, causing additional challenges for our production efficiency, the fluctuations of the PCB industry and our history of losses. We recorded a tax expense of \$158,000 in the year ended December 31, 2006 relating to the establishment of a valuation allowance on a deferred tax asset in respect of the loss carryforward of Kubatronik. We did not record any tax expense for the year ended December 31, 2007 with respect to Kubatronik as we utilized our tax loss carryforward.

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*Minority Interest.* Minority share in subsidiary's net results reflects the minority's interest of \$4,000 in Kubatronik's net profit in the year ended December 31, 2007, as compared to the minority's interest of \$60,000 in its net loss in the year ended December 31, 2006.

### ***Year Ended December 31, 2006 Compared with Year Ended December 31, 2005***

*Revenues.* Revenues increased by 21.3% to \$39.0 million in the year ended December 31, 2006 from \$32.2 million in the year ended December 31, 2005. This increase in revenues is primarily attributable to the increase in sales of our flex-rigid boards, which are higher priced than our rigid PCBs, and the increased number of PCBs sold in 2006. The increase was offset in part by the appreciation of the NIS against the U.S. dollar by 8.2% in 2006, which adversely affected the NIS value of our U.S. dollar revenues.

*Cost of Revenues.* Cost of revenues increased by 19.2% to \$30.1 million in the year ended December 31, 2006 from \$25.6 million in the year ended December 31, 2005. This increase in cost of revenues is primarily due to increased revenues and the increase in payroll and related benefits. Cost of revenues as a percentage of revenues decreased to 78.3% in the year ended December 31, 2006 from 79.7% in the year ended December 31, 2005. This decrease in cost of revenues as a percentage of revenues is primarily attributable to the increase in our sales volume, while our costs increased at a lower rate due to fixed costs being absorbed over a greater volume of sales.

*Gross Profit.* Gross profit increased by 29.8% to \$8.5 million in the year ended December 31, 2006 from \$6.5 million in the year ended December 31, 2005. This increase in gross profit is primarily due to increased revenues. Gross profit as a percentage of revenues increased to 21.7% in the year ended December 31, 2006 from 20.3% in the year ended December 31, 2005. This increase in gross profit as a percentage of revenues is primarily attributable to the increase in our sales volume, while our costs increased at a lower rate due to fixed costs being absorbed over a greater volume of sales.

*Research and Development Expenses, Net.* We generally do not engage in significant research and development efforts. In 2005 and 2006, we incurred \$249,000 and \$326,000, respectively, in research and development expenses in connection with our membership in OptiPac, a consortium within the framework of the MAGNET program of the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel, or the OCS. Of such total expenses in 2005 and 2006, \$105,000 and \$172,000, respectively, were reimbursed to us by the OCS in accordance with the terms of the OptiPac consortium.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased by 26.6% to \$5.6 million in the year ended December 31, 2006 from \$4.4 million in the year ended December 31, 2005. This increase in selling, general and administrative expenses is primarily attributable to the associated growth in payroll and employee benefits expenses, commissions to sales representatives, export and delivery expenses, travel expenses of marketing personnel and costs of professional services resulting from our increased revenues.

*Impairment loss on goodwill.* We did not record any impairment of goodwill for the year ended December 31, 2005. For the year ended December 31, 2006, following our annual impairment test of goodwill, we recorded an impairment loss of \$473,000 relating to our investment in Kubatronik.

*Operating profit (loss).* As a result of the foregoing, our operating profit was \$2.3 million in the year ended December 31, 2006 compared to \$2.0 million in the year ended December 31, 2005.

*Financial Expenses, Net.* Financial expenses, net decreased to \$538,000 in the year ended December 31, 2006 from \$592,000 million in the year ended December 31, 2005. These financial expenses were primarily attributable to interest paid on short-term debt and long-term debt as well as exchange rate expenses, net. This decrease in financial expenses is attributable to a reduction in our short-term debt, reduced interest

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rates, gain on currency hedging transactions and differences in foreign currency exchange rates.

*Other Income, Net.* We had other income, net of \$5,000 in the year ended December 31, 2006 and \$23,000 in the year ended December 31, 2005. Other income, net in the years ended December 31, 2006 and 2005 was attributable to the gains we recorded on the disposal of fixed assets.

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*Income tax expense.* We did not record any tax expenses in the years ended December 31, 2005 and 2006 in respect of our profits in Israel, as we utilized our tax loss carryforwards to offset such profits. Despite our accumulated profits in Israel during the years ended December 31, 2005 and 2006, we did not record a net deferred tax asset and related tax benefit in 2005 or 2006 with respect to our profits generated in Israel due to uncertainty about our ability to utilize such tax losses in the foreseeable future. Such uncertainty is primarily due to the appreciation of the NIS against the U.S. dollar, our dependency on one major customer whose product was at the end of its lifecycle, the uncertainty of our being able to attract sufficient business to compensate for the loss of such a major customer, the fluctuations of the PCB industry and our history of losses. We recorded a tax expense of \$158,000 in the year ended December 31, 2006, relating to the establishment of a valuation allowance on the deferred tax asset in respect of the loss carryforward of Kubatronik.

*Minority Interest.* Minority share in subsidiary's net results reflects the minority's interest of \$60,000 in Kubatronik's net loss in the year ended December 31, 2006, as compared to the minority's interest of \$49,000 in its net loss in the year ended December 31, 2005.

### Quarterly Results of Operations

The following table sets forth certain unaudited quarterly financial information in accordance with U.S. GAAP expressed in U.S. dollars and as a percentage of revenues for each of the eight fiscal quarters ended December 31, 2007. The data has been prepared on a basis consistent with our audited consolidated financial statements included elsewhere in this annual report and includes all adjustments, consisting only of normal recurring accruals, that we consider necessary for a fair presentation. The operating results for any quarter are not necessarily indicative of results for any future periods.

|  | Quarter Ended                    |         |         |         |         |         |         |         |
|--|----------------------------------|---------|---------|---------|---------|---------|---------|---------|
|  | 2006                             |         |         |         | 2007    |         |         |         |
|  | Mar. 31                          | Jun. 30 | Sep. 30 | Dec. 31 | Mar. 31 | Jun. 30 | Sep. 30 | Dec. 31 |
|  | (\$ in thousands)<br>(Unaudited) |         |         |         |         |         |         |         |
| Revenues   | 9,287                            | 9,568   | 10,046  | 10,144  | 10,223  | 8,593   | 8,771   | 9,889   |
| Cost of revenues   | (7,250)                          | (7,688) | (7,939) | (7,680) | (8,075) | (7,135) | (7,675) | (8,994) |
| Gross profit   | 2,037                            | 1,880   | 2,107   | 2,464   | 2,148   | 1,458   | 1,096   | 895     |
| Research and development income (expenses), net                | (34)                             | (33)    | (42)    | (45)    | (29)    | (54)    | (17)    | 26      |
| Selling, general and administrative expenses                   | (1,193)                          | (1,276) | (1,468) | (1,643) | (1,426) | (1,411) | (1,468) | (1,378) |
| Impairment loss on goodwill                                    | -                                | -       | -       | (473)   | -       | -       | -       | -       |
| Operating profit (loss)  | 810                              | 571     | 597     | 303     | 693     | (7)     | (389)   | (457)   |
| Financial income (expenses), net                               | (162)                            | (112)   | (120)   | (144)   | (116)   | (164)   | 165     | (30)    |
| Other income (expenses), net                                   | (2)                              | 9       | -       | (2)     | 4       | -       | 1       | 3       |
| Profit (loss) before income tax expenses and minority interest | 646                              | 468     | 477     | 157     | 581     | (171)   | (223)   | (484)   |
| Income tax expense   | -                                | -       | -       | (158)   | -       | -       | -       | -       |

|  | Quarter Ended |     |     |     |      |       |       |       |
|--|---------------|-----|-----|-----|------|-------|-------|-------|
|  |               |     |     |     |      |       |       |       |
| Profit (loss) after income tax expenses before minority interest | 646           | 468 | 477 | (1) | 581  | (171) | (223) | (484) |
| Minority interest  | (5)           | (3) | 5   | 63  | (16) | *     | *     | 12    |
| Net profit (loss)  | 641           | 465 | 482 | 62  | 565  | (171) | (223) | (472) |

\*Less than \$1,000

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|  | Quarter Ended                                      |         |         |         |         |         |         |         |
|--|--|---------|---------|---------|---------|---------|---------|---------|
|  | 2006   |         |         |         | 2007    |         |         |         |
|  | Mar. 31  | Jun. 30 | Sep. 30 | Dec. 31 | Mar. 31 | Jun. 30 | Sep. 30 | Dec. 31 |
|  | (As a percentage of total revenues)<br>(Unaudited) |         |         |         |         |         |         |         |
| Revenues   | 100%   | 100%    | 100%    | 100%    | 100%    | 100%    | 100%    | 100%    |
| Cost of revenues   | (78.1)   | (80.4)  | (79.0)  | (75.7)  | (79.0)  | (83.0)  | (87.5)  | (90.9)  |
| Gross profit   | 21.9   | 19.6    | 21.0    | 24.3    | 21.0    | 17.0    | 12.5    | 9.1     |
| Research and development income (expenses), net                  | (0.4)  | (0.3)   | (0.4)   | (0.4)   | (0.3)   | (0.6)   | (0.2)   | 0.3     |
| Selling, general and administrative expenses                     | (12.8)   | (13.3)  | (14.6)  | (16.2)  | (13.9)  | (16.4)  | (16.7)  | (14.0)  |
| Impairment loss on goodwill                                      | -  | -       | -       | (4.7)   | -       | -       | -       | -       |
| Operating profit (loss)  | 8.7  | 6.0     | 5.9     | 3.0     | 6.8     | *       | (4.4)   | (4.6)   |
| Financial income (expenses), net                                 | (1.7)  | (1.2)   | (1.2)   | (1.4)   | (1.1)   | (2.0)   | 1.9     | (0.3)   |
| Other income (expenses), net                                     | *  | 0.1     | -       | *       | *       | -       | *       | *       |
| Profit (loss) before income tax expenses and minority interest   | 7.0  | 4.9     | 4.7     | 1.6     | 5.7     | (2.0)   | (2.5)   | (4.9)   |
| Income tax expense   | -  | -       | -       | (1.6)   | -       | -       | -       | -       |
| Profit (loss) after income tax expenses before minority interest | 7.0  | 4.9     | 4.7     | *       | 5.7     | (2.0)   | (2.5)   | (4.9)   |
| Minority interest  | (0.1)  | *       | 0.1     | 0.6     | (0.2)   | *       | *       | 0.1     |
| Net profit (loss)  | 6.9  | 4.9     | 4.8     | 0.6     | 5.5     | (2.0)   | (2.5)   | (4.8)   |

\*Less than 0.1%

### Impact of Currency Fluctuations and of Inflation

Our reporting currency is U.S dollars, however our functional currency is NIS. Our revenues are primarily denominated in the U.S. dollar, while our expenses are primarily denominated in NIS, U.S. dollars, Euros, dollar-linked NIS and Euro-linked NIS. As a result, fluctuations in rates of exchange between NIS and non-NIS currencies may affect our operating results and financial condition. The NIS value of our U.S. dollar revenues are adversely affected by the appreciation of the NIS against the U.S. dollar. In addition, the U.S. dollar value of our expenses other than those paid in NIS or Euro are negatively impacted by the devaluation of the U.S. dollar against the NIS and Euro. In 2006 and 2007, the NIS appreciated against the U.S. dollar by 8.2% and 9.0%, respectively, and the Euro appreciated against the U.S. dollar by 11.3% and 11.7%, respectively, which had a significant adverse affect on our results of operations.

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

|                              | Year Ended December 31, |        |        |        |        |
|------------------------------|-------------------------|--------|--------|--------|--------|
|                              | 2003                    | 2004   | 2005   | 2006   | 2007   |
| U.S. dollar                  | (7.6)%                  | (1.6)% | 6.8%   | (8.2)% | (9.0)% |
| Euro                         | 11.3%                   | 6.2%   | (7.3)% | 2.1%   | 1.7%   |
| Israeli consumer price index | (1.9)%                  | 1.2%   | 2.4%   | (0.1)% | 3.4%   |

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We have engaged external consultants to assist us to manage our foreign exchange risk. From time to time in the past we have used hedging instruments in order to partially protect ourselves from currency fluctuation and inflation risks and may use hedging instruments from time to time in the future.

Because exchange rates between the NIS and the dollar and Euro 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.

### Conditions in Israel

We are incorporated under the laws of, and our executive offices, principal production facilities and research and development facilities are located in, the State of Israel. See Item 3D Key Information Risk Factors Risks Relating to Our Location in Israel for a description of governmental, economic, fiscal, monetary or political polices or factors that have materially affected or could materially affect our operations.

### Trade Relations

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

Israel and the European Union Community, known now as the European Union, concluded a Free Trade Agreement in July 1975 that confers some advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and some non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as the EFTA, established a free-trade zone between Israel and the

EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes a redefinition of rules of origin and other improvements, such as allowing Israel to become a member of the Research and Technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including Russia, China, India, Turkey and other nations in Eastern Europe and Asia.

### Effective Corporate Tax Rate

Israeli companies are generally subject to income tax on their taxable income. The applicable rate for 2007 was 29%, which was reduced to 27% in 2008 and will be further reduced to 26% in 2009 and 25% in 2010 and thereafter.

However, certain of our production facilities have been granted the status of an approved enterprise under the Law for the Encouragement of Capital Investments, 1959, as amended. Subject to certain time limitations, income derived from such approved enterprise will be subject to corporate tax of up to 25%. The base year is 2005, however due to our tax loss carryforwards, there was no tax payment in Israel for the year ended December 31, 2007. For additional information see Item 10E. Additional Information Taxation Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959 and Note 15A to our consolidated financial statements.

As of December 31, 2007, we had approximately \$14.3 million in tax loss carryforwards in Israel, which can be offset against future income in Israel without time limitation. In Israel, we have received final tax assessments through the 1995 tax year and the tax assessments we received for the 1996-2003 tax years are considered final due to the statute of limitations. Our principal foreign subsidiary, Kubatronik has received final tax assessments through the 2005 tax year, and as of December 31, 2007 had approximately \$0.9 million in tax loss carryforwards in Germany. We do not believe, on a more likely than not basis, that we will be able to utilize the tax asset attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and to our loss carry-forwards in the foreseeable future. Therefore we have recorded a full valuation allowance on the deferred tax asset in respect of these differences and loss carry-forwards.

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### Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board, or the FASB, issued FASB Statement No. 157, *Fair Value Measurement*, or Statement 157. Statement 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The statement does not require any new fair value measures. Statement 157 is effective for fair value measures already required or permitted by other standards for fiscal years beginning after November 15, 2007. We are required to adopt Statement 157 beginning on January 1, 2008. Statement 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening retained earnings in the year of adoption. The FASB announced a one year deferral of Statement 157's fair value measurement requirements for non-financial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. We believe that the adoption of Statement 157 will not have a material impact on our financial condition, results of operations or cash flows.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB No. 115*, or Statement 159. Statement 159 provides us the irrevocable option to carry most financial assets and liabilities at fair value that are not currently required to be measured at fair value. If the fair value is elected, changes in fair value would be recorded in earnings at each subsequent reporting date. Statement 159 is effective for our 2008 fiscal year. We believe that the adoption of Statement 159 will not have a material impact on our financial condition, results of operations or cash flows.

In December 2007, the FASB issued FASB Statement No. 141R, *Business Combinations*, or Statement 141R, and FASB Statement No. 160, *Non-controlling Interests in Consolidated Financial Statements- an amendment to ARB No. 51*, or Statement 160. Statement 141R and Statement 160 require most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at full fair value and require non-controlling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with non-controlling interest holders. Both Statements are effective for periods beginning on or after December 15, 2008, and earlier adoption is prohibited. Statement 141R will be applied to business combinations occurring after the effective date. Statement 160 will be applied prospectively to all non-controlling interests, including any that arose before the effective date. We are currently evaluating the impact of adopting Statement 141R and Statement 160 on our results of operations and financial position.

### B. LIQUIDITY AND CAPITAL RESOURCES

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

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

We invested approximately \$3.3 million in capital expenditures in cash in the year ended December 31, 2007 and \$1.9 million in the year ended December 31, 2006. In the years ended December 31, 2007 and 2006, our capital expenditures mainly related to our investments in production and manufacturing equipment, and leasehold improvements. We expect to invest in 2008 approximately \$2.0 million in capital expenditures, including approximately \$1.5 million in manufacturing equipment and approximately \$0.5 million in leasehold improvements for the expansion of our production facilities.

In June 2002, we acquired 76% of Kubatronik for approximately Euro 2.6 million (\$2.4 million as of the date of acquisition). The remaining 24% of Kubatronik is held by Mr. Alois Kubat. Pursuant to the agreement under which we acquired our interest in Kubatronik (as amended), following the termination of Mr. Kubat's employment with Kubatronik and prior to December 31, 2012 (which period is automatically extended for additional consecutive two-year periods unless otherwise notified in writing by either party upon at least six months prior notice), Mr. Kubat has the right to require us to purchase, and we have the right to require him (or his permitted transferee) to sell to us, his remaining interest in Kubatronik. The price for Mr. Kubat's remaining holdings in Kubatronik will not be less than Euro 552,000 (\$727,000) and will not exceed Euro 920,000 (\$1.2 million), subject to certain price adjustments set forth in the agreement. Mr. Kubat retired in October 2003. Under U.S. GAAP, such an arrangement gives rise to a derivative instrument which should be marked to market every reporting period, in accordance with SFAS 150, *Accounting for Certain Financial Instruments with characteristics of both Liabilities and Equity*. See Note 1A to the consolidated financial statements.

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In May 2007, Mr. Josef Maiman elected to convert a convertible note held of record by Merhav for an aggregate 985,796 ordinary shares. As a result, Mr. Maiman's beneficial ownership interest increased to 1,585,540 ordinary shares, representing approximately 24% of our then outstanding shares, of which 985,796 are held of record by Merhav and 599,744 are held of record by Integral.

### Cash Flows

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

|   | Year ended December 31, |          |
|---|-------------------------|----------|
|   | 2006                    | 2007     |
|   | (\$ in thousands)       |          |
| Net cash provided by operating activities           | \$ 2,704                | \$ 1,410 |
| Net cash used in investing activities               | (1,857)                 | (3,254)  |
| Net cash provided by (used in) financing activities | (506)                   | 2,305    |
| Effect of translation adjustments                   | 112                     | (24)     |
| Net increase in cash and cash equivalents           | 453                     | 437      |
| Cash and cash equivalents at beginning of year      | 1,577                   | 2,030    |
| Cash and cash equivalents at end of year            | 2,030                   | 2,467    |

Net cash provided by operating activities was \$1.4 million for the year ended December 31, 2007. This amount was primarily attributable to a decrease in trade receivables of \$0.3 million, fixed asset depreciation of \$2.3 million and an increase in trade payables of \$0.2 million. This amount was partially offset by net loss of \$0.3 million, an increase in other receivables and prepaid expenses of \$0.4 million and a decrease in other liabilities and accrued expenses of \$0.3 million. Net cash provided by operating activities was \$2.7 million for the year ended December 31, 2006. This amount was primarily attributable to net income of \$1.7 million, fixed asset depreciation of \$2.3 million, an impairment of goodwill of \$0.5 million, a decrease in other receivables and prepaid expenses of \$0.2, an increase of other liabilities and accrued expenses of \$0.6 million and cancellation of deferred taxes of \$0.2 million. This amount was partially offset by an increase in trade receivables of \$2.1 million and a decrease in trade payables of \$0.4 million.

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Net cash used in investing activities was \$3.3 million for the year ended December 31, 2007 and \$1.9 million for the year ended December 31, 2006. Net cash used in investing activities for the years ended December 31, 2006 and 2007 was primarily for the purchase of fixed assets for our production lines.

Net cash provided by financing activities was \$2.3 million for the year ended December 31, 2007, which was primarily attributable to new long-term loans of \$ 3.0 million from our banks and an increase of short-term credit from our banks, which was partly offset by the repayment of \$1.8 million of long-term loans and the repayment of \$0.2 million of credit from fixed asset payables. Net cash used in financing activities was \$0.5 million for the year ended December 31, 2006, which was primarily attributable to the repayment of \$2.4 million in long-term and short-term credit from our banks and the repayment of \$0.4 million of credit from fixed asset payables, which was partly offset by new loans of \$2.2 million from our banks and cash from the exercise of employee stock options of \$0.1 million.

As of December 31, 2007, we had \$2.5 million in cash and cash equivalents and working capital of \$0.7 million, as compared to \$2.0 million in cash and cash equivalents and working capital of \$1.7 million at December 31, 2006.

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As of December 31, 2007, the following revolving lines of credit and long-term loans were outstanding:

a revolving line of credit of approximately \$1.4 million with Bank Hapoalim B.M. Of such amount, \$110,000 is linked to the U.S. dollar and \$1.3 million is not linked.

long-term loans from Bank Hapoalim B.M. aggregating \$2.1 million. Of such amount, \$604,000 is linked to the Israeli consumer price index and \$1.5 million is not linked.

a revolving line of credit of approximately \$2.2 million with Israel Discount Bank Ltd, which is not linked.

long-term loans from Israel Discount Bank Ltd. in the aggregate amount of \$2.9 million. Of such amount, \$170,000 is linked to the Israeli consumer price index, \$1.0 million is linked to the U.S. dollar and \$1.7 million is not linked.

long-term loans from suppliers of fixed assets in the aggregate amount of \$672,000. Of such amount, \$91,000 is linked to the Israeli consumer price index, \$400,000 is linked to the U.S. dollar and \$181,000 is linked to the Euro.

Our credit lines bear annual interest ranging from 6.7% to 6.85% for non-linked credit and 6.7% for credit linked to the dollar. Our long-term loans bear annual interest ranging from 4.5% to 6.5% for long-term loans linked to the Israeli consumer price index, 4.0% to 6.9% for long-term loans linked to the dollar, 2.85% for long-term loans linked to the Euro and 6.5% to 8.4% for non-linked long-term loans.

In 2003, we negotiated a financing plan with our banks and controlling shareholder, pursuant to which the banks agreed to extend the payment of our outstanding debt and our major shareholder contributed \$500,000 to our company in consideration of a convertible note, which was converted into ordinary shares in May 2007(see above in this Item). In July 2003, as part of this financing plan, we signed an agreement with U Bank Ltd. (formerly Investec Bank (Israel) Ltd.), or U Bank, for a \$1.0 million factoring facility, in consideration for our assignment to U Bank of an equal amount of our accounts receivable. In December 2006, we replaced the factoring arrangement with a NIS 2.8 million line of credit from Israel Discount Bank Ltd. and a long-term loan of NIS 1.7 million from Bank Hapoalim B.M. Also see Item 7.B., Major Shareholders and Related Party Transactions Related Party Transactions.

The borrowings from our banks are secured by specific liens on certain assets, by a first priority charge on the rest of our now owned or after acquired assets and by a fixed lien on goodwill (intangible assets) and insurance rights (rights to proceeds on insured assets in the event of damage). In addition, the agreements with our banks prohibit us from selling or otherwise transferring any assets except in the ordinary course of business or from placing a lien on our assets without the banks' consent. Financial covenants in respect of our credit facilities and long-term debt with one of our banks require us to maintain the higher of shareholders' equity, excluding intangible assets, of NIS 24.0 million or 23% of our total assets (on a non-consolidated basis). With another bank, the financial covenants require us to maintain the higher of tangible shareholders' equity of NIS 17.5 million or 17% of our consolidated total assets. For these purposes, shareholders' equity excludes prepaid expenses (except insurance). As of December 31, 2007, we were in compliance with such covenants.

We expect to finance our 2008 budget from operational cash flow, revolving bank credit lines and long-term bank loans, and supplier financing. We believe that the availability of our revolving lines of credit, long-term bank loans and cash flow from operations will provide us with sufficient working capital to fund our operational and capital requirements through December 31, 2008.

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

We generally do not engage in significant research and development.

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In 2005, we were granted membership in OptiPac, a consortium within the framework of the MAGNET program of the Office of the Chief Scientist. OptiPac was created specifically to develop generic optical packaging technologies for the microelectronics sector, technologies that are critically important to the communications industry. Under the terms of the consortium, each member of the consortium will be provided with an advance for its research and development costs for a specific research and development project assigned to it by the consortium. The Office of the Chief Scientist reimburses 66% of such approved research and development expenses, less certain consortium expenses. These reimbursements are contingent upon our submitting periodic reports prepared in accordance with the requirements of the Office of the Chief Scientist. We are not required to pay the Office of the Chief Scientist royalties with respect to this grant. In 2005, 2006 and 2007, we incurred \$249,000, \$326,000 and \$167,000, respectively, in research and development expenses in connection with our membership in OptiPac, a consortium within the framework of the MAGNET program of the Office of the Chief Scientist of the Ministry of Industry and Trade of the State of Israel, or the OCS. Of such total expenses in 2005, 2006 and 2007, \$105,000, \$172,000 and \$93,000, respectively, were reimbursed to us by the OCS in accordance with the terms of the OptiPac consortium.

**D. TREND INFORMATION**

Since the third quarter of 2004 through the first quarter of 2007, we have experienced growth in our revenues, primarily as a result of the implementation of our new strategy to focus our marketing efforts in the high end of the PCB market, mainly in the flex-rigid PCB market. In addition, we are developing new business relationships with customers from abroad.

Our backlog at December 31, 2007 was approximately \$7.0 million compared to a backlog of approximately \$5.9 million at December 31, 2006. We include in our backlog all purchase orders scheduled for delivery within the next 12 months, although the majority of the backlog typically is scheduled for delivery within 45 days. For a variety of reasons, including the timing of orders, delivery intervals, customer and product mix and the possibility of customer changes in delivery schedules, backlog as of any particular date may not be a reliable measure of sales for any succeeding period. Cancellation charges generally vary depending upon the time of cancellation and, therefore, substantially all of our backlog may be subject to cancellation without penalty.

**E. OFF-BALANCE SHEET ARRANGEMENTS**

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

**F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS**

The following table summarizes our minimum contractual obligations as of December 31, 2007.

| Contractual Obligations                           | Payments due by period<br>(\$ in thousands) |                     |           |           |                      |
|---|---|---------------------|-----------|-----------|----------------------|
|   | Total                                       | less than 1<br>year | 1-3 years | 3-5 years | more than 5<br>years |
| Short-term bank credit (1)                        | 3,594                                       | 3,594               | -         | -         | -                    |
| Long-term debt obligations (2)                    | 5,742                                       | 1,495               | 3,272     | 975       | -                    |
| Operating lease and other contractual obligations | 7,668                                       | 1,576               | 1,956     | 1,407     | 2,729                |
| Purchase obligations                              | 2,345                                       | 2,345               | -         | -         | -                    |
| Other long-term liabilities reflected on the      |   |                     |           |           |                      |

| Contractual Obligations                 | Payments due by period<br>(\$ in thousands) |       |       |       |       |
|---|---|-------|-------|-------|-------|
|   |   |       |       |       |       |
| company's balance sheet under U.S. GAAP | 1,388                                       | -     | -     | -     | 1,388 |
| Total                                   | 20,737                                      | 9,010 | 5,224 | 2,382 | 4,117 |

- (1) Our short-term bank credit lines bear annual interest ranging from 6.7% to 6.85% for non-linked credit and 6.7% for credit that is linked to the dollar.
- (2) Our long-term debt obligations include long-term loans and long-term debt related to fixed assets financing transactions. Our long-term loans bear annual interest ranging from 4.5% to 6.5% for long-term loans that are linked to the Israeli consumer price index, 4.0% to 6.9% for long-term loans that are linked to the U.S. dollar, 2.85% for long-term loans that are linked to the Euro and 6.5% to 8.4% for non-linked long-term loans.

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## 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:

| Name                           | Age | Position  |
|--------------------------------|-----|---|
| Nissim Gilam(1)(2)             | 69  | Chairman of the Board of Directors                        |
| Arieh Reichart                 | 53  | President and Chief Executive Officer                     |
| Amnon Shemer                   | 48  | Vice President, Finance and Chief Financial Officer       |
| Dan Eshed                      | 57  | Senior Vice President, Subsidiaries                       |
| Eli Dvora                      | 51  | Vice President, Operations                                |
| Moshe Leibovich                | 50  | Vice President, Marketing and Sales                       |
| Roberto Tulman                 | 49  | Vice President, Technologies and Chief Technology Officer |
| Shlomo Danino                  | 45  | Vice President, Engineering and Quality Assurance         |
| Vardit Dekel                   | 43  | Vice President, Human Resources                           |
| David Banitt(1)(3)(4)          | 56  | Independent Director                                      |
| Josef Maiman                   | 61  | Director  |
| Eitan Popper                   | 30  | Director  |
| Ophira Rosolio-Aharonson(1)(3) | 58  | Outside Director  |
| Eliyaho Tov(1)(2)(3)(4)        | 64  | Outside Director  |
| Joseph Yerushalmi              | 69  | Director  |

(1) Member of the Executive Committee

(2) Member of the Compensation Committee

(3) Member of the Audit Committee

(4) Member of the Stock Option Committee

Mr. Joseph Yerushalmi, a Class I director, will serve as a director until our 2009 general annual meeting of shareholders. Messrs. David Banitt and Eitan Popper, Class II directors, will serve as directors until our 2010 annual general meeting of shareholders. Messrs. Josef A. Maiman and Nissim Gilam, Class III directors, will serve as directors until our 2008 general annual meeting of shareholders. Mr. Eliyaho Tov and Ms. Ophira Rosolio-Aharonson will serve as outside directors pursuant to the provisions of the Israeli Companies Law for a three-year term until our 2009 annual general meeting of shareholders, following which the service of Mr. Tov as an outside director may not be extended and

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service of Ms. Rosolio-Aharonson as an outside director may be renewed for one additional three-year term.

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

**Arieh Reichart** joined us in September 1984 as our chief financial officer and assumed the position of president and chief executive officer in May 1991. Mr. Reichart holds a B.A. degree in Economics and M.B.A. degree from Bar-Ilan University.

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

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

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

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

**Roberto Tulman** joined us in August 2005 as vice president, technologies and chief technology officer. During the 22 years prior to joining our company, Mr. Tulman served in the electronic research department of the Israel Defense Forces, where he held various research and development and management positions, and managed the printed circuits division during his last eight years of service. Mr. Tulman holds a B.Sc. degree (Cum Laude) in Chemistry, M.Sc degree in Chemistry (Electrochemistry) and MBA degree, all from Tel-Aviv University.

**Shlomo Danino** joined us in August 1985. During his employment with our company, Mr. Danino has served as product engineering manager, and was appointed as vice president, engineering and quality assurance in February 1999. Mr. Danino holds a B.Sc. degree in mechanics from Ort Technology College in Israel and a B.Sc. degree in general business from Champlain College, in Burlington, Vermont.

**Vardit Dekel** joined us in August 2005 as vice president, human resources. From May 2001 until July 2005, Ms. Dekel served as Human Resources manager of Chefa Ltd., an Israeli group engaged in food services for airlines, business and industry companies. During the 12 years prior to joining Chefa Ltd., Ms. Dekel served at Israel Elwyn's Residential Center for people with special needs, where she served in several management positions, including human resources and training manager and as its manager. Ms. Dekel holds a B.A degree in special education and MA degree in organizational sociology and organizational counseling, both from The Hebrew University of Jerusalem.

**David Banitt**, an independent director, has served as a director since March 1997. Since January 2006, Mr. Banitt has served as chief executive officer of YDesign Ltd., a company involved in the development of consumer products. Mr. Banitt is a member of the board of directors of Tidex Systems Ltd. From July 2005 until January 2006, Mr. Banitt was self-employed, providing consulting services in marketing, primarily in the PCB market. From August 2001 until July 2005, Mr. Banitt served as chief executive officer and member of the board of directors of Nano-OR Ltd., an Israeli start-up company engaged in the development of electro-optics systems. Prior to joining Nano-OR Technology Ltd. and from January 2001, Mr. Banitt was self-employed. From September 1997 until January 2001, Mr. Banitt served as President and member of the board of directors of Exsight Electro Optical Systems Ltd., an Israeli start-up company engaged in the development of electro-optics systems for the printed circuit boards industry. From 1993 until 1997, Mr. Banitt served as general manager of Nitzanim Initiative Center. From 1985 until 1992, Mr. Banitt served as Vice President of Marketing of Optrotech Ltd., an Israeli company that provided

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optical inspection systems to the PCB industry. Mr. Banitt holds a B.Sc. degree in Electronics Engineering from Tel Aviv University.

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**Josef Maiman** has served as a director since July 1988. Mr. Maiman has served as president of Merhav M.N.F. Ltd. since August 1972. Mr. Maiman has served as the chairman of the board of directors of Israel 10 Channel Ltd. since January 2002 and since April 2002, as the chairman of the board of directors of Ampal American Israel Corporation, a public holding company listed on The NASDAQ National Market, and since October 2006 he also serves as the CEO of Ampal. Mr. Maiman holds a B.A. degree in Economics from University of Texas and M.A. degree in Economics from Cornell University.

**Eitan Popper** has served as a director since December 2007. Mr. Popper has served as project engineer and executive assistant to the senior vice president of projects of Merhav M.N.F. Ltd. since 2003. In that position, Mr. Popper participated in the evaluation and analysis of large scale energy and infrastructure projects worldwide. Prior thereto and from 2002, Mr. Popper served as a civil and environmental engineer in the Mexico City and San Francisco offices of URS Corporation, a global engineering and consulting company traded on the New York Stock Exchange. Mr. Popper holds a B.Sc. degree in civil engineering from the Universidad Iberoamericana of Mexico and M.Sc. degree in environmental engineering from Stanford University. Mr. Popper is currently enrolled in the MBA program (specializing in finance) of the Recanati School of Business of Tel Aviv University.

**Ophira Rosolio-Aharonson** was appointed as an outside director (within the meaning of the Israeli Companies Law) in December 2006. Ms. Rosolio-Aharonson serves as an executive director of several private and publicly traded companies, a strategic business consultant to high-technology companies and an advisor to venture capital firms in Israel and the United States. From 2000 to 2006, Ms. Rosolio-Aharonson served as an active executive director and audit committee member of Scitex Ltd. (NASDAQ:SCIX), and as a director and chair of the audit committee of Cimatron Ltd. (NASDAQ:CIMT). Ms. Rosolio-Aharonson is a co-founder of Seagull Tech Inc. and KeyScan Inc. From 1992 through 1999, Ms. Rosolio-Aharonson served as the chief executive officer of Terra Computers, Inc. in the United States. From 1980 to 1989, Ms. Rosolio-Aharonson served as a senior executive, holding managerial positions, at Clal Ltd., an Israeli company publicly traded on the Tel Aviv Stock Exchange, including director, chief executive officer, chief operations officer and vice president of sales and marketing of Clal Ltd. subsidiaries. Ms. Rosolio-Aharonson holds a B.Sc. degree in applied mathematics and physics, and has completed courses required for a M.Sc. degree in bio-medical engineering, both from the Technion Israel Institute of Technology, Haifa and is a graduate of the executive business and management program of Tel Aviv University.

**Eliyaho Tov** was appointed as an outside director (within the meaning of the Israeli Companies Law) in December 2003. Since November 1999, Mr. Tov has been a freelance consultant as an economic advisor and currently serves as a director of several other companies. From 1973 until September 1999, Mr. Tov served as a senior economist of The Israel Corporation Ltd. and during such period served as a director of several companies within The Israel Corporation Ltd. group. Mr. Tov holds a B.A. degree in economics and political science and M.A. degree in business management, both from The Hebrew University of Jerusalem. Mr. Eliyaho Tov qualifies as an audit committee financial expert, as defined by rules of the Securities and Exchange Commission.

**Joseph Yerushalmi** has served as a director since December 2003. Since January 1996, Mr. Yerushalmi has served as a senior vice president in charge of the projects of Merhav M.N.F. Ltd. Mr. Yerushalmi serves as a member of the board of directors of Ampal Israel Corporation Ltd. From 1992 to 1996, Mr. Yerushalmi served as vice president, projects development at Israel Chemicals Ltd., Israel's largest chemical concern. Between 1989 and 1992, Mr. Yerushalmi was a visiting professor at the University of Pittsburgh. In 1980, Mr. Yerushalmi founded PAMA (Energy Resources Development) Ltd. in Israel with the goal of commercial utilization of Israel oil shale reserves and he served as its General Manager until 1989. From 1977 to 1980, Mr. Yerushalmi was Technical Manager of the Coal Gasification Program of the Electric Power Research Institute (EPRI) in Palo Alto, California. Between 1969 and 1977, Mr. Yerushalmi was professor of Chemical Engineering at the City College of New York where he pioneered in research the field of alternative energy. Mr. Yerushalmi holds a Ph.D. in Chemical Engineering from the City University of New York.

There are no family relationships between any of our directors and executive officers.

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## B. COMPENSATION

The following table sets forth all compensation we paid with respect to all of our directors and executive officers as a group for the year ended December 31, 2007.

|   | <u>Salaries, fees,<br/>commissions and<br/>bonuses</u> | <u>Pension, retirement<br/>and similar benefits</u> |
|---|--|---|
| All directors and executive officers as a group (then consisting of 15 persons) | \$ 1,381,000   | \$ 195,000  |

During the year ended December 31, 2007, we paid each of our outside and independent directors an annual fee of \$3,932 and a per meeting attendance fee of \$251. During such period we paid Nissim Gilam, chairman of our board of directors, a management fee of \$5,000 per month and reimbursed him for various expenses that he incurred in connection with his service as chairman of the board of directors in an annual amount of \$2,439. In addition, in accordance with the approval of our shareholders at our 2007 annual general meeting of shareholders, in 2007, we paid Mr. Gilam a special bonus in the amount of \$15,210 in consideration for his on-going efforts and substantial contribution to our company during the 2006 fiscal year. We also provide Mr. Gilam with a company car and pay all expenses in connection therewith.

As of December 31, 2007, our directors and executive officers as a group, consisting of 15 persons, held options to purchase an aggregate of 20,000 ordinary shares. Such options have an exercise price of \$1.14, vest over a three-year period (all of which had vested at December 31, 2007) and will expire in November 2009. All such options were granted under our 2000 Stock Option Plan. See Share Ownership Stock Option Plans.

## 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.

### Election of Directors

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

Pursuant to our articles of association, our board of directors is divided into three classes (other than outside directors). Generally, at each annual meeting of shareholders one of such classes of directors is elected for a term of three years by a vote of the holders of a majority of the voting power represented and voting at such meeting. All the members of our board of directors (except the outside directors as detailed below) may be reelected upon completion of their term of office. Directors (other than outside directors) may be removed earlier from office by a resolution passed at a general meeting of our shareholders, provided that shareholders holding in the aggregate no less than forty-percent of our outstanding share capital vote in favor of such resolution. Our board of directors may temporarily fill vacancies in the board or add to their body until the next annual meeting of shareholders, provided that the total number of directors will not exceed the maximum number permitted under our articles of association.

The board of directors of an Israeli public company is required to determine a minimum number of directors with accounting and financial expertise, as defined by regulations promulgated under the Israeli Companies Law. Our board of directors determined, accordingly, that at least one director must have accounting and financial expertise. Our Board of Directors has further determined that Mr. Eliyaho Tov has the requisite accounting and financial expertise.

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

## Outside and Independent Directors

*Outside Directors.* Under the Israeli Companies Law, Israeli companies 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 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 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.

At least one of the outside directors elected 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. Our outside director, Mr. Eliyaho Tov, has accounting and financial expertise and our other outside director, Ms. Ophira Rosolio-Aharonson, has professional qualification, as such terms are defined by regulations promulgated under the Israeli Companies Law.

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

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

Mr. Eliyaho Tov and Ms. Ophira Rosolio-Aharonson serve as our outside directors under the Israeli Companies Law until our 2009 annual general meeting of shareholders, following which the service of Mr. Tov as an outside director may not be extended and service of Ms. Rosolio-Aharonson as an outside director may be renewed for one additional three-year term.

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*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 Commission. However, on June 9, 2005, we provided NASDAQ with a notice of non-compliance with respect to (among other things) the requirement to maintain a majority of independent directors, as defined under NASDAQ Marketplace Rules. Instead, we follow Israeli law and practice which requires that we appoint at least two outside directors, within the meaning of the Israeli Companies Law, to our board of directors. (See below in this Item 6C. "Directors, Senior Management and Employees Board Practices - NASDAQ Marketplace Rules and Home Country Practices.") 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.

Our Board of Directors has determined that each of Messrs. Banitt and Tov and Ms. Rosolio-Aharonson qualifies as an independent director under the requirements of the Securities and Exchange Commission and NASDAQ.

## Committees of the Board of Directors

### *Executive Committee*

Our Board of Directors established an executive committee, which is responsible for monitoring the implementation of our annual work plan that is adopted each year by our board of directors, and recommending to our board of directors future strategies for our company and monitoring their implementation. Messrs. Gilam, Banitt and Tov and Ms. Rosolio-Aharonson are the current members of our executive

committee. Our executive committee meets approximately once a month with our Chief Executive Officer.

#### ***Audit Committee***

Under the Israeli Companies Law, the board of directors of any public company must establish an audit committee. The audit committee must consist of at least three directors and must include all of the outside directors. The audit committee may not include the chairman of the board of directors, any director employed by the company or providing services to the company on an ongoing basis, or a controlling shareholder or any of the controlling shareholder's relatives.

In addition, the NASDAQ Marketplace Rules require us to establish an audit committee comprised of at least three members, all of whom must be independent directors, each of whom is financially literate and satisfies the respective independence requirements of the Securities and Exchange Commission and NASDAQ and one of whom has accounting or related financial management expertise at senior levels within a company.

Our audit committee assists our Board of Directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent registered public accountants' qualifications and independence, the performance of our internal audit function and independent registered public accountants, finding any defects in the business management of our company and proposing to the Board of Directors ways to correct such defects, approving related-party transactions as required by Israeli law, and such other duties as may be directed by our Board of Directors. The audit committee may consult from time to time with our independent auditors and internal auditor with respect to matters involving financial reporting and internal accounting controls.

Our audit committee consists of three members of our Board of Directors who satisfy the respective independence requirements of the Securities and Exchange Commission, NASDAQ and Israeli Law for audit committee members. Our audit committee is currently composed of Messrs. Banitt and Tov and Ms. Rosolio-Aharonson. The audit committee meets at least once each quarter.

#### ***Compensation Committee***

Our board of directors established a compensation committee, which is responsible for the administration of our: (i) 1996 Stock Option Plan; and (ii) 2000 Stock Option Plan (see Item 6.E., Directors, Senior Management and Employees Share Ownership Stock Option Plans ). Messrs. Tov and Gilam are the current members of our compensation committee. Under the Israeli Companies Law, subject to certain conditions, the board of directors may delegate to a board committee its authority to grant options. The grant of options to our office holders (within the meaning of the Israeli Companies Law) requires the approval of our audit committee and board of directors, and if the office holder is a director, also by our shareholders.

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#### ***Stock Option Committee***

Our Board of Directors established a Stock Option Committee (see Item 6.E., Directors, Senior Management and Employees Share Ownership Stock Option Plans ). Messrs. Tov and Banitt are the current members of our Stock Option Committee. Our Stock Option Committee meets on an as required basis.

#### **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. The internal auditor must meet certain statutory requirements of independence. The role of the internal auditor is to examine, among other things, the compliance of the company's conduct with applicable law and orderly business practice. Mr. Daniel Shapira, Certified Public Accountant (Israel), serves as our internal auditor.

#### **Directors Service Contracts**

We do not have any service contracts with our directors, except for the compensation we pay to Mr. Nissim Gilam in connection with his services as Chairman of our Board of Directors. We pay Mr. Gilam a management fee of \$5,000 per month, reimburse him for various expenses that he incurs in connection with his service as Chairman of the Board of Directors in an annual amount up to NIS 18,000 (\$4,680) (in 2007 we paid him NIS 10,024 (\$2,439)), and provide him with a company car and pay all expenses in connection therewith. In addition, in accordance with the approval of our shareholders at our 2007 annual general meeting of shareholders, in 2007 we paid Mr. Gilam a special bonus in the

amount of NIS 60,000 (\$15,210) in consideration for his on-going efforts and substantial contribution to our company during the 2006 fiscal year. Mr. Gilam may receive this compensation directly or through his personal company, Nissim Gilam Ltd.

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 business feasibility 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 requires that an office holder act in good faith and for the benefit of the company, including (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 by virtue of his position as an office holder.

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#### *Disclosure of Personal Interests of an Office Holder; Approval of Transactions with Office Holders*

The Israeli Companies Law requires that an office holder promptly, and no 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 (as such term is described above) 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.

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 that apply to an office holder also apply to a transaction in which a controlling shareholder of the company has a personal interest. 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 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 or if the directors' compensation does not exceed the maximum amount of compensation for outside directors determined by applicable regulations. 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. If such objection is duly and timely submitted, then the transaction or compensation arrangement of the directors will require shareholders' approval as detailed above.

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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.

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. In such event, 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**

### *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. Our articles of association allow us to exculpate any office holder from his or her liability to us for breach of duty of care, to the maximum extent permitted by law, before or after the occurrence giving rise to such liability.

### *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 or omission performed in his or her capacity as an office holder, as a result of: (i) a breach of the office holder's duty of care to the company or to another person; (ii) 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 (iii) a monetary liability imposed upon the office holder in favor of another person.

Our articles of association provide that, subject to any restrictions imposed by applicable law, we may procure, and/or undertake to procure, insurance covering any past or present or future office holder against any liability which he or she may incur in such capacity, including insurance covering us for indemnifying such office holder, to the maximum extent permitted by law.

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#### *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 liabilities or expenses imposed on him or her, or incurred by him or her concerning acts or omissions performed by the office holder in such capacity for: (i) 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; (ii) reasonable litigation expenses, including attorney's fees, 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 an indictment against the office holder but with the imposition of a monetary liability on the office holder in lieu of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and (iii) reasonable litigation expenses, including attorney's 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 the office holder 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.

The Israeli Companies Law provides that a company's articles of association may permit the company to indemnify an office holder following a determination to this effect made by the company after the occurrence of the event in respect of which the office holder will be indemnified. It also provides that a company's articles of association may permit the company to undertake in advance to indemnify an office holder, 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.

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

#### *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 exempting an office holder from duty to the company shall be valid, where such insurance, indemnification or exemption relates to any of the following: (i) a breach by the office holder of his duty of loyalty, except with respect to insurance coverage or indemnification if the office holder acted in good faith and had reasonable grounds to assume that the act would not prejudice the company; (ii) 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; (iii) any act or omission committed with intent to derive an unlawful personal gain; and (iv) any fine or forfeiture imposed on the office holder.

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

We have agreed to indemnify our office holders to the fullest extent permitted by law. We currently maintain directors and officers liability insurance with a per claim and aggregate coverage limit of \$10 million. Under our current directors and officers liability insurance policy, losses will be paid in accordance with the following order of priority: first, on behalf of officers and directors, for all loss that they will be obligated to pay as a result of a claim made against them; thereafter, on our behalf, for all loss that an officer or director will be obligated to pay as a result of a claim made against them, to the extent that we are required or permitted by law to indemnify our officers and directors; and thereafter, on our behalf, for all loss that we will be obligated to pay as a result of a securities claim made against us.

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## 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, without the need to seek individual exemptions from NASDAQ. 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. On June 9, 2005, we provided NASDAQ with a notice of non-compliance with Rule 4350. We do not comply with the following requirements of Rule 4350, and instead follow Israeli law and practice in respect of such requirements:

the requirement to maintain a majority of independent directors, as defined under the NASDAQ Marketplace Rules. Instead, we follow Israeli law and practice which requires that we appoint at least two outside directors, within the meaning of the Israeli Companies Law, to our Board of Directors. In addition, we have the mandated three independent directors, within the meaning of the 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 Outside and Independent Directors.

the requirements regarding the directors nominations process. Under Israeli law and practice our board of directors and shareholders holding at least 1% of a company's voting rights are authorized to recommend to our shareholders director nominees for election. See above in this Item 6C. Directors, Senior Management and Employees Board Practices Election of Directors.

the requirement regarding the quorum for any meeting of the holders of common stock. Instead, we follow Israeli law and practice which provides that, unless otherwise provided by a company's articles of association, the quorum required for a general meeting of shareholders is at least two shareholders present who hold, in the aggregate, 25% of the company's voting rights. Our articles of association provide that the quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least 40% of the voting rights of the issued share capital. See Item 10A. Additional Information Share Capital Annual and Extraordinary Meetings of Shareholders.

### D. EMPLOYEES

As of December 31, 2007, we employed 326 full-time employees in Israel, of which 192 were employed in manufacturing services, 38 in process and product engineering, 43 in quality assurance and control, 14 in sales and marketing and 39 in finance, accounting, information service and administration.

As of December 31, 2006, we employed 310 full-time employees in Israel, of which 184 were employed in manufacturing services, 35 in process and product engineering, 42 in quality assurance and control, 12 in sales and marketing and 37 in finance, accounting, information service and administration.

As of December 31, 2005, we employed 273 full-time employees in Israel, of which 157 were employed in manufacturing services, 36 in process and product engineering, 30 in quality assurance and control, 13 in sales and marketing and 37 in finance, accounting, information service and administration.

In addition, as of December 31, 2007, Kubatronik, our subsidiary in Germany, employed 38 full-time employees and 8 part-time employees, compared to 40 full-time employees and 7 part-time employees at December 31, 2006 and 37 full-time employees and 9 part-time employees at December 31, 2005.

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

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

Pursuant to Israeli law, we are legally required to pay severance benefits upon certain circumstances, including the retirement or death of an employee or the termination of employment of an employee without due cause. Most of our employees are covered by contribution pension plans providing customary benefits including retirement and severance benefits. Some of our employees are covered by life and pension insurance policies providing similar benefits. We contribute between 12.0% and 14.5% of base salaries to such plans and employees contribute between 5.0% to 7.0% of base salaries. We also contribute 7.5% of base salaries to certain professional advancement funds for managers, engineers and others and such employees contribute 2.5% of base salaries. Our contribution and employee contributions are not limited; however, a company's contribution above certain specified maximum amounts are taxable income to the employee. Israeli employers and employees are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Subject to minimum thresholds, the employer contribution to the National Insurance Institute is at the rate of 4.9% of the salary and the employee contribution to the National Insurance Institute is at the rate of 8.0% of the salary (of which 4.1% relates to payments for national health insurance), both of which are limited to a maximum salary of NIS 35,760 (approximately \$8,900). In the year ended December 31, 2007, our aggregate payments as an employer to the National Insurance Institute amounted to approximately 4.9% of the salaries.

### E. SHARE OWNERSHIP

#### Beneficial Ownership of Executive Officers and Directors

The following table sets forth certain information as of April 28, 2008 regarding the beneficial ownership by each of our directors and executive officers:

| Name                     | Number of Ordinary<br>Shares<br>Beneficially Owned (1) | Percentage of<br>Ownership (2) |
|--------------------------|--|--------------------------------|
| Nissim Gilam             | -  | -                              |
| Arieh Reichart           | 85,515   | 1.3%                           |
| Amnon Shemer             | 10,000(3)  | *                              |
| Dan Eshed                | -  | -                              |
| Eli Dvora                | -  | -                              |
| Moshe Leibovich          | 10,000(3)  | *                              |
| Roberto Tulman           | -  | -                              |
| Shlomo Danino            | -  | -                              |
| Vardit Dekel             | -  | -                              |
| David Banitt             | -  | -                              |
| Eitan Popper             | -  | -                              |
| Josef Maiman             | 1,585,540(4)   | 24.0%                          |
| Ophira Rosolio-Aharonson | -  | -                              |
| Eliyaho Tov              | -  | -                              |
| Joseph Yerushalmi        | -  | -                              |

\* Less than 1%

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- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

- (2) The percentages shown are based on 6,609,807 ordinary shares issued and outstanding as of April 28, 2008.
- (3) Such shares are subject to currently exercisable options granted under our 2000 Stock Option Plan, having an exercise price of \$1.14 per share and that expire in November 2009.
- (4) Includes 985,796 held of record by Merhav M.N.F. Ltd., an Israeli private company controlled by Mr. Maiman and 599,744 ordinary shares held of record by Integral International Inc., a Panama corporation controlled by Mr. Maiman. Mr. Maiman may be deemed to be the beneficial owner of the aggregate 1,585,540 ordinary shares held directly by Merhav M.N.F. Ltd. and Integral International Inc.

### Major Shareholders Voting Rights

Our major shareholders do not have different voting rights.

### Stock Option Plans

#### *2000 Stock Option Plan*

Our 2000 Stock Option Plan, or the 2000 Plan, authorizes the grant of options to purchase up to 750,000 ordinary shares. Employees, officers, directors and consultants of our company and its subsidiaries are eligible to participate in the 2000 Plan. Awards under the 2000 Plan may be granted in the forms of incentive stock options as provided in Section 422 of the U.S. Internal Revenue Code of 1986, as amended, non-qualified stock options, options granted pursuant to Section 102 of the Israeli Income Tax Ordinance (New Version), 1961, or the Israeli Tax Ordinance, and options granted pursuant to Section 3.9 of the Israeli Tax Ordinance. The 2000 Plan has a term of ten years and will terminate on July 31, 2010. No award of options may be made after such date.

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

propose to grant awards under the 2000 Plan and recommend to the board of directors the persons to whom such awards be granted;

determine the form, terms and conditions of the written stock option agreement evidencing the option, including the type of option and the number of shares to which it pertains, the option price, the option period and its vesting schedule, and exercisability of the option in special cases (such as death, retirement, disability and change of control);

prescribe the form and provisions of the notice of exercise and payment of the option;

nominate a trustee for options issued under Section 102 of the Israeli Tax Ordinance;

adjust any or all of the number and type of shares that thereafter may be made the subject of options, the number and type of shares subject to outstanding options, and the grant or exercise price with respect to any option, or, if deemed appropriate, make provision for a cash payment to the holder of any outstanding option in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the 2000 Plan in the event of any dividend or other distribution, recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase, or exchange of shares or other securities;

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interpret the provisions of the 2000 Plan; and

prescribe, amend, and rescind rules and regulations relating to the 2000 Plan or any award thereunder as it may deem necessary or advisable.

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

The option price per share may not be less than 100% of the fair market value of such share on the date of the grant. However, in the case of an award of an incentive stock option made to a 10% owner, the option price per share may not be less than 110% of the fair market value (as such term is defined in the 2000 Plan) of such share on the date of the award. Generally the options vest ratably over a three-year period. An option may not be exercisable after the expiration of five years from the date of its award. No option may be exercised after the expiration of its term.

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

As of December 31, 2007, options for the purchase of 138,400 ordinary shares had been granted under the 2000 Plan (excluding options that expired without being exercised), of which, options to purchase 118,400 ordinary shares having an exercise price of \$4.375 per share and options to purchase 20,000 ordinary shares having an exercise price of \$1.14 per share. During the year ended December 31, 2007, no options were exercised. As of December 31, 2007, options to purchase 20,000 ordinary shares were outstanding and exercisable under the 2000 Plan. Of the options granted under the 2000 Plan (excluding options that expired without being exercised), options to purchase 59,500 ordinary shares were granted to our executive officers and the chairman of our board of directors, of which options to purchase 20,000 ordinary shares were outstanding and exercisable as of December 31, 2007 and the remaining options to purchase 39,500 ordinary shares were exercised in prior years. Since December 2004, we have not granted options under the 2000 Plan and we do not intend to grant any additional options under the 2000 Plan in the future.

### ***2005 Stock Option Plan***

Our 2005 Stock Option Plan, or the 2005 Plan, was adopted at our 2005 annual general meeting.

In August 2000, our company granted options under the 2000 Plan to certain of our employees, officers and the Chairman of our Board of Directors. The exercise price of such *options* was \$4.375, which, except for limited periods of time, exceeded the market price of our ordinary shares and the majority of the grantees did not exercise these options prior to their expiration on July 31, 2005. In order to maintain the interest of such individuals in our company in a manner that would defer the optionees' tax liability (if any) to the date that the options are exercised and so that the underlying shares issued upon exercise of the options will not be subject to a minimum lock-up period prior to the disposition thereof, as provided under new Section 102(c) of the Israeli Income Tax Ordinance that came into effect on January 1, 2003, we adopted the 2005 Plan, which was designed to reflect the provisions of such new Section 102(c). Under the 2005 Plan we granted options to those optionees who did not exercise their August 2000 options prior to the expiration, to the extent not exercised, and a few additional employees.

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The 2005 Plan authorized the issuance of up to an aggregate of 284,500 ordinary shares to our Israeli directors, officers and employees. Options granted under the 2005 Plan could only be awarded in accordance with Section 102 (c) of the Israeli Income Tax Ordinance. The 2005 Plan had a term of two years commencing on December 11, 2005 and expired on December 10, 2007. The exercise price per share of options granted under the 2005 Plan was \$5.46. All options granted under the 2005 Plan were fully vested upon their award. The period for which an option was granted under the 2005 Plan was two years.

We granted options to purchase an aggregate 284,500 ordinary shares to our Israeli directors, officers and employees under the 2005 Plan, all of which expired in December 2007 without being exercised. Of the options granted under the 2005 Plan, options to purchase 99,500 ordinary shares were granted to our executive officers and the chairman of our board of directors, all of which expired in December 2007 without being exercised.

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

### **A. MAJOR SHAREHOLDERS**

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The following table sets forth certain information as of April 28, 2008 regarding the beneficial ownership by all shareholders known to us to own beneficially 5% or more of our ordinary shares:

| Name                        | Number of Ordinary<br>Shares<br>Beneficially Owned (1) | Percentage<br>of Ownership (2) |
|-----------------------------|--|--------------------------------|
| Josef Maiman                | 1,585,540(3)   | 24.0%                          |
| Merhav M.N.F. Ltd.          | 985,796(4)   | 14.9%                          |
| Integral International Inc. | 599,744(5)   | 9.1%                           |

- (1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
- (2) The percentages shown are based on 6,609,807 ordinary shares issued and outstanding as of April 28, 2008.
- (3) Includes 985,796 held of record by Merhav M.N.F. Ltd., an Israeli private company controlled by Mr. Maiman and 599,744 ordinary shares held of record by Integral International Inc., a Panama corporation controlled by Mr. Maiman. Mr. Maiman may be deemed to be the beneficial owner of the aggregate 1,585,540 ordinary shares held directly by Merhav M.N.F. Ltd. and Integral International Inc.
- (4) Merhav M.N.F. Ltd. is an Israeli private company controlled by Mr. Maiman. Accordingly, Mr. Maiman may be deemed to be the beneficial owner of the ordinary shares held directly by Merhav M.N.F. Ltd.
- (5) Integral International Inc. is a Panama corporation controlled by Mr. Maiman. Accordingly, Mr. Maiman may be deemed to be the beneficial owner of the ordinary shares held directly by Integral International Inc.

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### Significant Changes in the Ownership of Major Shareholders

As of December 31, 2004, Mr. Josef Maiman beneficially held 2,015,956 ordinary shares, representing approximately 36.7% of our then outstanding ordinary shares. Of such shares, 341,500 ordinary shares, representing approximately 6.2% of our then outstanding shares, were held of record by Mr. Maiman, 606,060 ordinary shares, representing approximately 11.0% of our then outstanding shares, were held of record by Merhav M.N.F. Ltd., or Merhav, an Israeli private company controlled by Mr. Maiman (excluding ordinary shares that were issuable upon exercise of a convertible note then held by Merhav) and 1,068,396 ordinary shares, representing approximately 19.5% of our then outstanding shares, were held of record by Integral International Inc., or Integral, a Panama corporation controlled by Mr. Maiman.

During the period of March 24, 2005 through April 6, 2005, Mr. Josef Maiman sold 1,416,212 ordinary shares that were beneficially held by him, of which 606,060 ordinary shares were held of record by Merhav, 468,652 ordinary shares were held of record by Integral and 341,500 were held directly by Mr. Maiman. As a result, Mr. Maiman's beneficial ownership interest decreased to approximately 10.7% of our then outstanding shares (excluding ordinary shares that were issuable upon exercise of a convertible note then held by Merhav).

As of December 31, 2005 and 2006, Mr. Josef Maiman beneficially held 599,744 ordinary shares, which were held of record by Integral, representing approximately 10.7% of our outstanding shares at such times (excluding ordinary shares that were issuable upon exercise of a convertible note then held by Merhav).

In May 2007, Mr. Josef Maiman elected to convert a convertible note held of record by Merhav for an aggregate 985,796 ordinary shares. As a result, Mr. Maiman's beneficial ownership interest increased to 1,585,540 ordinary shares, representing approximately 24.0% of our then outstanding shares, of which 985,796 are held of record by Merhav and 599,744 are held of record by Integral.

**Major Shareholders Voting Rights**

Our principal shareholders do not have different voting rights attached to their ordinary shares.

**Record Holders**

Based on a review of the information provided to us by our transfer agent, as of April 28, 2008, there were 20 holders of record of our ordinary shares, of which 12 record holders holding approximately 75.0% of our ordinary shares had registered addresses in the United States. These numbers are not representative of the number of beneficial holders of our shares nor are they representative of where such beneficial holders reside, since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 74.68% of our outstanding ordinary shares as of such date).

**B. RELATED PARTY TRANSACTIONS**

In 2003, we negotiated a new financing plan with our banks and controlling shareholder. As part of this financing plan, we issued a convertible note in the principal amount of \$500,000 to Merhav M.N.F. Ltd., or Merhav, an Israeli private company controlled by our controlling shareholder, Mr. Josef A. Maiman. In January 2004, pursuant to the terms of the note, Merhav converted \$200,000 of the amounts due and payable under the note into 606,060 ordinary shares of our company, and we issued a replacement convertible note to Merhav for the amount that remained outstanding under the original note at such date, in the principal amount of \$325,312.5. The note became due on May 15, 2007. The note bore interest at the rate of 10% per year, compounded on a quarterly basis. Under the terms of the note, Merhav had the right, at any time, to convert the note into ordinary shares of our company at a price of \$0.33 per ordinary share. We had the right, at our sole discretion, to repay the accrued interest or convert the accrued interest into ordinary shares at the foregoing price. On May 15, 2007, Mr. Maiman elected to convert the entire note into 985,796 ordinary shares. Upon the conversion of the note, we elected to repay the accrued interest on the principal amount of the convertible note to Merhav in the amount of \$128,000. During 2006, we recorded interest and exchange rate expenses of \$5,680 on the convertible note, and we recorded interest and exchange rate income of \$10,166 on the convertible note during 2007.

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**C. INTERESTS OF EXPERTS AND COUNSEL**

Not applicable.

**ITEM 8. FINANCIAL INFORMATION**

**A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION**

See the consolidated financial statements, including the notes thereto, and the exhibits listed in Item 18 hereof and incorporated herein by this reference.

**Legal Proceedings**

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

**Dividend Distributions Policy**

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

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According to the Israeli Companies Law, a company may distribute dividends out of its profits provided that there is no reasonable concern that such dividend distribution will prevent the company from paying all its current and foreseeable obligations, as they become due. Notwithstanding the foregoing, dividends may be paid with the approval of a court, provided that there is no reasonable concern that such dividend distribution will prevent the company from satisfying its current and foreseeable obligations, as they become due. Profits, for purposes of the Israeli Companies Law, means the greater of retained earnings or earnings accumulated during the preceding two years, after deducting previous distributions that were not deducted from the surpluses. In the event cash dividends are declared, such dividends will be paid in NIS.

### B. SIGNIFICANT CHANGES

None.

## 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 Capital Market:

| Year | High    | Low     |
|------|---------|---------|
| 2003 | \$ 1.84 | \$ 0.31 |
| 2004 | \$ 2.84 | \$ 0.82 |
| 2005 | \$ 6.40 | \$ 1.21 |
| 2006 | \$ 5.35 | \$ 2.87 |
| 2007 | \$ 4.92 | \$ 2.35 |

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#### *Quarterly Stock Information*

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

|                    | High    | Low     |
|--------------------|---------|---------|
| <b><u>2006</u></b> |         |         |
| First Quarter      | \$ 5.35 | \$ 3.79 |
| Second Quarter     | \$ 5.05 | \$ 3.70 |
| Third Quarter      | \$ 4.25 | \$ 2.87 |
| Fourth Quarter     | \$ 4.66 | \$ 3.55 |
| <b><u>2007</u></b> |         |         |
| First Quarter      | \$ 4.55 | \$ 3.70 |
| Second Quarter     | \$ 4.92 | \$ 4.10 |
| Third Quarter      | \$ 4.35 | \$ 2.35 |
| Fourth Quarter     | \$ 4.04 | \$ 2.50 |
| <b><u>2008</u></b> |         |         |
| First Quarter      | \$ 3.10 | \$ 1.51 |

**Monthly Stock Information**

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

|                             | <u>High</u> | <u>Low</u> |
|-----------------------------|-------------|------------|
| <b>Month</b>                |             |            |
| November 2007               | \$ 3.52     | \$ 2.80    |
| December 2007               | \$ 3.10     | \$ 2.50    |
| January 2008                | \$ 3.10     | \$ 2.27    |
| February 2008               | \$ 2.95     | \$ 2.50    |
| March 2008                  | \$ 3.02     | \$ 1.51    |
| April 2008 (until April 25) | \$ 2.34     | \$ 1.80    |

**B. PLAN OF DISTRIBUTION**

Not applicable.

**C. MARKETS**

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

**D. SELLING SHAREHOLDERS**

Not applicable.

**E. DILUTION**

Not applicable.

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**F. EXPENSE OF THE ISSUE**

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION****A. SHARE CAPITAL**

Not applicable.

**B. MEMORANDUM AND ARTICLES OF ASSOCIATION**

*Set out below is a description of certain provisions of our memorandum of association and articles of association and of the Israeli Companies Law related to such provisions. This description is only a summary and does not purport to be complete and is qualified by reference to the full text of the memorandum of association and articles of association, which are incorporated by reference as exhibits to this Annual Report, and to Israeli law.*

**Purposes and Objects of the Company**

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

**The Powers of the Directors**

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

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

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

**Rights Attached to Shares**

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

**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 its profits, as defined under the Israeli Companies Law. See Item 8A. Financial Information Consolidated and Other Financial Information Dividend Distributions Policy. If after 30 days a dividend has been declared and it is still unclaimed, the dividend may be invested or otherwise used by us for our own account, as we deem fit, until such dividend is claimed; and we will not be deemed a trustee in respect thereof. We are not obliged to pay, and may not pay interest on declared but unpaid dividends if the shareholders entitled to such dividends fails to collect the same or to provide us the necessary information for the payment thereof, or if we are for any other reason unable to pay the dividend to such shareholder.

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**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.

Unless otherwise required by law, all resolutions require approval of no less than a majority of the voting rights represented at the meeting in person or by proxy and voting thereon.

Pursuant to our articles of association, our board of directors is divided into three classes (other than outside directors). Generally, at each annual meeting of shareholders one of such classes of directors is elected for a term of three years by a vote of the holders of a majority of the voting power represented and voting at such meeting. For information regarding the election of our outside directors, see Item 6C. Directors, Senior Management and Employees Board Practices Election of Directors.

**Rights to share in our profits.** Our shareholders have the right to share in our profits distributed as a dividend and any other permitted distribution. See this Item 10B. Additional Information Memorandum and Articles of Association Rights Attached to Shares Dividend Rights.

**Rights to share in surplus in the event of liquidation.** In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the nominal value of their holdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future.

**Limitations on any existing or prospective major shareholder.** See Item 6C. Directors and Senior Management Board Practices Approval of Related Party Transactions Under Israeli Law.

### Changing Rights Attached to Shares

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

### Annual and Extraordinary Meetings of Shareholders

The board of directors must convene an annual meeting of shareholders at least once every calendar year, within fifteen months of the last annual meeting. 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. 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. See this Item 10B. Additional Information Memorandum and Articles of Association- Rights Attached to Shares-Voting Rights.

The quorum required for an ordinary meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least 40% of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum is adjourned by three business days, at the same time and place, or any time and place as the board of directors unanimously designate in a notice to the shareholders. The requisite quorum at an adjourned general meeting will be: (i) if the original meeting was convened upon requisition by shareholders pursuant to the Israeli Companies Law the number of shareholders holding the minimum number of voting shares necessary to make such requisition, present in person or by proxy; and (ii) in any other case one or more shareholders, present in person or by proxy, holding at least one share. We do not follow the requirements of the NASDAQ Marketplace Rules regarding the quorum for any meeting of the holders of common stock. See Item 6C. Directors, Senior Management and Employees Board Practices NASDAQ Marketplace Rules and Home Country Practices.

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### Limitations on the Rights to Own Securities in Our Company

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

### Provisions Restricting Change in Control of Our Company

**Tender Offer.** A person wishing to acquire shares, or any class of shares, of a publicly traded Israeli company and who would as a result hold over 90% of the company's issued and outstanding share capital, or a class of shares, is required by the Israeli Companies Law to make a tender offer to all of the company's shareholders for the purchase of all of the remaining issued and outstanding shares of the company, or the class of shares, as the case may be. If the shareholders who do not respond to the offer hold less than 5% of the issued share capital of the company, or of the relevant class of shares, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. However, the shareholders may petition the court to determine the consideration for the acquisition if the consideration is less than the shares' fair value. If the dissenting shareholders hold more than 5% of the issued and outstanding share capital of the company, or of the relevant class of shares, as the case may be, the acquirer may not acquire additional shares of the company from shareholders who accepted the tender offer if following such acquisition the acquirer would own over 90% of the company's issued and outstanding share capital, or of the relevant class of shares.

The Israeli Companies Law provides that an acquisition of shares of a public company be made by means of a tender offer if as a result of the acquisition the purchaser would become the holder of a control block. Under the Israeli Companies Law shares conferring 25% or more of the voting rights in the company constitute a control block. The requirement for a tender offer does not apply if there is already another holder of

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a control block. 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 acquirer would hold more than 45% of the voting rights in the company, unless there is another person holding more than 45% of the voting rights in the company. These requirements do not apply if:

the acquisition was made in a private placement the object of which was to confer to the acquirer a control block where there is no holder of a control block, or to confer to the acquirer more than 45% of the voting rights in the company where there is no holder of more than 45% of the voting rights in the company, and the private placement received the general meeting's approval; or

the acquisition was from the holder of a "control block" and resulted in the acquirer becoming the holder of a "control block"; or

the acquisition was from a shareholder holding more than 45% of the voting rights in the company and resulted in the acquirer becoming a holder of more than 45% of the voting rights in the company.

*Merger.* The Israeli Companies Law permits merger transactions if approved by each party's board of directors and, unless certain requirements described under the Israeli Companies Law are met, the majority of each party's shares voted on the proposed merger at a shareholders meeting convened by with prior notice of at least 35 days. A merger is defined as the transfer of all assets and liabilities, including conditional, future, known and unknown debts of the target company to the surviving company, as a result of which the target company is liquidated, and stricken out of the Companies Register.

Under the Israeli Companies Law, if the approval of a general meeting of the shareholders is required, merger transactions may be approved by holders of a simple majority of the shares present and voting, in person or by proxy or by written ballot, at the general meeting convened to approve the transaction. If one of the merging companies, or a shareholder that holds 25% or more of the means of control of one of the merging companies, or a substantial shareholder, holds shares of the other merging company, then a dissenting vote of holders of the majority of the shares of the other merging company present and voting, excluding shares held by the merging company or a substantial shareholder thereof, or by anyone acting on behalf of either of them, their relatives and corporations controlled thereby, is sufficient to reject the merger transaction. Means of control are defined as any of the following: (i) the right to vote at a general meeting of a company and (ii) the right to appoint a director of a company. If the transaction would have been approved but for the exclusion of the votes as previously indicated, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of the company. The court will not approve a merger unless it is convinced that the merger is fair and reasonable, taking into account the values of the merging companies and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of the merged company. In addition, a merger may not be completed unless at least 50 days have passed from the date that a proposal for approval of the merger was filed with the Israeli Registrar of Companies and 30 days from the date that shareholder approval of both merging companies was obtained.

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Notwithstanding the foregoing, a merger is not subject to the approval of the shareholders of the target company if the target company is a wholly-owned subsidiary of the acquiring company. A merger is not subject to the approval of the shareholders of the acquiring company if:

the merger does not require the alteration of the memorandum or articles of association of the acquiring company;

the acquiring company would not issue more than 20% of the voting rights thereof to the shareholders of the target company in the course of the merger and no person will become, as a result of the merger, a controlling shareholder of the acquiring company, on a fully diluted basis;

neither the target company, nor any shareholder that holds 25% of the means of control of the target company is a shareholder of the acquiring company; and

there is no person that holds 25% or more of the means of control in both companies.

### Disclosure of Shareholders Ownership

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

## Changes in Our Capital

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

## C. MATERIAL CONTRACTS

None.

## D. EXCHANGE CONTROLS

Israeli law and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares.

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.

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## E. TAXATION

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on 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 or by court. 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

#### General Corporate Tax Structure

Israeli companies are subject to Corporate Tax on their worldwide income. The applicable rate for 2006 was 31%. The rate was reduced to 29% in 2007 and will be further reduced to 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter. However, the effective rate of tax payable by a company which is qualified under Israeli law as an Industrial Company and/or which derives income from an approved enterprise or a benefited enterprise (as further discussed below) may be lower. See Item 10E. Additional Information Taxation Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959.

As of December 31, 2007, we had approximately \$14.3 million in tax loss carryforwards in Israel, which can be offset against future income in Israel without time limitation. In Israel, we have received final tax assessments through the 1995 tax year and the tax assessments we received for the 1996-2003 tax years are considered final due to the statute of limitations. Our principal foreign subsidiary, Kubatronik, has received final tax assessments through the 2005 tax year and as of December 31, 2007 had approximately \$0.9 million in tax loss carryforwards in Germany. Despite our accumulated profits in Israel during the three years ended December 31, 2007, we did not record a net deferred tax asset in 2007 and related tax benefit in 2005, 2006 or 2007 with respect to our net operating losses generated in Israel due to uncertainty about our ability to utilize such losses in the foreseeable future. Such uncertainty is primarily due to the appreciation of the NIS against the U.S. dollar, the replacement of a high volume of revenue from our former largest customer with many smaller orders, causing additional challenges for our production efficiency, the fluctuations of the PCB industry and our history of losses.

#### Tax Benefits Under the Law for the Encouragement of Industry (Taxes) 1969

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

capital gains, interest and dividends) is derived from an Industrial Enterprise it owns. An Industrial Enterprise is defined for purposes of the Industry Law as an enterprise whose majority activity in a given tax year is industrial production.

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

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

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

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

#### **Tax Benefits Under The Law for the Encouragement of Capital Investments, 1959**

##### ***General***

Certain of our production facilities have been granted approved enterprise and benefited enterprise status pursuant to the Law for the Encouragement of Capital Investments, 1959, as amended, or the Investment Law, which provides certain tax and financial benefits to investment programs that have been granted such status. As of December 31, 2007, one benefited investment program is applicable to us, the period of tax benefits relating to which has not yet commenced and will expire no later than 2016 (see below). The benefit period for all other programs (approved enterprises) expired in 2005.

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

The Investment Law provides that capital investments in production facilities (or other eligible facilities) may, upon application to the Israeli Investment Center, be designated as an approved enterprise. Each instrument of approval for an approved enterprise relates to a specific investment program, delineated both by the financial scope of the investment, including sources of funds, and by the physical characteristics of the facility or other assets.

In April 2005, the Israeli legislature passed an amendment to the Investment Law in which it revised the criteria for investments qualified to receive tax benefits not involving a government grant, referred to as a benefited enterprise. The primary changes are as follows:

Companies that meet the criteria of the alternative package of tax benefits track will receive those benefits without need for prior approval, rather, a company may claim the tax benefits offered by the Investment Law directly in its tax returns. In addition, there will be no requirement to file reports with the Investment Center. Audits will be the responsibility of the Income Tax Authorities as part of their tax audits. Companies may also approach the Israeli Tax Authority for a pre-ruling regarding its eligibility for benefits under the April 2005 amendment.

Tax benefits of the alternative benefits track include lower tax rates or no tax depending on the area and the track chosen, lower tax rates on dividends and accelerated depreciation.

In order to receive benefits in the grant track or the alternative benefit track, the industrial enterprise must contribute to the economic independence of the Israeli economy, be competitive (as defined in the April 2005 amendment) and contribute to the gross local product in one of the manners stipulated in the amended Investment Law. Tax benefits would be available, subject to certain conditions (described below), to production facilities that generally derive more than 25% of their annual revenue from export, or that do not derive 75% or more of their annual revenue in a single market.

Upon the establishment of an enterprise, an investment of at least NIS 300 thousand in production machinery and equipment within three years is required in order for the investment to qualify for the alternative benefits track. For an expansion of an enterprise under the alternative benefits track, a company is required to invest within three years in production machinery and equipment the greater of NIS 300 thousand or a certain percentage of its existing production machinery and equipment.

The April 2005 amendment to the Investment Law generally does not apply to investment programs having an approved enterprise approval certificate from the Investment Center issued prior to December 31, 2004.

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On September 20, 2006, we received a ruling from the Israeli Tax Authority approving our most recent investment plan as a benefited enterprise in lieu of the former approved enterprise status. Pursuant to such ruling, the former approved enterprise status of that investment plan was terminated by the Investment Center.

The benefited enterprise status granted to our investment plan provides for a tax exemption on undistributed earnings derived from the program for two years and a reduced tax rate for the remainder of the benefit period (see below). The benefit period with respect to such program has not yet commenced, and will expire no later than 2016.

The tax benefits available under any instrument of approval relate only to taxable profits attributable to the specific program and are contingent upon meeting the criteria set out in the instrument of approval.

If, (i) only a part of a company's taxable income is derived from an approved enterprise or a benefited enterprise, as in our case; or (ii) a company owns more than one approved enterprise or benefited enterprise, the resulting effective corporate tax rate of the company represents the weighted combination of the various applicable rates. A company owning a mixed enterprise (which is a company that derives income from one or more sources in addition to an approved enterprise or benefited enterprise) generally may not distribute a dividend that is attributable only to the approved enterprise or benefited enterprise.

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

#### ***Tax Benefits***

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

A company owning an approved enterprise, which was approved after April 1, 1986, and before December 31, 2004 could elect to forego the entitlement to grants and to certain tax benefits otherwise available under the Investment Law, and apply for an alternative package of tax benefits. Qualified investments which were not approved before January 1, 2005 and meet the criteria of the alternative package of tax benefits track will receive the benefits without need for prior approval.

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

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The tax benefits available to benefited enterprises are: (1) benefited enterprise situated in zone A may choose between (a) limited corporate tax rate of 11.5%; and (b) tax exemption from corporate tax on undistributed income; (2) benefited enterprise qualified as strategic investments is entitled to a tax exemption; (3) benefited enterprise situated in zone B or elsewhere ( zone C ) is entitled to tax exemption on undistributed income for six or two years, respectively, and to beneficial tax rate (25% or less in the case of a qualified foreign investor s company which is at least 49% owned by non-Israeli residents) for the remainder of the applicable period of benefits. Our plant is located in zone C.

Dividends paid out of income derived from an approved enterprise or benefited enterprise (or out of dividends received from a company whose income is derived from an approved enterprise or benefited enterprise) are generally subject to withholding tax at the rate of 15% (deductible at source). The rate of 15% is limited to dividends and distributions out of income derived during the benefits period and actually paid at any time up to 12 years thereafter. A company which elects the alternative package of tax benefits will be subject to corporate tax at the otherwise applicable rate of 25% (or lower in the case of a qualified foreign investor s company which is at least 49% owned by non Israeli residents) in respect of the gross amount of the dividend if it pays a dividend out of income derived from its approved enterprise or benefited enterprise during the tax exemption period. Dividends paid to a qualifying non-resident out of the profits of benefited enterprise subject to 11.5% corporate tax are subject to withholding tax at the rate of 4%.

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

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

### ***Financial Benefits***

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

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

### **Taxation Under Inflationary Conditions**

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

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

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Pursuant to the Inflationary Adjustments Law to which we are subject, results for tax purposes are measured in real terms in accordance with the changes in the Israeli consumer price index.

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On February 26, 2008, the Israeli Income Tax Law (Inflationary Adjustments) (Amendment No. 20) (Restriction of Period of Application) 2008 was passed by the Knesset. According to the amendment, the inflationary adjustments law will no longer be applicable subsequent to the 2007 tax year except for the transitional provisions whose objectives are to prevent distortion of the income tax calculations.

In addition, according to the amendment commencing in the 2008 tax year, the adjustment of the income for the effects of inflation for tax purposes will no longer be calculated. Additionally, depreciation on the protected assets and tax loss carryforwards will no longer be linked to the Consumer Price Index, or the CPI, subsequent to the 2007 tax year, and the balances that have been linked to the CPI through the end of 2007 tax year, will be used going forward. As a result, our carryforward tax loss will no longer be linked to the Israeli CPI.

### Capital Gains Tax and Taxation of Dividends

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain that is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index between the date of purchase and the date of sale. Foreign residents who purchased an asset in foreign currency may request that the inflationary surplus will be computed on the basis of the devaluation of the New Israeli Shekel against such foreign currency. The real gain is the excess of the total capital gain over the inflationary surplus. The inflationary surplus accumulated from and after December 31, 1993, is exempt from any capital gains tax in Israel while the real gain is taxed at the applicable rate discussed below.

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

Subject to certain transitional provisions relating to capital gains derived from the sale of assets, including our shares, purchased prior to January 1, 2003, the tax rate on capital gains, including capital gain from the sale of securities listed on a stock exchange, is generally a uniform rate of 20% for individuals and 25% for corporate bodies and substantial individual shareholders (who are, generally, shareholders of 10% or more of the shares of the company on the date of the sale of the shares or at any date during the 12 months before the sale). The tax rate on dividends is generally a uniform rate of 20% for individuals and non-resident corporate shareholders and 25% for substantial individual and substantial non-resident corporate shareholders. Dividends paid to an Israeli company by another Israeli company are not subject to tax, unless received out of income derived from approved enterprises or stems from income derived or accrued outside of Israel.

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

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

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

If the shares were sold by Israeli residents, then (i) for the period ending December 31, 2002 their sale would be tax exempt so long as (1) the shares were listed on a stock exchange, such as, in our case, the NASDAQ Capital Market, which is recognized by the Israeli Ministry of Finance on December 31, 2002, and (2) we qualified as an Industrial Company or Industrial Holding Company under the law for Encouragement of Industry (Taxes) 1969, at the relevant times as provided by the Income Tax Ordinance [New Version], 1961, which we believe we so qualified and (ii) for the period commencing January 1, 2003, the sale of the shares would be, generally, subject to a 20% tax if sold by non-substantial individual shareholders and 25% tax if sold by a corporate body or a substantial individual shareholders. We cannot provide any assurance that the Israeli tax authorities will agree with the determination that we qualified as an Industrial Company at the relevant times.

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On the distribution of dividends other than bonus shares (stock dividends) to individual Israeli residents shareholders or to non-Israeli shareholders, income tax applies at the rate of 20% or 25%, as described above, but is generally withheld at source at the rate of 20% (for as long as we are listed) or the lower rate payable with respect to dividends received out of income derived from approved enterprises (see Law for the Encouragement of Capital Investments, 1959 ), unless a double taxation treaty is in effect between Israel and the shareholder's country of residence which provides for a lower tax rate in Israel on dividends. The Convention between the State of Israel and the Government of the United States relating to relief from double taxation provides for a maximum tax of 25% on dividends paid to a resident of the United States. Dividends paid to an Israeli company by another Israeli company are not subject to corporate tax, unless received out of income derived from approved enterprises or unless the dividend stems from income produced or accrued abroad.

### Taxation of Non-Resident Holders of Shares

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares or stock dividends, income tax at the rate of 20% (or 25% as described above), 12.5% for dividends not generated by an approved enterprise if the non-resident is a U.S. corporation and holds 10% of our voting power for a designated period, and 15% for dividends generated by an approved enterprise applies, unless a different rate is provided for based on a treaty between Israel and the shareholder's country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident will be 25%. However, under the Investment Law, dividends generated by an approved enterprise or benefited enterprise are, generally, taxed at the rate of 15%.

Subject to certain conditions, non-Israeli residents will be tax exempt on capital gain derived from investments in Israeli companies made within the period commencing July 1, 2005 through December 31, 2008, even if the capital gain was derived after such period and without derogating from any other capital gain tax exemption applying to non-Israeli resident under Israeli law or under any applicable double tax treaty.

### Foreign Exchange Regulation and Withholding Taxes

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

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

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## UNITED STATES FEDERAL INCOME TAX CONSEQUENCES

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

- broker-dealers,
- financial institutions,
- certain insurance companies,
- regulated investment companies or real estate investment trusts,
- investors liable for alternative minimum tax,
- tax-exempt organizations,

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non-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 acquire their ordinary shares through the exercise of employee stock options or otherwise as compensation for services,

investors who actually or constructively own, or have owned, 10 percent or more of our voting shares, and

investors holding ordinary shares as part of a straddle or appreciated financial position or a hedging or conversion transaction.

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

This summary does not address the effect of any U.S. federal taxation other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or foreign taxation. You are urged to consult your tax advisors regarding the foreign and United States federal, state and local tax considerations of an investment in ordinary shares.

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

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 treated as a corporation, created or organized in or under the laws of the United States or any political subdivision thereof;

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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 the heading *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 for U.S. federal income tax purposes. You will be required to include this amount of dividends in gross income as ordinary income. Distributions in excess of our 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 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 set out in the Code, 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 income category or general category income for United States foreign tax credit purposes. 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. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

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. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

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## 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 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, or the IRS. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

## Passive Foreign Investment Companies

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

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

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,

the amount allocated to each year during which we are considered a PFIC other than the year of the dividend payment or disposition would be subject to tax at the highest individual or corporate tax 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,

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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

you would be required to file 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, in each year in which we are considered a PFIC, 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 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.

### **F. DIVIDENDS AND PAYING AGENTS**

Not applicable.

**G. STATEMENT BY EXPERTS**

Not applicable.

**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.

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

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the following Securities and Exchange Commission public reference rooms at 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.eltekglobal.com](http://www.eltekglobal.com). You may obtain information on the operation of the Securities and Exchange Commission's public reference room in Washington, D.C. by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Exchange Act file number for our Securities and Exchange Commission filings is 0-28884.

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

**I. SUBSIDIARY INFORMATION**

Not applicable.

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

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

**Foreign Currency Exchange Risk**

Our reporting currency is U.S. dollars, however our functional currency is NIS. Our revenues are generally denominated in foreign currencies, primarily the U.S. dollar, while our expenses are primarily denominated in NIS, U.S. dollars, Euros, dollar-linked NIS and Euro-linked NIS. As a result, fluctuations in rates of exchange between NIS and non-NIS currencies may affect our operating results and financial condition. The NIS value of our U.S. dollar revenues are adversely affected by the appreciation of the NIS against the U.S. dollar. In addition, the U.S. dollar value of our expenses other than those paid in NIS or Euro is negatively impacted by the devaluation of the U.S. dollar against the NIS and Euro. In 2006 and 2007, the NIS appreciated against the U.S. dollar by 8.2% and 9.0%, respectively, and the Euro appreciated against the U.S. dollar by 11.3% and 11.7%, respectively, which had a significant adverse affect on our results of operations. We estimate that a devaluation of 1% of the U.S. dollar against the NIS would result in a decrease of approximately \$200,000 in our operating income.

We have engaged external consultants to assist us to manage our foreign exchange risk. From time to time in the past we have engaged in hedging transactions in order to partially protect ourselves from currency fluctuation and inflation risks and may use hedging instruments from time to time in the future.

**Interest Rate Risk**

Our exposure to market risk for changes in interest rates relates primarily to our short-term credit lines, our non-linked and U.S. dollar linked long-term loans and our factoring agreement. These are principally denominated in (i) NIS and bear annual interest ranging from 4.5% to 8.4% as of December 31, 2007; (ii) U.S. dollars and bear interest from 4% to 6.9% as of December 31, 2007 and (iii) Euro and bear interest of 2.85% as of December 31, 2007. For purposes of specific risk analysis, we use sensitivity analysis to determine the impact that market risk exposure may have on the financial expenses derived from our short-term credit lines, long-term loans and factoring agreement. A hypothetical increase of 1% in the interest rate would result in an increase of approximately \$87,000 in our financial expenses.

A hypothetical increase of 1% in the Israeli consumer price index would result in an increase of approximately \$10,000 in our financial expenses.

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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**

None.

**ITEM 15. CONTROLS AND PROCEDURES**

Not applicable.

**ITEM 15T. 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

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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 is responsible for establishing and maintaining adequate internal control over our financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the company's principal executive and principal financial officers and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transaction and dispositions of the assets of the company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

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Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2007. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on that assessment, our management concluded that as of December 31, 2007, our internal control over financial reporting is effective.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. 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

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 controls over financial reporting.

**ITEM 16. [RESERVED]**

**ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our Board of Directors has determined that Mr. Eliyaho Tov, an outside director, 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. Tov'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 employees of our company, including the chief financial officer and the comptroller. The code of ethics is publicly available on our website at [www.eltekglobal.com](http://www.eltekglobal.com). Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.

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

**Fees Paid to Independent Registered Public Accountants**

The following table sets forth, for each of the years indicated, the fees paid to our independent registered public accountants, Somekh Chaikin, a member firm of KPMG International. All of such fees were pre-approved by our Audit Committee.

| Services Rendered | 2006       | 2007       |
|-------------------|------------|------------|
| Audit (1)         | \$ 160,000 | \$ 146,000 |
| Tax (2)           | 6,000      | 12,000     |
| Total             | \$ 160,000 | \$ 158,000 |

- (1) Audit fees relate to services that are normally provided in connection with statutory and regulatory filings or engagements, including services that generally only the independent registered public accounting firm can reasonably provide.
- (2) Tax fees relate to services performed by the tax division for tax compliance and tax advice.

**Pre-Approval Policies and Procedures**

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

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

**Issuer Purchase of Equity Securities**

Neither we nor any affiliated purchaser has purchased any of our securities during 2007.

**ITEM 17. FINANCIAL STATEMENTS**

Not applicable.

**ITEM 18. FINANCIAL STATEMENTS****Consolidated Financial Statements**

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**ITEM 19. EXHIBITS****Index to Exhibits**

| <u>Exhibit</u> | <u>Description</u>  |
|----------------|---|
| 1.1            | Memorandum of Association of the Registrant (1)   |
| 1.2            | Articles of Association of the Registrant, as amended (2)   |
| 2.1            | Specimen of Share Certificate (1)   |
| 4.1            | Indemnity Agreement provided to Arieh Reichart dated December 5, 1996 and a schedule of similar indemnity agreements provided by the Registrant to its officers and directors (1)         |
| 4.2            | 2000 Stock Option Plan (3)  |
| 4.3            | 2005 Stock Option Plan (4)  |
| 4.4            | Services Factoring Agreement dated July 8, 2003 (5)   |
| 4.5            | Share Purchase Agreement dated June 10, 2002, by and among En-Eltek Netherlands 2000 B.V., Kubatronik-Leiterplatten GmbH, Mr. Alois Kubat, Mr. Thomas Kubat and Ms. Heike Heidenreich (6) |
| 4.6            | Extension of Put/Call Option Agreement dated May 4, 2005, by and between En-Eltek Netherlands 2000 B.V. and Mr. Alois Kubat (7)   |
| 4.7            | Second Extension of Put/Call Option Agreement Provisions under the Share Purchase Agreement dated December 28, 2007, by and between En-Eltek Netherlands 2000 B.V. and Mr. Alois Kubat    |

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- 8.1 List of Subsidiaries of the Registrant
- 12.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
- 12.2 Certification by 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 Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 13.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 15.1 Consent of Somekh Chaikin, a member firm of KPMG International, Independent Registered Public Accounting Firm

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- (1) Filed as an exhibit to our registration statement on Form F-1, registration number 333-5770, as amended, filed with the Securities and Exchange Commission and incorporated herein by reference.
  - (2) Filed as Exhibit 3.2 to our Annual Report on Form 20-F for the year ended December 31, 2003 and incorporated herein by reference.
  - (3) Filed as Exhibit 10.4 to our Annual Report on Form 20-F for the year ended December 31, 2000 and incorporated herein by reference.
  - (4) Filed as Appendix A to the Proxy Statement for our 2005 Annual General Meeting of Shareholders filed on Report of Foreign Private Issuer on Form 6-K for the month of November 2005, and incorporated herein by reference.
  - (5) Filed as Exhibit 10.5 to our Annual Report on Form 20-F for the year ended December 31, 2002 and incorporated herein by reference.
  - (6) Filed as Exhibit 4.5 to our Annual Report on Form 20-F for the year ended December 31, 2004 and incorporated herein by reference.
  - (7) Filed as Exhibit 4.6 to our Annual Report on Form 20-F for the year ended December 31, 2004 and incorporated herein by reference.

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Eltek Ltd. and its Subsidiaries

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### Consolidated Financial Statements as of December 31, 2007

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### **Report of Independent Registered Public Accounting Firm**

**The Board of Directors and Shareholders of**

**Eltek Ltd.:**

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

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

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

The Company's consolidated financial statements for the years ended December 31, 2006 were previously prepared in conformity with Israeli GAAP and in New Israeli Shekel (NIS). As more fully described in Note 1C to the consolidated financial statements, the Company elected, at the beginning of 2007, to prepare its consolidated financial statements in accordance with U.S. GAAP and in US\$. Consequently, the Company's financial statements for all previous years have been prepared under U.S. GAAP and in US\$.

As discussed in Note 1M to the consolidated financial statements, effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes.

/s/ Somekh Chaikin  
 Somekh Chaikin  
 Certified Public Accountants (Isr.)  
 Member firm of KPMG International

Tel-Aviv, Israel, April 27, 2008

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Eltek Ltd. and its Subsidiaries

## Consolidated Balance Sheets

|  | Note   | December 31   |               |
|--|--------|---------------|---------------|
|  |        | 2007          | 2006          |
| \$ in thousands                                    |        |               |               |
| <b>Assets</b>                                      |        |               |               |
| <b>Current assets</b>                              |        |               |               |
| Cash and cash equivalents                          | 1G; 2  | 2,467         | 2,030         |
| Account receivables:                               |        |               |               |
| Trade, net of provision for doubtful accounts      | 1H     | 8,173         | 7,707         |
| Other  | 3      | 742           | 261           |
| Inventories  | 1I; 4  | 4,271         | 3,766         |
| Prepaid expenses                                   |        | 204           | 192           |
| <b>Total current assets</b>                        |        | <b>15,857</b> | <b>13,956</b> |
| Assets held for employees' severance benefits      | 1J; 10 | 1,319         | 1,106         |
| <b>Fixed assets, less accumulated depreciation</b> | 1K; 5  | <b>10,997</b> | <b>8,143</b>  |
| <b>Goodwill</b>                                    | 1L; 6  | <b>1,009</b>  | <b>903</b>    |
| <b>Total assets</b>                                |        | <b>29,182</b> | <b>24,108</b> |

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

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Eltek Ltd. and its Subsidiaries

## Consolidated Balance Sheets

|                 | Note | December 31 |      |
|-----------------|------|-------------|------|
|                 |      | 2007        | 2006 |
| \$ in thousands |      |             |      |

|  | December 31 |               |               |
|--|-------------|---------------|---------------|
| <b>Liabilities and shareholders' equity</b>  |             |               |               |
| <b>Current liabilities</b>   |             |               |               |
| Short-term credit and current maturities of long-term debt   | 7           | 4,623         | 2,776         |
| Accounts payable:  |             |               |               |
| Trade  |             | 7,354         | 5,941         |
| Other  | 8           | 3,147         | 3,114         |
| Convertible note   | 1N          | -             | 436           |
| <b>Total current liabilities</b>   |             | <b>15,124</b> | <b>12,267</b> |
| <b>Long-term liabilities</b>   |             |               |               |
| Long-term debt, excluding current maturities   | 9           | 4,243         | 3,068         |
| Employee severance benefits  | 10          | 1,388         | 1,187         |
| <b>Total long-term liabilities</b>   |             | <b>5,631</b>  | <b>4,255</b>  |
| <b>Minority interests</b>  |             | <b>353</b>    | <b>311</b>    |
| <b>Commitments and contingent liabilities</b>  | 11          |               |               |
| <b>Shareholders' equity</b>  | 12          |               |               |
| Ordinary shares, NIS 0.6 par value   |             |               |               |
| Authorized 50,000,000 shares, issued and outstanding 6,609,807 shares as of December 31, 2007 (5,624,011 shares as of December 31, 2006) |             | 1,384         | 1,236         |
| Additional paid-in capital   |             | 14,328        | 14,152        |
| Cumulative translation adjustment related to change in reporting currency  |             | 2,412         | 1,671         |
| Cumulative foreign currency translation adjustments  |             | 451           | 416           |
| Capital reserves   |             | 695           | 695           |
| Accumulated deficit  |             | (11,196)      | (10,895)      |
| <b>Total shareholders' equity</b>  |             | <b>8,074</b>  | <b>7,275</b>  |
| <b>Total liabilities and shareholders' equity</b>  |             | <b>29,182</b> | <b>24,108</b> |

/s/ Arieh Reichart

/s/ Amnon Shemer

/s/ Nissim Gilam

Arieh Reichart  
President, Chief Executive OfficerAmnon Shemer  
Chief Financial OfficerNissim Gilam  
Chairman of the Board of Directors

Date: April 27, 2008

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

## Consolidated Statements of Operations

|   | Note   | Year ended December 31                                     |          |          |
|---|--------|--|----------|----------|
|   |        | 2007   | 2006     | 2005     |
|   |        | \$ in thousands<br>(except earnings (loss) per share data) |          |          |
| <b>Revenues</b>   | 1O; 13 | <b>37,476</b>  | 39,045   | 32,177   |
| <b>Cost of revenues</b>   |        | <b>(31,879)</b>  | (30,557) | (25,638) |
| <b>Gross profit</b>   |        | <b>5,597</b>   | 8,488    | 6,539    |
| <b>Operating expenses</b>   |        |  |          |          |
| Research and development, gross   | 1P     | <b>167</b>   | 326      | 249      |
| Government grants   | 1P     | <b>(93)</b>  | (172)    | (105)    |
| Research and development expenses, net  |        | <b>74</b>  | 154      | 144      |
| Selling, general and administrative expenses  |        | <b>5,683</b>   | 5,580    | 4,409    |
| Impairment loss on goodwill   |        | <b>-</b>   | 473      | -        |
| <b>Operating profit (loss)</b>  |        | <b>(160)</b>   | 2,281    | 1,986    |
| Financial expenses, net   | 14     | <b>145</b>   | 538      | 592      |
| <b>Operating profit (loss)</b>  |        | <b>(305)</b>   | 1,743    | 1,394    |
| Other income, net   |        | <b>8</b>   | 5        | 23       |
| <b>Profit (loss) before income tax expense and minority interest</b>                                      |        | <b>(297)</b>   | 1,748    | 1,417    |
| Income tax expense  | 1M; 15 | <b>-</b>   | 158      | -        |
| <b>Profit (loss) before minority interest</b>   |        | <b>(297)</b>   | 1,590    | 1,417    |
| Minority interest   |        | <b>(4)</b>   | 60       | 49       |
| <b>Net profit (loss)</b>  |        | <b>(301)</b>   | 1,650    | 1,466    |
| Basic net earnings (loss) per ordinary share  |        | <b>(0.05)</b>  | 0.29     | 0.26     |
| Diluted net earnings (loss) per ordinary share  |        | <b>(0.05)</b>  | 0.24     | 0.22     |
| Weighted average number of ordinary shares used to compute basic net earnings (loss) per ordinary share   |        | <b>6,247</b>   | 5,617    | 5,575    |
| Weighted average number of ordinary shares used to compute diluted net earnings (loss) per ordinary share |        | <b>6,247</b>   | 6,954    | 6,785    |

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

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Eltek Ltd. and its Subsidiaries

**Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income**

|  | Ordinary shares |        | Additional<br>paid-in<br>capital | Accumulated<br>other<br>comprehensive<br>income | Capital<br>reserves | Accumulated<br>deficit | Total<br>shareholders'<br>equity |
|--|-----------------|--------|----------------------------------|---|---------------------|------------------------|----------------------------------|
|  | Shares          | Amount |                                  |   |                     |                        |                                  |
| (\$ thousands, except number of shares)                                      |                 |        |                                  |   |                     |                        |                                  |
| <b>Balance as of December 31, 2004</b>                                       | 5,491,711       | 1,218  | 13,588                           | 1,895   | 695                 | (14,011)               | 3,385                            |
| <b>Changes during the year</b>   |                 |        |                                  |   |                     |                        |                                  |
| Translation adjustment related to change in reporting currency               | -               | -      | -                                | (258)   | -                   | -                      | (258)                            |
| Foreign currency translation adjustments                                     | -               | -      | -                                | (148)   | -                   | -                      | (148)                            |
| Net profit   | -               | -      | -                                | -   | -                   | 1,466                  | 1,466                            |
| Comprehensive income   | -               | -      | -                                | -   | -                   | -                      | 1,060                            |
| Exercise of employee stock options   | 110,800         | 15     | 469                              | -   | -                   | -                      | 484                              |
| <b>Balance as of December 31, 2005</b>                                       | 5,602,511       | 1,233  | 14,057                           | 1,489   | 695                 | (12,545)               | 4,929                            |
| <b>Changes during the year</b>   |                 |        |                                  |   |                     |                        |                                  |
| Translation adjustment related to change in reporting currency               | -               | -      | -                                | 562   | -                   | -                      | 562                              |
| Foreign currency translation adjustments                                     | -               | -      | -                                | 36  | -                   | -                      | 36                               |
| Net profit   | -               | -      | -                                | -   | -                   | 1,650                  | 1,650                            |
| Comprehensive income   | -               | -      | -                                | -   | -                   | -                      | 2,248                            |
| Exercise of employee stock options   | 21,500          | 3      | 95                               | -   | -                   | -                      | 98                               |
| <b>Balance as of December 31, 2006</b>                                       | 5,624,011       | 1,236  | 14,152                           | 2,087   | 695                 | (10,895)               | 7,275                            |
| <b>Changes during the year</b>   |                 |        |                                  |   |                     |                        |                                  |
| Translation adjustment related to change in reporting currency               | -               | -      | -                                | 741   | -                   | -                      | 741                              |
| Foreign currency translation adjustments                                     | -               | -      | -                                | 35  | -                   | -                      | 35                               |
| Net loss   | -               | -      | -                                | -   | -                   | (301)                  | (301)                            |
| Comprehensive income   | -               | -      | -                                | -   | -                   | -                      | 475                              |
| Convertible note and accrued interest thereon converted into ordinary shares | 985,796         | 148    | 176                              | -   | -                   | -                      | 324                              |
| <b>Balance as of December 31, 2007</b>                                       | 6,609,807       | 1,384  | 14,328                           | 2,863   | 695                 | (11,196)               | 8,074                            |

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

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Eltek Ltd. and its Subsidiaries

**Consolidated Statements of Cash Flows**

|   | Year ended December 31 |                |                |
|---|------------------------|----------------|----------------|
|   | 2007                   | 2006           | 2005           |
|   | \$ thousands           |                |                |
| <b>Cash flows from operating activities:</b>  |                        |                |                |
| Net profit (loss)   | (301)                  | 1,650          | 1,466          |
| <b>Adjustments to reconcile net profit (loss) to net cash flows provided by operating activities:</b> |                        |                |                |
| Depreciation  | 2,264                  | 2,330          | 2,284          |
| Impairment of goodwill  | -                      | 473            | -              |
| Capital gain on disposal of fixed assets, net   | (3)                    | (5)            | (23)           |
| Minority share of subsidiary's net results  | 4                      | (60)           | (49)           |
| Interest payment on convertible note  | (128)                  | -              | -              |
| Increase (decrease) in employee severance benefits, net   | 3                      | 15             | (183)          |
| Decrease (increase) in trade receivables  | 342                    | (2,141)        | 186            |
| Decrease (increase) in other receivables and prepaid expenses   | (422)                  | 225            | (297)          |
| Decrease (increase) in inventories  | (106)                  | 42             | (578)          |
| Increase (decrease) in trade payables   | 152                    | (428)          | 201            |
| Increase (decrease) in other liabilities and accrued expenses   | (271)                  | 556            | (10)           |
| Deferred tax assets   | -                      | 158            | -              |
| Other, net  | (124)                  | (111)          | 162            |
| <b>Net cash provided by operating activities</b>  | <b>1,410</b>           | <b>2,704</b>   | <b>3,159</b>   |
| <b>Cash flows from investing activities:</b>  |                        |                |                |
| Purchase of fixed assets  | (3,257)                | (1,862)        | (2,832)        |
| Proceeds from sale of fixed assets  | 3                      | 5              | 37             |
| <b>Net cash used in investing activities</b>  | <b>(3,254)</b>         | <b>(1,857)</b> | <b>(2,795)</b> |
| <b>Cash flows from financing activities:</b>  |                        |                |                |
| Increase (decrease) in short-term credit  | 1,300                  | (641)          | (357)          |
| Repayment of long-term loans  | (1,837)                | (1,789)        | (1,671)        |
| Proceeds from long-term loans   | 3,048                  | 2,188          | 1,851          |
| Proceeds from exercise of employee stock options  | -                      | 94             | 472            |
| Repayment of credit from fixed asset payables   | (206)                  | (358)          | -              |
| <b>Net cash provided by (used in) financing activities</b>  | <b>2,305</b>           | <b>(506)</b>   | <b>295</b>     |
| <b>Effect of translation adjustments</b>  | <b>(24)</b>            | <b>112</b>     | <b>(74)</b>    |

|  | Year ended December 31 |       |       |
|--|------------------------|-------|-------|
|  | 2002                   | 2001  | 2000  |
| <b>Net increase in cash and cash equivalents</b>                               | 437                    | 453   | 585   |
| <b>Cash and cash equivalents at beginning of the year</b>                      | 2,030                  | 1,577 | 992   |
| <b>Cash and cash equivalents at end of the year</b>                            | 2,467                  | 2,030 | 1,577 |
| <b>Supplemental cash flow information:</b>                                     |                        |       |       |
| Interest paid  | 457                    | 460   | 381   |
| <b>Non-cash activities:</b>  |                        |       |       |
| Conversion of convertible note and accrued interest thereon into share capital | 325                    | -     | -     |
| Purchase of fixed assets not yet paid  | 1,030                  | 679   | -     |

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

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Eltek Ltd. and its Subsidiaries

## Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

### Note 1 Organization and Summary of Significant Accounting Policies

#### A. General

Eltek Ltd. ("the Company") was incorporated in Israel in 1970, and the Company's shares have been publicly traded on the NASDAQ Capital Market since 1997.

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

#### Acquisition of Kubatronik Leiterplatten GmbH

In June 2002, the Company established a wholly-owned subsidiary, EN-Eltek Netherlands 2002 B.V. ( EN-Eltek ), for the purpose of the acquisition of Kubatronik Leiterplatten GmbH

On June 10, 2002, the Company acquired 76% of the shares of Kubatronik Leiterplatten GmbH ( Kubatronik ) for the consideration of 2.6 million (\$2.4 million as of the date of acquisition) See Note 1(B).

The acquisition resulted in the recognition of goodwill in the amount of 1.1 million (\$1 million as of the date of acquisition) see Note 6.

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Pursuant to the agreement, the seller has until December 31, 2012, the right to require the Company to purchase ( Put option ), and the Company has the right to require the seller to sell to the Company ( Call option ), the seller's remaining 24% interest in Kubatronik. The acquisition price for the remaining 24% interest varies depending on several factors. Through the date of these financial statements the seller has not approached the Company to exercise the put option. The fair value of the above options is calculated based on the Binomial model and recorded in the balance sheet.

### **Establishment of Eltek USA Inc.**

In 2007, the Company established a wholly-owned subsidiary, Eltek USA Inc. for the purpose of sales, promotion and marketing in the North American market. Eltek USA Inc. commenced operations beginning in 2008.

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Eltek Ltd. and its Subsidiaries

### **Notes to the Consolidated Financial Statements**

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**(All amounts in thousands of \$, except where otherwise stated)**

#### **Note 1 Organization and Summary of Significant Accounting Policies (cont d)**

##### **B. Basis of presentation**

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ).

For previous periods up to December 31, 2006 the Company's financial statements were prepared in accordance with Generally Accepted Accounting Principles in Israel (Israeli GAAP) with a reconciliation note to U.S. GAAP. Effective January 1, 2007 the Company is reporting under U.S. GAAP. All comparative data was adjusted accordingly and is presented in these financial statement in accordance with U.S. GAAP.

The consolidated financial statements include the accounts of the Company and its subsidiaries (EN-Eltek, Kubatronik and Eltek International).

All intercompany transactions and balances were eliminated in consolidation.

##### **C. Functional and reporting currency**

The Company's functional currency is the New Israeli Shekel (NIS).

Effective January 1, 2007, the Company changed its reporting currency from NIS to the U.S. dollar. The change in reporting currency was accounted for in accordance with Financial Accounting Standards (SFAS) No. 52, Foreign Currency Translation (SFAS No. 52). Assets and liabilities of the Company have been translated using the exchange rate at the balance sheet date except for equity accounts which were translated using historical exchange rates. The average exchange rate for the period has been used to translate revenues and expenses. Translation adjustments were reported separately as a component of comprehensive income (cumulative translation adjustment).

##### **D. Translation of foreign entity operations**

The financial statements of a foreign subsidiary are translated into the functional currency as follows:

1. The assets and liabilities, both monetary and non-monetary, are translated according to the exchange rate on the consolidated balance sheet date including the goodwill arising from the acquisition of the subsidiary.

2. Income and expense items are translated according to the weighted average exchange rate for the period.
3. The resulting exchange rate differences are classified as a separate item in shareholders' equity.

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Eltek Ltd. and its Subsidiaries

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**Notes to the Consolidated Financial Statements**


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(All amounts in thousands of \$, except where otherwise stated)

**Note 1 Organization and Summary of Significant Accounting Policies (cont'd)****E. Exchange rates and linkage bases**

1. Balances linked to the Consumer Price Index (CPI) are recorded pursuant to contractual linkage terms of the specific assets and liabilities.
2. Details of the CPI and the representative exchange rates are as follows:

|                                | Israeli<br>CPI | Exchange rate<br>of one US<br>dollar | Exchange rate<br>of one Euro |
|--------------------------------|----------------|--------------------------------------|------------------------------|
|                                | Points         | NIS                                  | NIS                          |
| For the year ended:            |                |                                      |                              |
| December 31, 2005              | 185.05         | 4.603                                | 5.447                        |
| December 31, 2006              | 184.69         | 4.225                                | 5.564                        |
| <b>December 31, 2007</b>       | <b>191.15</b>  | <b>3.846</b>                         | <b>5.659</b>                 |
|                                | %              | %                                    | %                            |
| Changes during the year ended: |                |                                      |                              |
| December 31, 2005              | 2.39           | 6.85                                 | (7.32)                       |
| December 31, 2006              | (0.19)         | (8.21)                               | 2.1                          |
| <b>December 31, 2007</b>       | <b>3.5</b>     | <b>(8.97)</b>                        | <b>1.71</b>                  |

**F. Use of estimates**

The preparation of the consolidated financial statements in accordance with generally accepted accounting principles in the United States of America requires management of the Company to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the period. Significant items subject to such estimates and assumption include the useful lives of fixed assets, allowances for doubtful accounts, valuation of derivatives, deferred tax asset, fixed assets, inventory, investments, income tax uncertainties and other contingencies. Actual results could differ from these estimates.

**G. Cash and cash equivalents**

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

**H. Provision for doubtful accounts receivable**

The allowance for doubtful accounts receivable is calculated on the basis of specific identification of customer balances. The allowance is determined based on management's estimate of the aged receivable balance considered uncollectible, based on historical experience, aging of the receivable and information available about specific customers, including their financial condition and volume of their operations.

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Eltek Ltd. and its Subsidiaries

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 1 Organization and Summary of Significant Accounting Policies (cont d)****H. Provision for doubtful accounts receivable (cont d)**

The activity in the allowance for doubtful accounts for the three years ended December 31, 2007 is as follows:

|  | Year ended December 31 |      |      |
|--|------------------------|------|------|
|  | 2007                   | 2006 | 2005 |
|  | \$ thousands           |      |      |
| Opening balance                          | 477                    | 370  | 425  |
| Additions during the year                | 48                     | 85   | 16   |
| Write-offs charged against the allowance | (7)                    | (11) | (44) |
| Foreign currency translation adjustments | 47                     | 33   | (27) |
| Closing balance                          | 565                    | 477  | 370  |

**I. Inventories**

Inventories are recorded at the lower of cost or market value. Cost is determined on the weighted average basis for raw materials and finished goods, and on the basis of actual manufacturing costs for work in progress.

**J. Assets held for employees' severance payments**

Assets held for employees' severance payments represent contributions to insurance policies and are recorded at their current redemption value.

**K. Fixed assets**

Fixed assets are stated at cost. Depreciation is computed by the straight-line method over the estimated useful lives of the assets at the following annual rates:

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

Machinery and equipment purchased under capital lease arrangements are recorded at the present value of the minimum lease payments at lease inception. Such assets and leasehold improvements are depreciated and amortized respectively, using the straight-line method over the shorter of the lease term or estimated useful life of the asset.

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Eltek Ltd. and its Subsidiaries

## Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

### Note 1 Organization and Summary of Significant Accounting Policies (cont d)

#### K. Fixed assets (cont d)

The Company accounts for long-lived assets and certain intangible assets in accordance with the provisions of SFAS No. 144,

Accounting for the Impairment of or Disposal of Long-Lived Assets ( Statement 144 ). This Statement requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset or asset group to the undiscounted future net cash flows expected to be generated by the asset or the asset group. 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.

#### L. Goodwill

Goodwill represents the excess of the aggregate purchase price over the fair value of the net assets acquired in a purchase business combination.

Goodwill is reviewed for impairment at least annually in accordance with the provisions of FASB Statement No. 142, Goodwill and Other Intangible Assets ( Statement 142 ). The goodwill impairment test is a two-step test. Under the first step, the fair value of the reporting unit is compared with its carrying value. An indication of goodwill impairment exists if the fair value of the reporting unit is less than its carrying value, and the enterprise must perform step two of the impairment test (measurement). Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, in accordance with FASB Statement No. 141, Business Combinations . The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. If the fair value of the reporting unit exceeds its carrying value, step two does not need to be performed.

In 2006, following the Company's annual impairment test of goodwill, an impairment of \$473 was recorded. In 2007, the Company concluded that there was no impairment of goodwill.

#### M. Taxes on income

The Company accounts for income taxes under SFAS No. 109, Accounting for Income Taxes ( Statement 109 ). Under Statement 109, deferred tax assets or liabilities are recognized in respect of the future tax consequences attributable to temporary differences between the tax bases of assets and liabilities and their financial reporting amounts as well as tax loss and credit carryforwards, based on enacted tax

rates applicable to the periods in which such temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the consolidated statements of operations in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is more likely than not to be realized.

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**Notes to the Consolidated Financial Statements**


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(All amounts in thousands of \$, except where otherwise stated)

**Note 1 Organization and Summary of Significant Accounting Policies (cont d)**
**M. Taxes on income (cont d)**

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which prescribes recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted FIN 48 on January 1, 2007. The effect of adoption on the Company's consolidated results of operations, financial position and cash flows based on Company management's evaluation is presented in Note 15.

The Company records interest related to unrecognized tax benefits in interest expense that is included as part of the net financial expenses and penalties in general and administrative expenses in the consolidated statements of operations.

**N. Convertible note**

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

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

In January 2004, \$200 of the principal amount of the Note was converted into 606,060 ordinary shares. The conversion price per share for the remaining \$300 was 0.33.

In May 2007, the remaining \$300 of the principal amount of the Note and additional \$25 of accrued interest was converted into 985,796 ordinary shares. The remaining accrued interest of \$128 was paid to the Note holder in May.

**O. Revenue recognition**

The Company recognizes revenues upon shipment of the products and after the customer takes ownership and assumes risk of loss, collection of the corresponding receivable is probable, persuasive evidence of an arrangement exists, and the sale price is fixed or determinable. Commission income is accounted for on the accrual basis.

**P. Research and development**

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

In 2005, the Company was granted membership in OptiPac, a consortium within the framework of the MAGNET program of the OCS which deals with future innovative technology. The OptiPac target is to develop generic electro-optical packaging technologies for optical fiber based telecommunication systems and for several other industries and applications.

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**Notes to the Consolidated Financial Statements**

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(All amounts in thousands of \$, except where otherwise stated)

**Note 1 Organization and Summary of Significant Accounting Policies (cont d)****P. Research and development (cont d)**

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

These OCS grants are contingent upon the Company submission of periodic reports prepared in accordance with the requirement of the OCS and are not subject to royalties or any future payments to be made by the Company. The Company has been in compliance with such OCS requirements.

**Q. Stock compensation plans to employees and directors**

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2005), Share-Based Payment ( SFAS No. 123R ). This Statement requires compensation expense relating to share-based payments to be recognized in net income using a fair-value measurement method. Under the fair value method, the estimated fair value of awards is charged to income on a straight-line basis over the requisite service period, which is the vesting period. The Company elected the modified-prospective method and therefore prior periods were not restated. Under the modified-prospective method, compensation costs recognized in 2006 and 2007 includes also compensation costs for all share-based payments granted prior to, but not yet vested, as of December 31, 2005.

Stock-based compensation recognized in the Consolidated Statement of Operations for the year ended December 31, 2007 is based on awards ultimately expected to vest. As a result, the expense has been reduced for estimated forfeitures. SFAS No. 123R required forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ) for the periods prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

The implementation of SFAS No. 123R did not have a material effect the profit before taxes, net profit or the earning per share for the years ended December 31, 2006 and 2007.

Prior to January 1, 2006, the Company has followed SFAS No. 123, which permitted entities to recognize as an expense over the vesting period, the fair value on the date of grant of all stock-based awards. Alternatively, Statement 123 allowed entities to continue to apply the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations ( APB Opinion No. 25 ) and provide pro forma net income and pro forma earnings per share disclosures for employee stock option grants as if the fair-value based method defined in Statement 123 had been applied.

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**Notes to the Consolidated Financial Statements**

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(All amounts in thousands of \$, except where otherwise stated)

**Note 1 Organization and Summary of Significant Accounting Policies (cont d)**

**Note 1 Organization and Summary of Significant Accounting Policies (cont d)****R. Profit (loss) per ordinary share**

Basic and diluted profit (loss) per ordinary share is presented in conformity with SFAS No. 128, Earnings Per Share, for all years presented. Basic profit (loss) per ordinary share is calculated by dividing the net profit (loss) attributable to ordinary shares, by the weighted average number of ordinary shares outstanding. Diluted profit (loss) per ordinary share calculation is similar to basic earnings per share except that the weighed average of common shares outstanding is increased to include the number of additional common shares that would have been outstanding if the ordinary shares from options had been exercised, to the extent that these options had diluted effect.

The following table summarizes information related to the computation of basic and diluted earnings (loss) per ordinary share for the years indicated.

|   | Year ended December 31, |       |       |
|---|-------------------------|-------|-------|
|   | 2007                    | 2006  | 2005  |
| Net earnings (loss) attributable to ordinary shares   | (301)                   | 1,650 | 1,466 |
| Weighted average number of ordinary shares outstanding used in basic earnings (loss) per ordinary share calculation   | 6,247                   | 5,617 | 5,575 |
| Add assumed exercise of outstanding dilutive potential ordinary shares  | -                       | 1,337 | 1,210 |
| Weighted average number of ordinary shares outstanding used in diluted earnings (loss) per ordinary share calculation | 6,247                   | 6,954 | 6,785 |
| Basic earnings (loss) per ordinary share  | (0.05)                  | 0.29  | 0.26  |
| Diluted earnings (loss) per ordinary share  | (0.05)                  | 0.24  | 0.22  |
| Number of options excluded from the diluted earning per share calculation because of anti-dilutive effect             | 6                       | 273   | 300   |

**S. Derivative financial instruments**

The Company applies Financial Accounting Standards Board (FASB) Statement No. 133, Accounting for Derivative Instruments and Certain Hedging Activities, as amended, which require that all derivative instruments be recorded on the balance sheet at their respective fair values.

Changes in fair value are recognized in the consolidated statements of operations, as a financing item.

The fair value of derivative financial instruments is determined on the basis of their market values or the quotations of financial institutions. In the absence of a market value or financial institution quotation the fair value is determined on the basis of a valuation

model.

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Eltek Ltd. and its Subsidiaries

## Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

### Note 1 Organization and Summary of Significant Accounting Policies (cont d)

#### T. Concentration of credit risk

Financial instruments that may subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents and trade accounts receivable. Cash and cash equivalents are deposited with major financial institutions in Europe, the United States, Japan, Australia and Israel.

The Company performs ongoing credit evaluations of the financial condition of its customers. The risk of collection associated with trade receivables is reduced by the large number and geographical dispersion of the Company's customer base and the Company's policy of requiring collateral or security with respect to receivables due from distributors.

#### U. Recent accounting pronouncements

In September 2006, the FASB issued FASB Statement No. 157, Fair Value Measurement (Statement 157). Statement 157 defines fair value, establishes a framework for the measurement of fair value, and enhances disclosures about fair value measurements. The statement does not require any new fair value measures. The statement is effective for fair value measures already required or permitted by other standards for fiscal years beginning after November 15, 2007. The Company is required to adopt Statement 157 beginning on January 1, 2008. Statement 157 is required to be applied prospectively, except for certain financial instruments. Any transition adjustment will be recognized as an adjustment to opening retained earnings in the year of adoption. The FASB announced a one year deferral of Statement 157's fair value measurement requirements for non-financial assets and liabilities that are not required or permitted to be measured at fair value on a recurring basis. The Company believes that the adoption of Statement 157 will not have a material impact on the Company's financial condition, results of operations or cash flows.

In February 2007, the FASB issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB No. 115 (Statement 159). Statement 159 gives the Company the irrevocable option to carry most financial assets and liabilities at fair value that are not currently required to be measured at fair value. If the fair value is elected, changes in fair value would be recorded in earnings at each subsequent reporting date. SFAS 159 is effective for the Company's 2008 fiscal year. The Company believes that the adoption of Statement 159 will not have a material impact on the Company's financial condition, results of operations or cash flows.

In December 2007, the FASB issued FASB Statement No. 141R, Business Combinations (Statement 141R) and FASB Statement No. 160, Non-controlling Interests in Consolidated Financial Statements- an amendment to ARB No. 51 (Statement 160). Statements 141R and 160 require most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at full fair value and require non-controlling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with non-controlling interest holders. Both Statements are effective for periods beginning on or after December 15, 2008, and earlier adoption is prohibited. Statement 141R will be applied to business combinations occurring after the effective date. Statement 160 will be applied prospectively to all non-controlling interests, including any that arose before the effective date. The Company is currently evaluating the impact of adopting Statement 141R and Statement 160 on its results of operations and financial position.

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## Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

## Note 2 Cash and Cash Equivalents

|                                    | Interest rate<br>as of<br>December 31 | December 31  |              |
|------------------------------------|---------------------------------------|--------------|--------------|
|                                    | 2007                                  | 2007         | 2006         |
|                                    | %                                     |              |              |
| Denominated in U.S. dollars        | 0-4.25                                | 886          | 574          |
| Denominated in New Israeli Shekels | 0-3.7                                 | 1,043        | 1,248        |
| Denominated in Euro                | 0                                     | 538          | 190          |
| Others                             | 0                                     | -            | 18           |
|                                    |                                       | <u>2,467</u> | <u>2,030</u> |

## Note 3 Other Receivables

|   | December 31 |            |
|---|-------------|------------|
|   | 2007        | 2006       |
| Employees                                   | 40          | 41         |
| Advances to suppliers                       | 38          | 18         |
| Government of Israel and other institutions | 364         | 113        |
| Government of Germany                       | 173         | 86         |
| Derivative instruments (Note 14)            | 127         | -          |
| Other receivables                           | -           | 3          |
|   | <u>742</u>  | <u>261</u> |

## Note 4 Inventories

|                 | December 31 |       |
|-----------------|-------------|-------|
|                 | 2007        | 2006  |
| Raw materials   | 2,357       | 2,107 |
| Work-in-process | 1,029       | 1,039 |

|                   | December 31  |       |
|-------------------|--------------|-------|
|                   | 2007         | 2006  |
| Finished products | 885          | 620   |
|                   | <b>4,271</b> | 3,766 |

Finished products are presented net of allowance for inventory obsolescence in the amounts of \$887 and \$1,400 as of December 31, 2006 and 2007, respectively.

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Eltek Ltd. and its Subsidiaries

### Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

#### Note 5 Fixed Assets, Less Accumulated Depreciation

|  | December 31     |          |
|--|-----------------|----------|
|  | 2007            | 2006     |
| Machinery and equipment                    | 32,315          | 27,150   |
| Leasehold improvements                     | 7,459           | 5,032    |
| Motor vehicles                             | 190             | 164      |
| Office furniture and equipment             | 1,591           | 1,394    |
| Fixed assets                               | <b>41,555</b>   | 33,740   |
| Accumulated depreciation                   | <b>(30,558)</b> | (25,597) |
| Fixed assets less accumulated depreciation | <b>10,997</b>   | 8,143    |

Depreciation expense for the years ended December 31, 2005, 2006 and 2007 were \$2,284, \$2,330 and \$2,264, respectively.

#### Note 6 Goodwill

Changes in the carrying amount of goodwill for the years ended December 31, 2006 and 2007 are as follows:

|  | December 31 |      |
|--|-------------|------|
|  | 2007        | 2006 |

|                                      | December 31  |            |
|--------------------------------------|--------------|------------|
|                                      | 2007         | 2006       |
| Balance at the beginning of the year | 903          | 1,259      |
| Impairment                           | -            | (473)      |
| Effect of translation adjustments    | 106          | 117        |
|                                      | <u>1,009</u> | <u>903</u> |

**Note 7 Short-Term Credit and Current Maturities of Long-Term Debt**

|   | Annual<br>interest rate at<br>December 31<br>2007 | December 31  |              |
|---|---|--------------|--------------|
|   |   | 2007         | 2006         |
|   | %   |              |              |
| In NIS (unlinked)   | 6.7-6.85  | 3,484        | 1,893        |
| In U.S. dollars   | 6.7   | 110          | 110          |
| Current maturities of long-term<br>debts due to banks (Note 9A) |   | <u>1,029</u> | <u>773</u>   |
|   |   | <u>4,623</u> | <u>2,776</u> |

As to pledges securing the credit, see Note 11A.

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Eltek Ltd. and its Subsidiaries

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 8 Accounts Payable Other**

|  | December 31 |            |
|--|-------------|------------|
|  | 2007        | 2006       |
| Accrued payroll and related benefits               | 1,008       | 1,211      |
| Provision for vacation and other employee benefits | 968         | 821        |
| Net written put option (Note 1A)                   | 47          | 146        |
| Accrued expenses                                   | 903         | 809        |
| Other liabilities                                  | <u>221</u>  | <u>127</u> |

| December 31 |       |
|-------------|-------|
| 3,147       | 3,114 |

**Note 9 Long-Term Debt, Excluding Current Maturities****A. Banks and others**

|                           | Annual<br>interest rate at<br>December 31<br>2007 | December 31 |         |
|---------------------------|---|-------------|---------|
|                           |   | 2007        | 2006    |
|                           | %   |             |         |
| <b>Linkage terms</b>      |   |             |         |
| U.S. dollar               | 4 - 6.9   | 1,357       | 1,036   |
| CPI                       | 4.5 - 6.5   | 865         | 580     |
| Euro                      | 2.85  | 181         | -       |
| Unlinked                  | 6.5 - 8.4   | 3,335       | 2,546   |
|                           |   | 5,738       | 4,162   |
| Less - current maturities |   | (1,495)     | (1,094) |
|                           |   | 4,243       | 3,068   |

Financial covenants in respect of the Company's credit facilities and long-term debt with one of its banks require the Company to maintain the higher of shareholders' equity, excluding intangible assets, of NIS 24.0 million or 23% of the Company's total assets (on a non consolidated basis). With another bank, the financial covenants require the Company to maintain the higher of tangible shareholders' equity of NIS 17.5 million or 17% of the Company's consolidated total assets. For these purposes, shareholders' equity excludes prepaid expenses (except insurance). As of December 31, 2007, the Company was in compliance with these covenants.

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 9 Long-Term Debt, Excluding Current Maturities (cont d)**

- B.** The aggregate maturities of long-term debt for each of the five years subsequent to December 31, 2007 and thereafter are as follows:

|                                 |       |
|---------------------------------|-------|
| First year (current maturities) | 1,495 |
|---------------------------------|-------|

|                           |       |
|---------------------------|-------|
| Second year               | 2,320 |
| Third year                | 948   |
| Fourth year               | 653   |
| Fifth year and thereafter | 322   |
|                           | <hr/> |
|                           | 4,243 |
|                           | <hr/> |
|                           | 5,738 |
|                           | <hr/> |

As to pledges securing the loans, see Note 11A.

#### **Note 10 Employee Severance Benefits**

Under Israeli law and labor agreements, the Company is required to make severance and pension payments to their retired or dismissed employees and to employees leaving employment in certain other circumstances.

1. The liability in respect of most of its non-senior employees is discharged by participating in a defined contribution pension plan and making regular deposits with a pension fund. The liability deposited with the pension fund is based on salary components as prescribed in the existing labor agreement. The custody and management of the amounts so deposited are independent of the Company and accordingly, such amounts funded (included in expenses on an accrual basis) and related liabilities are not reflected in the balance sheet.

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

2. In respect of certain employees, the Company has an approval from the Israeli Ministry of Labor and Welfare, pursuant to the terms of Section 14 of the Israeli Severance Pay Law, 1963, according to which the current deposits in the pension fund and/or with the insurance company exempt it from any additional obligation to the employees for whom the said depository payments were made.
3. In respect of the liability to other employees, individual insurance policies are purchased and deposits are made with recognized severance pay funds.

The liability for severance pay is calculated on the basis of the latest salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited including accumulated income thereon as well as by the unfunded provision.

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Eltek Ltd. and its Subsidiaries

#### **Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 10 Employee Severance Benefits (cont d)**

4. Kubatronik owns an insurance policy and makes regular deposits with an insurance company for securing pension rights on behalf of one of its key employees. Such amounts deposited and the related liabilities are reflected in the consolidated balance sheet.

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

5. Details of the provision and amounts funded:

|   | December 31 |           |
|---|-------------|-----------|
|   | 2007        | 2006      |
| Liability for employee severance benefits | 1,388       | 1,187     |
| Assets held for severance benefits        | (1,319)     | (1,106)   |
| Employee severance benefits, net          | <b>69</b>   | <b>81</b> |

Expenses recorded in respect of employee severance payments for the years ended December 31, 2005, 2006 and 2007 are \$92, \$118 and \$79, respectively.

**Note 11 Commitments and Contingent Liabilities**

- A.
- The Company has pledged certain items of its equipment and the rights to any insurance claims on such items to secure its indebtedness with banks, as well as floating liens on all of its remaining assets in favor of the banks.
  - As a guarantee of the implementation of the approved projects and in compliance with the conditions of the approval (see Note 15A).
  - The Company has also pledged a machine and a computer system to suppliers to secure its indebtedness.
  - The Company has signed an agreement with a consulting company to incorporate the Theory of Constraint ( TOC ) into its operation. The purpose is to improve several operational measures identified by the Company's management. Pursuant to the agreement in 2004, the Company paid consultation fees and agreed to pay bonuses to the consulting company based on its success. During the years ended December 31, 2005 and 2006, the consulting company was entitled to a bonus of \$115 and \$106, respectively. In the year ended December 31, 2007, the consulting company was not entitled to a bonus. The agreement will expire on September 30, 2008.

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 11 Commitments and Contingent Liabilities (cont d)**

- B.**
1. The premises occupied by the Company and Kubatronik are leased under operating agreements which expire in February 2017 and June 2008, respectively.
  2. Two parking areas that serve the employees of Kubatronik are leased under operating agreements which expire in December 2010.
  3. The Company has signed several lease and maintenance agreements for production equipment with suppliers of equipment. Of such agreements, two principal agreements will expire in September 2009 and March 2010.
  4. Two production machines are leased under operating agreements which will expire in January 2008 and April 2009.
  5. The Company has signed several other maintenance agreements for production equipment and software.
  6. The majority of the Company's motor vehicles are leased under three year operating agreements.
  7. Minimum future payments at December 31, 2007 due under the above agreements over the next five years and thereafter are as follows:

|                           | <u>Operating<br/>leases</u> | <u>Other<br/>agreements</u> |
|---------------------------|-----------------------------|-----------------------------|
| First year                | 711                         | 865                         |
| Second year               | 655                         | 479                         |
| Third year                | 655                         | 167                         |
| Fourth year               | 655                         | 51                          |
| Fifth year and thereafter | 3,384                       | 46                          |
|                           | <u>6,060</u>                | <u>1,608</u>                |

Payments required under operating lease agreements are charged to expense by the straight-line method over the periods of the respective leases.

Rental expenses under the lease agreements for the years ended December 31, 2005, 2006 and 2007 were \$700, \$527 and \$725, respectively.

**C. Indemnification agreement**

The Company entered into an indemnification agreement with its directors and officers and undertook to enter into the same agreement with future directors and officers, for losses incurred by a director or officer. Such indemnification amount shall be limited to the lesser of \$2,000 or 25% of the Company's shareholders' equity.

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 12 Shareholders Equity****A. Authorized, issued and outstanding share capital in historical terms is as follows:**

|   | Authorized                   | Issued and outstanding |                     |
|---|------------------------------|------------------------|---------------------|
|   | December 31<br>2006 and 2007 | December 31<br>2007    | December 31<br>2006 |
| <b>Number of shares:</b>                  |                              |                        |                     |
| Ordinary shares of par value NIS 0.6 each | 50,000,000                   | 6,609,807              | 5,624,011           |
| <b>Amount in US\$</b>                     |                              |                        |                     |
| Ordinary shares of par value NIS 0.6 each | 7,800,312                    | 1,384,266              | 1,235,504           |

**B. Stock based compensation**

In August 2000, the Company adopted the Eltek Ltd. 2000 Stock Option Plan (the 2000 Plan). The 2000 Plan authorized the issuance of options to purchase an aggregate of 750,000 ordinary shares. The options generally expire on the fifth anniversary of the date of grant, vest ratably over a three-year period and may not be exercised for a period of one year from the date of grant. The exercise prices of these options are equal to the market price of the underlying stock on the date of the grant.

As of December 31, 2006 and 2007, options to purchase 20,000 ordinary shares with an exercise price of \$1.14 per share were outstanding under the 2000 Plan.

The Company does not intend to grant additional options under the 2000 plan.

In November 2005, the Board of Directors of the Company adopted and the Shareholders subsequently approved the Eltek Ltd. 2005 Stock Option Plan (the 2005 Plan). The aggregate number of options granted under the 2005 Plan amounted to 284,500 options. The options will expire two years from the date of the Shareholders' Approval of such plan, which was December 11, 2005, and no awards may be made under the 2005 Plan after December 31, 2005. Options granted under the 2005 Plan were fully vested on the grant date, and each option was designated as a Section 102(c) option of the Israeli tax ordinance. The exercise price per option was set to NIS 21 which equaled the market price of the Company's ordinary shares on date of grant.

On December 11, 2007 all the remaining options granted under the 2005 plan expired.

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Eltek Ltd. and its Subsidiaries

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 12 Shareholders Equity (cont d)****B. Stock based compensation (cont d)**

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

| Number<br>of | Weighted<br>average |
|--------------|---------------------|
|--------------|---------------------|

|  | options       | exercise price |
|--|---------------|----------------|
|  |               | US\$           |
| Balance as at December 31, 2004        | 414,933       | 4.22           |
|  | Granted       | 284,500        |
|  | Exercised     | (110,800)      |
|  | Expired       | (274,533)      |
|  | Forfeited     | (2,000)        |
| Balance as at December 31, 2005        | 312,100       | 4.34           |
|  | Granted       | -              |
|  | Exercised     | (21,500)       |
|  | Forfeited     | (3,200)        |
| Balance as at December 31, 2006        | 287,400       | 4.70           |
|  | Granted       | -              |
|  | Exercised     | -              |
|  | Expired       | (267,400)      |
| <b>Balance as at December 31, 2007</b> | <b>20,000</b> | <b>1.14</b>    |

The following table summarizes information concerning options outstanding at December 31, 2007:

| Exercise prices | Number of<br>options<br>outstanding at<br>December 31<br>2007 | Number of<br>options<br>exercisable at<br>December 31<br>2007 | Remaining<br>contractual life<br>(in years) |
|-----------------|---|---|---|
| U.S.\$ 1.14     | <b>20,000</b>   | <b>20,000</b>   | <b>1.9</b>                                  |

As of December 31, 2007, the intrinsic value of the outstanding options is \$28.

## Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

### Note 13 Revenues

#### A. Revenues by activities

Year ended December 31

|                                     | Year ended December 31 |               |               |
|-------------------------------------|------------------------|---------------|---------------|
|                                     | 2007                   | 2006          | 2005          |
| Sales of manufactured products      | 36,997                 | 38,751        | 31,859        |
| Sales of non- manufactured products | 266                    | 93            | 231           |
| Commissions                         | 213                    | 201           | 87            |
|                                     | <b>37,476</b>          | <b>39,045</b> | <b>32,177</b> |

Customer who accounted for over 10% of the total consolidated revenues:

|  | Year ended December 31 |       |       |
|--|------------------------|-------|-------|
|  | 2007                   | 2006  | 2005  |
| Customer A - Sales of manufactured products    | *-                     | 25.2% | 30.6% |
| Customer B ** - Sales of manufactured products | 15.2%                  | 11.7% | 12.9% |

\* Less than 10%.

\*\* Consisting of two affiliated companies

#### B. Revenues by geographic areas

|                   | Year ended December 31, |               |               |
|-------------------|-------------------------|---------------|---------------|
|                   | 2007                    | 2006          | 2005          |
| Israel            | 18,505                  | 17,876        | 13,603        |
| Europe            | 13,602                  | 17,952        | 16,287        |
| Rest of the world | 5,369                   | 3,217         | 2,287         |
|                   | <b>37,476</b>           | <b>39,045</b> | <b>32,177</b> |

#### Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

**Note 14 Financial Expenses, Net**

|  | Year ended December 31 |            |            |
|--|------------------------|------------|------------|
|  | 2007                   | 2006       | 2005       |
| Interest and exchange rate expenses on long-term loans                                   | 336                    | 114        | 234        |
| Expenses on short-term credit and bank charges   | 210                    | 319        | 343        |
| Effect of exchange rate differences on expenses and net gain from derivative instruments | (386)                  | 101        | (60)       |
| Other financing expenses (income), net   | (15)                   | 4          | 75         |
|  | <b>145</b>             | <b>538</b> | <b>592</b> |

The Company uses forward contracts and option strategies to manage its foreign exchange rate exposures. Contracts with notional amount that totaled \$300 and \$1,200 and with estimated fair values that totaled \$3 and \$127, respectively, at December 31, 2006 and 2007, respectively, which the Company did not designate as hedging instruments for accounting purposes. The change in fair value of these contracts of \$22, \$(19) and \$124 for the years ended December 31, 2005, 2006 and 2007 have been recognized to finance income in those years. The periodic net cash (receipts) settlements totaled \$9, \$63 and \$380 for the years ended December 31, 2005, 2006 and 2007, respectively. These amounts have been recorded as reductions or additions to finance expense in those years.

**Note 15 Taxes on Income****A. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (the Law )**

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

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

Entitlement to the above benefits is conditional upon the Company complying with the conditions stipulated by the Law and the regulations promulgated thereunder, as well as the criteria set forth in the approval for the specific investment in the approved enterprise. In the event of failure to comply with these conditions, the tax benefits may be cancelled, and the Company may be required to refund the amount of the cancelled benefits, together with CPI linkage adjustment and interest. See Note 11A2 for a pledge registered in this respect.

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

(All amounts in thousands of \$, except where otherwise stated)

**Note 15 Taxes on Income (cont d)**

**A. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (the Law ) (cont d)**

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

Income of the Company not derived from the approved enterprise is subject to the regular corporate tax rate, which is 29% in 2007.

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

**2. Amendments to the Law**

On March 30, 2005, the Israeli Parliament approved a reform of the above Law. The primary changes are as follows:

- (a) Companies that meet the criteria of the Alternative Benefits track will receive those tax benefits without prior approval. In addition, there will be no requirement to file reports with the Investment Center. Companies will be required to notify the Israeli Tax Authorities regarding the implementation of the Alternative Benefits track. Audits will be the responsibility of the Israeli Income Tax Authorities as part of their tax audits. Request for pre-ruling is possible.
- (b) Tax benefits of the Alternative Benefits track include lower tax rates or no tax depending on area and the path chosen, lower tax rates on dividends and accelerated depreciation.
- (c) In order to receive benefits in the Grant Path or the Alternative Benefits track, the industrial enterprise must contribute to the economic independence of Israel's economy in one of the following ways:
  - 1. Its primary activity is in the Biotechnology or Nanotechnology fields and pre-approval has been obtained from the head of research and development at the OCS;
  - 2. Its revenue from a specific country is not greater than 75% of its total revenues that year;
  - 3. 25% or more of its revenues are derived from a specific foreign market of at least 12 million residents.
  - 4. Upon the establishment of an enterprise, an investment of at least NIS 300 thousand in production machinery and equipment within three years is required.

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Eltek Ltd. and its Subsidiaries

**Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

**Note 15 Taxes on Income (cont d)****A. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (the Law ) (cont d)****2. Amendments to the Law (cont d)**

5. For an expansion, a company is required to invest within three years the greater of NIS 300 thousand in production machinery and equipment or a certain percentage of its existing production machinery and equipment.

The amendments to the Law does not retroactively apply for investment programs having an approved enterprise approval certificate from the Investment Center issued prior to December 31, 2004. Therefore, the amendments do not impact an existing approved enterprise which received prior written approval. The new tax regime shall apply for a new approved enterprise and for an approved enterprise expansion for which the first year of benefits is 2004 or thereafter.

**B. Taxation of employee stock option plans**

In respect to employee stock incentive plans, the 2003 Israeli tax reform codified past practice and determined three alternative tracks for taxing employee stock option plans. Where a trustee arrangement is in place, the employer can either claim an expense for tax purposes while the employee will be fully taxed up to the maximum marginal tax rate of 49% (the Ordinary Income Route ) or the Company can waive the tax deduction and the employee will pay a reduced tax rate of 25% (the Capital Gains Route ). Where there is no trustee arrangement, the employee is fully taxed and no tax deduction is allowed to the Company. There are detailed provisions for implementing these tracks. The tax reform s new regulations do not apply for options granted before December 31, 2002. The options granted by the Company during 2004 and 2005 were granted pursuant to the Capital Gains Route.

**C. Amendments to the Income Tax Ordinance**

1. On June 29, 2004, the Knesset (the Israeli Parliament) passed the Law for the Amendment of the Income Tax Ordinance (Amendment No. 140 and Temporary Order) 2004 ( the 2004 Amendment ). The 2004 Amendment provides for a gradual reduction in the corporate tax rate from 36% to 30% in the following manner: 35% for the 2004 tax year, 34% for the 2005 tax year, 32% for the 2006 tax year and 30% for the 2007 tax year and thereafter.
2. On July 25, 2005 the Knesset passed the Law for the Amendment of the Income Tax Ordinance (No. 147 and Temporary Order) 2005 (the 2005 Amendment).

The 2005 Amendment provides for a gradual reduction in the corporate tax rate in the following manner: in 2006 the tax rate will be 31%, in 2007 the tax rate will be 29%, in 2008 the tax rate will be 27%, in 2009 the tax rate will be 26% and from 2010 onward the tax rate will be 25%. Furthermore, as from 2010, upon reduction of the company tax rate to 25%, real capital gains will be subject to tax of 25%.

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Eltek Ltd. and its Subsidiaries

**Notes to the Consolidated Financial Statements****(All amounts in thousands of \$, except where otherwise stated)****Note 15 Taxes on Income (cont d)****D. Taxation under Inflationary Conditions**

The Israeli Income Tax Law (Inflationary Adjustments) 1985 (hereinafter the Inflationary Adjustments Law ) is effective from the 1985 tax year. The Inflationary Adjustments Law introduced the concept of measurement of results for tax purposes on a real (net of inflation) basis. The various adjustments required by the aforesaid law are designed to achieve taxation of income on a real basis. However, the

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earnings adjusted according to the Inflationary Adjustments Law are not identical to the earnings reported according to the accounting standards. As a result, differences arise between the reported income in the financial statements and the adjusted income for tax purposes.

On February 26, 2008, the Israeli Income Tax Law (Inflationary Adjustments) (Amendment No. 20)(Restriction of Period of Application) 2008 ( the Amendment ) was passed by the Knesset. According to the Amendment, the Inflationary Adjustments Law will no longer be applicable subsequent to the 2007 tax year, except for the transitional provisions whose objectives are to prevent distortion of the income tax calculations.

In addition, according to the Amendment, commencing in the 2008 tax year, the adjustment of income for the effects of inflation for tax purposes will no longer be calculated. Additionally, depreciation on protected assets and tax loss carryforwards will no longer be linked to the CPI, subsequent to the 2007 tax year, and the balances that have been linked to the CPI through the end of the 2007 tax year, will be used going forward.

### **E. Tax loss carryforwards**

As of December 31, 2007, the Company's tax loss carryforwards were approximately \$14.3 million while its principal foreign subsidiary's tax loss carryforwards were \$0.9 million. The tax loss carryforwards in Israel are linked to the CPI in accordance with the Inflationary Adjustments Law.

The Company and its principal foreign subsidiary tax loss carryforwards do not have an expiration date.

### **F. Income tax assessments**

In Israel, the Company has received final tax assessments through the 1995 tax year.

The Company's principal foreign subsidiary has received final tax assessments through the 2005 tax year.

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

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Eltek Ltd. and its Subsidiaries

## **Notes to the Consolidated Financial Statements**

(All amounts in thousands of \$, except where otherwise stated)

### **Note 15 Taxes on Income (cont d)**

#### **G. Profit (loss) before income tax expense and minority interest included in the consolidated statements of operations**

|  | <b>Consolidated</b>                        |  |  |
|--|--|--|--|
|  | <b>Year ended<br/>December 31<br/>2007</b> | <b>Year ended<br/>December 31<br/>2006</b> | <b>Year ended<br/>December 31<br/>2005</b> |
| Profit (loss) before income tax expense<br>and minority share: |  |  |  |
| Israel   | (347)                                      | 1,870                                      | 1,708                                      |
| Foreign jurisdiction   | 50   | (122)                                      | (291)                                      |
|  |  |  |  |

|       | Consolidated |       |       |
|-------|--------------|-------|-------|
|       | 2007         | 2006  | 2005  |
| Total | (297)        | 1,748 | 1,417 |

#### H. Reconciliation of the theoretical income tax expense to the actual income tax expense

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

|  | Consolidated                      |                                   |                                   |
|--|-----------------------------------|-----------------------------------|-----------------------------------|
|  | Year ended<br>December 31<br>2007 | Year ended<br>December 31<br>2006 | Year ended<br>December 31<br>2005 |
| Income (loss) before income taxes as reported in the consolidated statements of operations | (297)                             | 1,748                             | 1,417                             |
| Statutory tax rates  | 29%                               | 31%                               | 34%                               |
| Theoretical tax expense (benefit) calculated   | (86)                              | 542                               | 482                               |
| Differences between the definition of capital and assets for tax purposes and other        | (556)                             | (732)                             | (492)                             |
| Change in valuation allowance  | 641                               | 366                               | 10                                |
| Foreign tax rate differential in subsidiaries  | 1                                 | (18)                              | -                                 |
| Total  | 86                                | (384)                             | (482)                             |
| Income tax expense   | -                                 | 158                               | -                                 |

The income tax expense recorded for the year ended December 31, 2006 is deferred tax expense attributable to the foreign subsidiary.

#### Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

#### Note 15 Taxes on Income (cont d)

##### I. Deferred tax assets and liabilities

Deferred taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and such amounts for income tax purposes. Significant components of the Company's deferred tax liabilities and assets

are as follows:

|  | Consolidated        |                     |
|--|---------------------|---------------------|
|  | December 31<br>2007 | December 31<br>2006 |
| Deferred tax assets:                       |                     |                     |
| Tax loss carryforwards (in Israel)         | 3,566               | 2,672               |
| Tax loss carryforwards (outside Israel)    | 227                 | 296                 |
| Severance benefits                         | 18                  | 10                  |
| Vacation pay                               | 259                 | 226                 |
| Allowance for doubtful accounts            | 153                 | 136                 |
|  | <u>          </u>   | <u>          </u>   |
| Total gross deferred tax assets            | 4,223               | 3,340               |
| Less valuation allowance                   | (3,578)             | (2,937)             |
|  | <u>          </u>   | <u>          </u>   |
| Net deferred tax assets                    | 645                 | 403                 |
|  | <u>          </u>   | <u>          </u>   |
| Deferred tax liabilities:                  |                     |                     |
| Fixed assets - differences in depreciation | (645)               | (403)               |
|  | <u>          </u>   | <u>          </u>   |
| Total gross deferred tax liabilities       | (645)               | (403)               |
|  | <u>          </u>   | <u>          </u>   |
| Net deferred tax assets                    | -                   | -                   |
|  | <u>          </u>   | <u>          </u>   |

The valuation allowance for deferred tax assets as of January 1, 2006 and 2005, was \$2,571 and \$2,561, respectively. The net change in the total valuation allowance for each of the years ended December 31, 2007, 2006 and 2005, was an increase of \$641, \$366 and \$10, respectively. The valuation allowance at 2007 and 2006 was primarily related to domestic and foreign net operating loss carryforwards that, in the judgment of management are not more likely than not to be realized. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Management considers the scheduled reversal of deferred tax liabilities, projected taxable income, and tax-planning strategies in making this assessment.

#### Notes to the Consolidated Financial Statements

(All amounts in thousands of \$, except where otherwise stated)

**Note 15 Taxes on Income (cont d)**

**J. Accounting for uncertainty in income taxes**

The Company and its subsidiaries adopted the provisions of FIN 48 on January 1, 2007, and there was no effect on the consolidated financial statements. As a result, the Company and its subsidiaries did not record any cumulative effect adjustment related to adopting FIN 48.

As of January 1, 2007, and for the 12-month period ended December 31, 2007, the Company and its subsidiaries did not have any unrecognized tax benefits and thus, no interest and penalties related to unrecognized tax benefits were recognized. In addition, the Company and its subsidiaries do not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

The Company files its income tax return in Israel while its principal foreign subsidiary files its income tax return in Germany. The Israeli tax returns of the Company are open to examination by the Israeli Tax Authorities for the tax years beginning in 2004 while the German tax returns of its principal foreign subsidiary remain subject to audit for the tax years beginning in 2006.

**Note 16 Financial Instruments and Risk Management**

The Company's financial instruments include cash and cash equivalents, accounts receivable, deposits, assets held for severance benefits, derivative instruments and accounts payable. Their carrying amounts approximate fair value. The fair value of the Company's derivative instruments is disclosed in Note 3.

The Company is exposed to credit, interest and currency risks in the ordinary course of business. The Company uses derivative instruments in order to reduce the exposure to currency risks.

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SIGNATURES

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

ELTEK LTD.

By: /s/ Arie Reichart

Arie Reichart  
President and Chief Executive Officer

By: /s/ Amnon Shemer

Amnon Shemer  
Chief Financial Officer

Dated: April 28, 2008

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