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א.ג.נ.,

הנדון : אלביט מערכות בע"מ ("החברה") – דוחות כספיים לשנת 2004

מצ"ב הדוחות הכספיים המבוקרים של החברה ודו"ח ההנהלה על תוצאות פעילות החברה לשנת 2004.

בכוונתנו להגיש דוחות אלה לרשות ניירות ערך בארה"ב.

בכבוד רב,

אילן פכולדר
מזכיר החברה

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES
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CONSOLIDATED FINANCIAL STATEMENTS
as of December 31, 2004
(In U.S. dollars)

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES
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CONSOLIDATED FINANCIAL STATEMENTS
as of December 31, 2004
In U.S. dollars

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**To the Shareholders of
Elbit Systems Ltd.**

Haifa, Israel

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have audited the accompanying consolidated balance sheets of Elbit Systems Ltd. (the "Company") and its subsidiaries as of December 31, 2004 and 2003 and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2004. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2004 and 2003 and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2004 in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2(X) to the consolidated financial statements, on January 1, 2004 the Company adopted SFAS No. 123 "Accounting for Stock-Based Compensation."

Kost Forer Gabbay & Kasierer
A member of Ernst & Young Global

Haifa, Israel
March 14, 2005



REPORT OF INDEPENDENT AUDITORS

To the Shareholders of Elbit Systems Ltd.

We have audited the accompanying consolidated statements of operations, changes in shareholders' equity and cash flows of Elbit Systems Ltd. And its subsidiaries for the year ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated results of the Company and its subsidiaries operations and their cash flows for the year ended December 31, 2002 in conformity with United States generally accepted accounting principles.

LUBOSHITZ KASIERER
AN AFFILIATE MEMBER OF ERNST & YOUNG INTERNATIONAL

Haifa, Israel
March 24, 2003

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U. S. dollars (In thousands)

	<u>Note</u>	<u>December 31,</u> <u>2004</u>	<u>2003</u>
CURRENT ASSETS:			
Cash and cash equivalents		\$ 34,109	\$ 76,156
Short-term bank deposits		738	690
Trade receivables, (net of allowance for doubtful accounts in the amount of \$3,064 and \$3,861 as of December 31, 2004 and 2003, respectively)	(3)	214,816	203,281
Other receivables and prepaid expenses	(4)	52,335	48,363
Inventories, net of advances	(5)	249,041	249,225
Total current assets		<u>551,039</u>	<u>577,715</u>
INVESTMENTS AND LONG-TERM RECEIVABLES:			
Investments in affiliated companies and a partnership	(6A)	33,124	26,478
Available for sale securities	(1G)	18,017	-
Investments in other companies	(6B)	11,745	11,745
Long-term bank deposits and trade receivables	(7)	2,102	2,347
Severance pay fund	(2P)	82,998	76,218
		<u>147,986</u>	<u>116,788</u>
PROPERTY, PLANT AND EQUIPMENT, NET	(8)	<u>244,288</u>	<u>229,221</u>
INTANGIBLE ASSETS:			
Goodwill	(9)	32,847	32,576
Other intangible assets, net		63,140	67,436
		<u>95,987</u>	<u>100,012</u>
		<u>\$ 1,039,300</u>	<u>\$1,023,736</u>

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U. S. dollars (In thousands, except share and per share data)

		December 31,	
	Note	2004	2003
CURRENT LIABILITIES:			
Short-term bank credit and loans	(10)	\$ 8,592	\$ 8,509
Current maturities of long-term loans	(13)	1,656	6,532
Trade payables		118,391	106,252
Other payables and accrued expenses	(11)	169,702	157,820
Customers advances and amounts in excess of costs incurred on contracts in progress	(12)	80,109	99,618
Total current liabilities		<u>378,450</u>	<u>378,731</u>
LONG-TERM LIABILITIES:			
Long-term loans	(13)	86,234	62,324
Advances from customers	(12)	10,320	7,592
Deferred income taxes	(15)	24,516	24,916
Accrued termination liability	(14,2P)	100,740	93,979
		<u>221,810</u>	<u>188,811</u>
COMMITMENTS AND CONTINGENT LIABILITIES	(16)		
MINORITY INTERESTS		<u>4,340</u>	<u>4,115</u>
SHAREHOLDERS' EQUITY:	(17)		
Share capital			
Ordinary shares of New Israeli Shekels (NIS) 1 par value;			
Authorized – 80,000,000 shares as of			
December 31, 2004 and 2003;			
Issued – 40,969,947 and 39,746,125 shares as			
of December 31, 2004 and 2003, respectively;			
Outstanding – 40,561,126 and 39,337,304 shares			
as of December 31, 2004 and 2003, respectively		11,548	11,273
Additional paid-in capital		274,432	259,033
Accumulated other comprehensive loss		(3,346)	(3,992)
Retained earnings		156,387	190,086
Treasury shares - 408,821 shares as of			
December 31, 2004 and 2003		(4,321)	(4,321)
		<u>434,700</u>	<u>452,079</u>
		<u>\$ 1,039,300</u>	<u>\$1,023,736</u>

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

U. S. dollars (In thousands, except share and per share data)

		Year ended December 31,		
	Note	2004	2003	2002
Revenues	(18)	\$ 939,925	\$ 897,980	\$ 827,456
Cost of revenues		689,626	672,711	605,313
Gross profit		250,299	225,269	222,143
Research and development costs, net	(19)	66,846	54,919	57,010
Marketing and selling expenses		69,912	69,943	65,691
General and administrative expenses		47,832	46,077	41,651
		184,590	170,939	164,352
Operating income		65,709	54,330	57,791
Financial expenses, net	(20)	(5,852)	(4,870)	(3,035)
Other income (expenses), net		770	53	(462)
Income before taxes on income		60,627	49,513	54,294
Taxes on income	(15)	15,219	11,334	9,348
		45,408	38,179	44,946
Equity in net earnings of affiliated companies and partnership		7,765	7,209	675
Minority interests in losses (earnings) of subsidiaries		(180)	557	(508)
Net income		\$ 52,993	\$ 45,945	\$ 45,113
Earnings per share	(17G)			
Basic net earnings per share		\$ 1.33	\$ 1.18	\$ 1.17
Diluted net earnings per share		\$ 1.29	\$ 1.14	\$ 1.13
Number of share used in computation of basic net earnings per share		39,952	39,061	38,489
Number of share used in computation of diluted net earnings per share		41,041	40,230	39,863

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U. S. dollars (In thousands, except share and per share data)

	Number of outstanding shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income (loss)	Retained earnings	Treasury shares	Total shareholders' equity	Total other comprehensive income
Balance as of January 1, 2002	38,330,272	\$ 11,054	\$ 244,625	\$ -	\$ 126,627	\$ (4,321)	\$ 377,985	
Exercise of options	473,235	100	4,040	-	-	-	4,140	
Tax benefit in respect of options exercised	-	-	648	-	-	-	648	
Stock based compensation	-	-	(926)	-	-	-	(926)	
Dividends paid	-	-	-	-	(12,717)	-	(12,717)	
Other comprehensive income (loss):								
Minimum pension liability	-	-	-	(2,882)	-	-	(2,882)	\$ (2,882)
Net income	-	-	-	-	45,113	-	45,113	45,113
Total comprehensive income								<u>\$ 42,231</u>
Balance as of December 31, 2002	38,803,507	\$ 11,154	\$ 248,387	\$ (2,882)	\$ 159,023	\$ (4,321)	\$ 411,361	
Exercise of options	533,797	119	5,147	-	-	-	5,266	
Tax benefit in respect of options exercised	-	-	758	-	-	-	758	
Stock based compensation	-	-	4,741	-	-	-	4,741	
Dividends paid	-	-	-	-	(14,882)	-	(14,882)	
Other comprehensive income (loss):								
Unrealized loss on derivative instruments	-	-	-	(578)	-	-	(578)	\$ (578)
Foreign currency translation differences	-	-	-	340	-	-	340	340
Minimum pension liability	-	-	-	(872)	-	-	(872)	(872)
Net income	-	-	-	-	45,945	-	45,945	45,945
Total comprehensive income								<u>\$ 44,835</u>
Balance as of December 31, 2003	<u>39,337,304</u>	<u>\$ 11,273</u>	<u>\$ 259,033</u>	<u>\$ (3,992)</u>	<u>\$ 190,086</u>	<u>\$ (4,321)</u>	<u>\$ 452,079</u>	

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (CONT.)

U. S. dollars (In thousands, except share and per share data)

	Number of outstanding shares	Share capital	Additional paid-in capital	Accumulated other comprehensive loss	Retained earnings	Treasury shares	Total shareholders' equity	Total other comprehensive income
Balance as of January 1, 2004	39,337,304	\$ 11,273	\$ 259,033	\$ (3,992)	\$ 190,086	\$ (4,321)	\$ 452,079	
Cumulative effect of first time adoption of the fair value based method for stock based compensation expense	-	-	(152)	-	-	-	(152)	
Exercise of options	1,223,822	275	10,985	-	-	-	11,260	
Tax benefit in respect of options exercised	-	-	1,179	-	-	-	1,179	
Stock based compensation	-	-	3,387	-	-	-	3,387	
Dividends paid	-	-	-	-	(86,692)	-	(86,692)	
Other comprehensive income (loss):								
Unrealized loss on derivative instruments	-	-	-	(299)	-	-	(299)	(299)
Foreign currency translation differences	-	-	-	450	-	-	450	450
Unrealized gains on available for sale securities, net	-	-	-	1,396	-	-	1,396	1,396
Minimum pension liability	-	-	-	(901)	-	-	(901)	(901)
Net income	-	-	-	-	52,993	-	52,993	52,993
Total comprehensive income								\$ 53,639
Balance as of December 31, 2004	<u>40,561,126</u>	<u>\$ 11,548</u>	<u>\$ 274,432</u>	<u>\$ (3,346)</u>	<u>\$ 156,387</u>	<u>\$ (4,321)</u>	<u>\$ 434,700</u>	

Accumulated other comprehensive loss (net of taxes)

	<u>December 31,</u>	
	<u>2004</u>	<u>2003</u>
Accumulated gains on derivative instruments	\$ (877)	\$ (578)
Accumulated foreign currency translation differences	790	340
Accumulated gains on available for sale securities	1,396	-
Accumulated minimum pension liability	(4,655)	(3,754)
Accumulated other comprehensive loss	<u>\$ (3,346)</u>	<u>\$ (3,992)</u>

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U. S. dollars (In thousands)

	Year ended December 31,		
	2004	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 52,993	\$ 45,945	\$ 45,113
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	42,261	37,890	32,937
Stock based compensation	3,387	4,741	(926)
Deferred income taxes, net	153	35	(5,620)
Accrued severance pay, net	(2,304)	(1,240)	6,260
Gain (loss) on sale of property, plant and equipment	143	(915)	743
Tax benefit in respect of options exercised	1,179	758	648
Minority interests in earnings (losses) of subsidiaries	180	(557)	508
Equity in net losses (earnings) of affiliated companies and partnership, net of dividend received (*)	385	(4,995)	(675)
Changes in operating assets and liabilities:			
Decrease (increase) in short and long-term trade receivables, other receivables and prepaid expenses	(16,871)	45,297	58,554
Decrease (increase) in inventories	2,932	(38,651)	(55,106)
Increase (decrease) in trade payables, other payables and accrued expenses	20,522	32,147	(19,321)
Increase (decrease) in advances received from customers	(18,535)	(27,855)	42,999
Settlement of royalties with the Office of the Chief Scientist	(3,714)	(1,581)	9,197
Other adjustments	(1,228)	337	683
Net cash provided by operating activities	81,483	91,356	115,994
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of property, plant and equipment	(53,008)	(61,287)	(46,003)
Investment grants received for property, plant and equipment	-	-	119
Acquisition of subsidiaries and businesses (Schedule A)	(2,315)	(2,458)	(5,280)
Investments in affiliated companies and subsidiaries	(2,522)	(1,049)	(1,681)
Proceeds from sale of property, plant and equipment	2,560	5,815	956
Grant of long-term loan	-	-	(714)
Collection of long-term loan	-	2,400	-
Collection of short-term loan	-	-	1,371
Investment in long-term bank deposits	(1,203)	(1,750)	(1,228)
Proceeds from sale of long-term bank deposits	1,507	3,568	1,689
Short-term bank deposits, net	(48)	960	(204)
Investment in available for sale securities	(15,869)	-	-
Net cash used in investing activities	(70,898)	(53,801)	(50,975)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from exercise of options	11,260	5,266	4,140
Repayment of long-term bank loans	(35,826)	(27,066)	(3,249)
Receipt of long-term bank loans	58,410	10,000	2,233
Dividends paid	(86,692)	(14,882)	(12,717)
Change in short-term bank credit and loans, net	216	(10,997)	(19,729)
Net cash used in financing activities	(52,632)	(37,679)	(29,322)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(42,047)	(124)	35,697
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	76,156	76,280	40,583
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	\$ 34,109	\$ 76,156	\$ 76,280
(*) Dividend received	\$ 8,150	\$ 2,214	\$ -

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT.)

U. S. dollars (In thousands)

	Year ended December 31,		
	2004	2003	2002
SUPPLEMENTAL CASH FLOW INFORMATION:			
Cash paid during the year for:			
Income taxes	\$ 13,305	\$ 14,666	\$ 21,730
Interest	\$ 3,122	\$ 4,034	\$ 2,947
SCHEDULE A:			
Subsidiaries and businesses acquired (*)			
Estimated net fair value of assets acquired and liabilities assumed at the date of acquisition was as follows:			
Working capital (surplus) deficiency (excluding cash and cash equivalents)	\$ (707)	\$ 657	\$ -
Property, plant and equipment	(10)	(249)	(275)
Goodwill and other intangible assets	(1,598)	(1,334)	(5,078)
Deferred income taxes	-	(1,765)	-
Long-term liabilities	-	198	-
Minority interest	-	35	-
	(2,315)	(2,458)	(5,353)
Less short-term debt incurred on acquisition	-	-	73
	\$ (2,315)	\$ (2,458)	\$ (5,280)

- (*) Defense Systems Division of Elron Telesoft in 2002 (see Note 1(C)).
 In 2003 a European subsidiary (see Note 1(D)) and AD&D (see Note 1(E)).
 In 2004 the assets of Computer Instruments Corporation Inc. (see Note 1(F))

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

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U. S. dollars (In thousands)

Note 1 - GENERAL

- A. Elbit Systems Ltd. (the "Company") is an Israeli corporation, 49% owned by the Federmann Group. On July 28, 2004, Elron Electronic Industries Ltd. completed the sale of all of its holdings in the Company, constituting approximately 19% of the Company's outstanding share capital, to Federmann Enterprises Ltd. The Company's shares are traded on the Tel Aviv Stock Exchange and on the Nasdaq National Market in the United States. The Company and its subsidiaries (the "Group") are engaged mainly in the field of defense electronics. The Company's principal wholly-owned subsidiaries are EFW Inc. ("EFW") and Elop Electro-Optics Industries, Ltd. ("El-Op").
- B. A majority of the Group's revenues are derived from direct or indirect sales to governments or to government agencies. As a result, a substantial portion of the Group's sales is subject to the special risks associated with sales to governments or to government agencies. These risks include, among others, the dependency on the resources allocated by governments to defense programs, changes in governmental priorities and changes in governmental approvals regarding export licenses required for the Group products and for its suppliers. As for major customers refer to Note 18(C).
- C. In January 2002, the Company acquired from Elron Telesoft Inc. and its subsidiaries ("Elron Telesoft") the assets and the business of the Defense Systems Division of Elron Telesoft ("the Government Division") in consideration for \$5,700 in cash. The excess of the purchase price over the fair value of net tangible assets acquired in the amount of approximately \$5,100 was allocated to technology and other intangible assets to be amortized over a weighted average period of 3 years.

The Government Division is engaged mainly in the development of communication systems, information technology and image intelligence processing for defense and military applications.

The results of the Government Division have been included in the consolidated financial statements from the first quarter of 2002.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of the Government Division were not material in relation to total consolidated revenues and net income for the year 2002.

- D. In June 2003, the Company (through El-Op) acquired all of the outstanding ordinary shares of a European subsidiary, a company registered in Belgium, in consideration for \$1,846 in cash. The acquisition was accounted for by the purchase method of accounting.

This subsidiary develops, manufactures and supports electro-optical products, mainly for the defense and space markets.

The results of this subsidiary's operations have been included in the consolidated financial statements from the date of acquisition.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 1 - GENERAL (Cont.)

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of this subsidiary. were not material in relation to total consolidated revenues and net income for the years 2002 and 2003.

- E. In July 2003, the Company acquired approximately 54% of the outstanding shares of Aero Design Development Ltd. ("AD&D") an Israeli company in consideration for \$1,406 in cash. The acquisition was accounted for by the purchase method of accounting.

AD&D develops, manufactures and builds airborne models and other engineered products.

The excess of the purchase price over the fair value of net tangible assets acquired in the amount of approximately \$1,334 was allocated to technology (\$1,000) to be amortized by the straight-line method over a period of 10 years and to technology goodwill (\$334).

The results of AD&D.'s operations have been included in the consolidated financial statements from the date of acquisition.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of AD&D were not material in relation to total consolidated revenues and net income for the years 2002 and 2003.

- F. In August 2004, the Company (through a subsidiary of EFW) acquired a business from Computer Instruments Corporation Inc. ("CIC") of Westbury, New York in consideration for approximately \$2,315 in cash. The acquired assets relate to the design and manufacture of aviation pressure transducers, air data probes and air data computers.

The following table summarizes the fair value of the assets acquired and liabilities assumed at the date of acquisition as estimated by the Company, with the support of an external appraisal:

Current Assets	\$ 994
Property and equipment	10
Technology	1,327
Goodwill	271
Total assets acquired	<u>2,602</u>
Current liabilities assumed	<u>(287)</u>
Net assets acquired	<u>\$ 2,315</u>

The technology acquired will be amortized by the straight-line method over a period of 5-7 years. The results of CIC's operations have been included in the consolidated financial statements from the date of acquisition.

Pro forma information in accordance with SFAS No. 141 has not been provided, since the revenues and net income of CIC were not material in relation to total consolidated revenues and net income for the years 2003 and 2004.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 1 - GENERAL (Cont.)

- G. On December 27, 2004, the Company reached an agreement with Koor Industries ("Koor") to purchase all of Koor's holdings in Tadiran Communications Ltd. ("Tadiran"), which represents approximately a 32% interest in Tadiran. This purchase will be made in parallel to Koor's purchase of approximately 9.8% of the Company's shares from Federmann Enterprises Ltd. ("Federmann") based on agreements reached between Federmann and Koor. The transaction will be executed in two stages as described below.

In the first stage, the Company will purchase from Koor approximately 13.8% of Tadiran's shares, and Koor will purchase from Federmann approximately 5.3% of the Company's shares. As of March 1, 2005, the Company held approximately 6% of Tadiran's shares acquired through purchases on the market, and therefore, following completion of the first stage the Company will own approximately 20% of Tadiran's shares. On completion of the first stage, Koor will support the Company's appointment of the greater of 3 members or 20% of Tadiran's board of directors, and Federmann will support Koor's appointment of a member to the Company's board of directors.

In the second stage, the Company will purchase the balance of Koor's holdings in Tadiran. Koor will purchase an additional approximately 4.5% of the Company's shares from Federmann, and Federmann will support Koor's appointment of an additional member to the Company's board of directors, including the board's Vice Chairman. The second stage is subject to Koor completing the sale to Tadiran of Koor's 70% holdings in Elisra Electronic Systems Ltd. ("Elisra") on agreed upon terms. Subject to those terms the Company agreed to support the purchase of the Elisra shares by Tadiran at Tadiran's general shareholders meeting. In the event that the sale of the Elisra shares to Tadiran is not made by April 2006, then Koor and the Company will have equal representation on Tadiran's board of directors, and an agreement regarding joint control of Tadiran will enter into effect between the Company and Koor.

The Company will purchase from Koor the 32% of the Tadiran shares at a price of \$37 per share, resulting in a total purchase price of approximately \$146,000. Koor will purchase from Federmann the 9.8% of the shares in the Company at a price of \$24.70 per share, resulting in a total purchase price of approximately \$99,000.

Under the Koor-Federmann shareholders agreement, which will become effective upon the completion of the first stage of the Koor-Federmann transaction, Koor will obtain certain tag along rights in the event of Federmann's sale of shares in the Company, and Koor will be subject to certain restrictions on the transfer of its shares in the Company. Also, Koor has agreed to vote at general shareholders meetings of the Company in accordance with Federmann's instructions, with certain exceptions, and Koor will receive certain additional non-transferable rights.

On January 5, 2005, the Company's Audit Committee and board of directors approved the agreements with Koor relating to the Company's purchase of Koor's shares in Tadiran.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 1 - GENERAL (Cont.)

On February 28, 2005, the Company's shareholders at an extraordinary general shareholders meeting approved the agreements with Koor relating to the Company's purchase of Koor's shares in Tadiran. As of March 1, 2005, the parties were in the process of obtaining the remaining approvals required for the transaction.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). As applicable to the consolidated financial statements of the Group, such principles are substantially identical to accounting principles generally accepted in Israel, except as described in Note 22.

A. USE OF ESTIMATES

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

B. FINANCIAL STATEMENTS IN U.S. DOLLARS

The Company's revenues are generated mainly in U.S. dollars. In addition, most of the Company's costs are incurred in U.S. dollars. The Company's management believes that the U.S. dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the U.S. dollar.

Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transaction and balances in other currencies have been remeasured into U.S. dollars in accordance with principles set forth in SFAS No. 52 "Foreign Currency Translation". All exchange gains and losses from the remeasurement mentioned above are reflected in the statement of income in financial income or expenses.

For those foreign subsidiaries whose functional currency has been determined to be other than the U.S. dollar, assets and liabilities are translated at year-end exchange rates and statement of income items are translated at average exchange rates prevailing during the year. Such translation adjustments are recorded as a separate component of accumulated other comprehensive income in shareholders' equity.

C. PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly and majority-owned subsidiaries.

The consolidated subsidiaries include El-Op, EFW and other Israeli and non-Israeli subsidiaries.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

C. PRINCIPLES OF CONSOLIDATION (CONT.)

Intercompany transactions and balances including profit from intercompany sales not yet realized outside the Group have been eliminated upon consolidation.

D. CASH EQUIVALENTS

Cash equivalents, are short-term highly liquid investments that are readily convertible to cash with maturities of three months or less at the date of acquisition.

E. SHORT-TERM BANK DEPOSITS

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The short-term bank deposits are presented at their cost.

F. MARKETABLE SECURITIES

Investments in a marketable securities are designed as available for sale according to Statement of Financial Accounting Standard No. 115 "Accounting for Certain Investments in Debt and Equity Securities", ("SFAS No. 115"). Accordingly, these securities are stated at fair value, with unrealized gains and losses, net of taxes, reported in accumulated other comprehensive income (loss), a separate component of the shareholders equity.

G. INVENTORIES

Inventories are stated at the lower of cost or net realizable value. Inventory write-offs are provided for slow-moving items or technological obsolescence for which recoverability is not probable.

Cost is determined as follows:

- Raw materials using the average cost method.
- Costs incurred on long-term contracts in progress include direct labor costs, material costs, subcontractors, other direct costs and overheads. These costs represent recoverable costs incurred for production, allocable operating overhead cost and, where appropriate, research and development costs (refer to Note 2(T)).
- Labor overhead is generally included in our hourly rate and is allocated to each project according to the amount of hours invested. Material overhead is allocated to each project based on the value of direct material that is charged to the project.

Advances from customers are allocated to the applicable contract inventories and are reflected as an offset against the related inventory balances.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

H. INVESTMENT IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES

Investments in non-marketable shares of companies in which the Group holds less than 20% and the Group does not have the ability to exercise significant influence over operating and financial policies of the companies are recorded at cost.

Investments in companies and partnership over which the Group can exercise significant influence (generally, entities in which the Group holds between 20% and 50% of voting rights) are presented using the equity method of accounting. Profits on intercompany sales, not realized outside the Group, were eliminated. The Group discontinues applying the equity method when its investment (including advances and loans) is reduced to zero and it has not guaranteed obligations of the affiliate or otherwise committed to provide further financial support to the affiliate.

The Group applies Emerging Issues Task Force ("EITF 99-10") "Percentage Used to Determine the Amount of Equity Method Losses", according to which the Group recognizes equity method losses based on the ownership level of the particular investee security or loan held by the Group to which the equity method losses are being applied.

A change in the Company's proportionate share of a subsidiary's or investee's equity, resulting from issuance of shares by the subsidiary or investee to third parties, is recorded as a gain or loss in the consolidated income statements. If the realization is not assured, such as when the issuing company is a development stage company, the gain from issuance is accounted for as an equity transaction pursuant to SAB 51 "Accounting Sales of Stock by a Subsidiary".

Management evaluates investments in affiliates and other companies for evidence of other than temporary declines in value. When relevant factors indicate a decline in value that is other than temporary, the Company records a provision for the decline in value. A judgmental aspect of accounting for investments involves determining whether an other-than-temporary decline in value of the investment has been sustained. Such evaluation is dependent on the specific facts and circumstances. Accordingly, management evaluates financial information (e.g. budgets, business plans, financial statements, etc.) in determining whether an other-than-temporary decline in value exists. Factors indicative of an other-than-temporary decline include recurring operating losses, credit defaults and subsequent rounds of financings at an amount below the cost basis of the investment. This list is not all inclusive and management weighs all quantitative and qualitative factors in determining if an other-than-temporary decline in value of an investment has occurred.

I. LONG-TERM TRADE RECEIVABLES

Long-term trade receivables from extended payment agreements are recorded at their estimated present values (determined based on the original rates of interest).

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

J. LONG-TERM BANK DEPOSITS

Long-term bank deposits are deposits with maturities of more than one year. These deposits are presented at cost including accumulated interest.

K. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost, net of accumulated depreciation and investment grants. For equipment produced for the Group's own use, cost includes materials, labor and overhead, but not in excess of the fair value of the equipment.

Depreciation is calculated by the straight-line method over the estimated useful life of the assets at the following annual rates:

	%	
Buildings	2-4	(mainly 4%)
Instruments, machinery and equipment	10-33	
Office furniture and other	6-33	
Motor vehicles	15-20	(mainly 15%)

Land rights and leasehold improvements - over the term of the lease.

L. INVESTMENT GRANTS

As a governmental incentive for industrial companies in Israel, the "Investment Center", which is a branch of the Israel Ministry of Industry and Trade, permits industrial companies to submit a request to qualify as an "Approved Enterprise". An Approved Enterprise is entitled to certain benefits in respect of capital investments. The benefits may be in the form of reduced tax rates and of capital grants received as a percentage of the investments of the Approved Enterprise. The amount of a capital grant is determined as a percentage of the Approved Enterprise investment in property, plant and equipment. As a condition to the granting of these benefits, the Approved Enterprise is obligated to perform the applicable industrial plan as detailed in the request to the Investment Center (see Note 15(A)(3) and 16(J)). These capital grants are non-royalty bearing and are not conditioned on the results of operations. As the capital grants are a direct participation in the cost of the acquisition, of property, plant and equipment they are offset against property, plant and equipment and amortized over the period of the related investments.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

M. IMPAIRMENT OF LONG-LIVED ASSETS

The Group's long-lived assets and identifiable intangible assets are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" 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 an asset to the future undiscounted cash flows expected to be generated by the asset. If an asset is determined to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. As of December 31, 2004, no impairment losses have been identified.

N. INTANGIBLE ASSETS

Intangible assets are stated at cost net of accumulated amortization. Intangible assets are being amortized over their useful life using the straight-line method.

O. GOODWILL

Goodwill represents the excess of the cost of acquired businesses over the net fair values of the assets acquired and liabilities assumed. Goodwill that arose from acquisitions prior to July 1, 2001, was amortized until December 31, 2001 on a straight-line basis over 10 - 20 years. Under SFAS No. 142, effective as of January 1, 2002, goodwill is no longer amortized, but is instead tested for impairment at least annually (or more frequently if impairments indicators arise).

SFAS 142 prescribes a two phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures impairment.

In the first phase of impairment testing, goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. If the carrying value of the reporting unit exceeds its fair value, the second phase is then performed. The second phase of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess.

Fair value of a reporting unit is determined using discounted cash flows. Significant estimates used in the methodology include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital for each of the reporting units.

As of December 31, 2004, no impairment losses have been identified.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

P. SEVERANCE PAY

Under Israeli law and employment agreements, the Group's companies in Israel are required to make severance payments and, in certain situations, pay pensions to terminated employees. The calculation is based on the employee's latest salary and the period of his/her employment. The companies' obligation for severance pay and pension is provided by monthly deposits with insurance companies, pension funds and by an accrual.

The value of severance pay funds is presented in the balance sheet and includes profits accumulated to balance sheet date. The amounts deposited may be withdrawn only after fulfillment of the obligations pursuant to Israeli severance pay law or labor agreements. The values of the deposited funds are based on the cash surrendered value of these funds and include immaterial profits.

Severance pay expenses for the years ended December 31, 2004, 2003 and 2002, amounted to approximately \$15,574, \$11,491 and \$10,138, respectively.

Q. REVENUE RECOGNITION

The Group generates revenues from long-term contracts involving the design, development, manufacture and integration of defense systems and products and providing support and services for such systems and products.

Revenues from long-term contracts are recognized based on Statement of Position 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" ("SOP 81-1") according to which revenues are recognized on the percentage of completion basis.

Sales under long-term fixed-price contracts which provide for a substantial level of development efforts in relation to total contract efforts are recorded using the cost-to-cost method of accounting as the basis to measure progress toward completing the contract and recognizing revenues. According to this method, sales and profits are recorded based on the ratio of costs incurred to estimated total costs at completion. In certain circumstances, when measuring progress toward completion, the Company considers other factors, such as achievement of performance milestones.

Sales and anticipated profit under long-term fixed-price production type contracts are recorded on a percentage of completion basis, using the units-of-delivery as the basis to measure progress toward completing the contract and recognizing revenues.

Sales and anticipated profit under long-term fixed-price contracts that involve both development and production are recorded on a percentage of completion basis, using the cost-to-cost method and units-of-delivery method as applicable. In certain circumstances, when measuring progress toward completion under the development portion of the contract, the Company considers other factors, such as achievement of performance milestones.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Q. REVENUE RECOGNITION (CONT.)

Estimated contract profit is included in earnings in proportion to recorded sales.

The percentage-of-completion method of accounting requires management to estimate the cost and gross profit margin for each individual contract. Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original estimated forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis. Anticipated losses on contracts are charged to earnings when determined to be probable.

Sales under cost-reimbursement-type contracts are recorded as costs are incurred. Applicable estimated profits are included in earnings in the proportion that incurred costs bear to total estimated costs.

Amounts representing contract change orders, claims or other items are included in sales only when they can be reliably estimated and realization is probable. Penalties and awards applicable to performance on contracts are considered in estimating sales and profit rates and are recorded when there is sufficient information to assess anticipated contract performance.

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

In cases where the contract involves the delivery of products and performance of services, the Group follows the guidelines specified in EITF 00-21, "Revenue Arrangements with Multiple Deliverables" in order to allocate the contract fees between the products accounted for under SOP 81-1 and the services accounted for under SAB 104. The services are recognized throughout the service period.

In certain circumstances, sales under short-term fixed-price production type contracts are accounted for in accordance with SAB No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"), and recognized when the following criteria are met: persuasive evidence of an arrangement exists, delivery has occurred, the seller's price to the buyer is fixed or determinable, no further obligation exists and collectability is reasonably assured.

As for research and development costs accounted for as contract costs refer to Note 2(T) .

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

R. PRE-CONTRACT COSTS

Pre-contract costs are deferred and included in inventory, only when such costs can be directly associated with a specific anticipated contract and if their recoverability from the specific contract is probable according to the guidelines of SOP 81-1.

S. WARRANTY

The Group estimates the costs that may be incurred under its basic warranty and records a liability in the amount of such costs at the time revenue is recognized. The specific terms and conditions of those warranties vary depending upon the product sold and the country in which the Group does business. Factors that affect the Group's warranty liability include the number of delivered products, engineering estimates and anticipated rates of warranty claims. The Group periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary.

Changes in the Group's provision for warranty during the year are as follows:

	<u>2004</u>	<u>2003</u>
Balance, at January 1	\$ 9,692	\$ 8,541
Warranties issued during the year	4,737	4,491
Warranties forfeited or exercised during the year	<u>(4,952)</u>	<u>(3,340)</u>
Balance, at December 31	<u>\$ 9,477</u>	<u>\$ 9,692</u>

T. RESEARCH AND DEVELOPMENT COSTS

Research and development costs, net of participations, are charged to operations as incurred. Group sponsored research and development costs primarily include independent research and development and bid and proposal efforts.

Under certain arrangements in which a customer participates in product development costs, the Group's portion of such unreimbursed costs is expensed as incurred. Customer-sponsored research and development costs incurred pursuant to contracts are accounted for as part of the contract costs.

Certain Group companies in Israel receive grants (mainly royalty-bearing) from the Government of Israel and from other sources for the purpose of funding approved research and development projects. These grants are recognized as a deduction from research and development costs at the time the applicable company is entitled to such grants on the basis of the research and development costs incurred.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

U. INCOME TAXES

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

V. CONCENTRATION OF CREDIT RISKS

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

The majority of the Group's cash and cash equivalents and deposits are invested in dollar instruments with major banks in Israel and in the U.S. Management believes that the financial institutions that hold the Group investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments.

The Group's trade receivables are derived primarily from sales to large and stable customers and governments located mainly in Israel, the United States and Europe. The Group performs ongoing credit evaluations of its customers and to date, has not experienced any unexpected material losses except for a one time loss in 2002 of approximately \$4,600 due to the insolvency of one of the Group's customers. An allowance for doubtful accounts is determined with respect to those amounts that the Group has determined to be doubtful of collection.

W. DERIVATIVE FINANCIAL INSTRUMENTS

Financial Accounting Standards Board Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), requires companies to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e. gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

W. DERIVATIVE FINANCIAL INSTRUMENTS (CONT.)

For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain and loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the same line item associated with the hedged item in current earnings during the period of the change in fair values. For derivative instruments that are designated and qualify as a cash flow hedge (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings.

The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized as a financial expense in current earnings during the period of change.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized as a financial expense in current earnings during the period of change.

As part of its hedging strategy, the Group enters into forward exchange contracts in order to protect the Group from the risk that the eventual dollar cash flows from the sale of products to international customers will be adversely affected by changes in the exchange rates.

As part of its cash flow hedging strategy the Group enters into forward exchange contracts to hedge forecasted salary expenses denominated in a currency other than the U.S. dollar.

As of December 31, 2004, the Group had forward contracts with a notional amount of approximately \$30,900 to purchase and sell foreign currencies (\$20,800 in Euro, \$5,400 in Great Britain Pounds ("GBP") and \$4,800 in other currencies). The Group also had options to hedge future cash flow denominated in GBP in the amount of \$154,000. The forward contracts and the options mature in 2005.

The fair value of the foreign exchange contracts and the options as of December 31, 2004 is minimal.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

X. STOCK-BASED COMPENSATION

Up until January 1, 2004, the Company elected to follow Accounting Principles Board Opinion No. 25 ("APB 25") "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44 ("FIN 44") "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. Under APB 25, the Company accounted for stock option grants using the intrinsic value method whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price at the grant date of the award or if applicable at a subsequent measurement date. The Company recognized the expense over the vesting period of the award on a straight-line basis. Phantom options were accounted for as variable awards and accordingly, compensation expenses were measured at the end of each reporting period and amortized on an accelerated basis over the remaining vesting period. (See Note 17).

Effective January 1, 2004, the Company adopted the fair value recognition provisions of SFAS No. 123. Under the modified prospective method of adoption selected by the Company under the provisions of SFAS No. 148, the recognition provisions are applied to all employee awards granted, modified, or settled after January 1, 2004, and to previously granted awards that were not fully vested on the date of adoption. Compensation cost is recorded over the vesting period on a straight-line basis.

The cumulative effect on the deferred taxes relating to stock based compensation resulting from the adoption of SFAS No. 123 amounted to a reduction of \$152 and was recorded as a one time adjustment to additional paid-in capital.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands, except share and per share data)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

X. STOCK-BASED COMPENSATION (CONT.)

If the Company had elected to adopt the fair value recognition provisions of SFAS No. 123 as of its original effective date, pro forma net income and pro forma basic diluted net income per share for the years ended December 31, 2002 and 2003 would be as follows:

	Year ended December 31,		
	2004	2003	2002
Net income as reported	\$ 52,993	\$ 45,945	\$ 45,113
Add - Stock based compensation expense (income), net of related tax effects as reported (intrinsic method in 2003 and 2002)	2,710	3,793	(741)
Deduct - Stock based compensation expense under fair value based method of SFAS 123 net of related of tax effects	(2,710)	(2,956)	(2,956)
Pro forma net income	<u>\$ 52,993</u>	<u>\$ 46,782</u>	<u>\$ 41,416</u>
Net earnings per share:			
Basic net earnings per share as reported	<u>\$ 1.33</u>	<u>\$ 1.18</u>	<u>\$ 1.17</u>
Diluted net earnings per share as reported	<u>\$ 1.29</u>	<u>\$ 1.14</u>	<u>\$ 1.13</u>
Pro forma basic net earnings per share	<u>\$ 1.33</u>	<u>\$ 1.20</u>	<u>\$ 1.08</u>
Pro forma diluted net earnings per share	<u>\$ 1.29</u>	<u>\$ 1.16</u>	<u>\$ 1.04</u>

The fair value for these options was estimated using a Black-Scholes option pricing model with the following weighted average assumptions:

	2004	2003	2002
Divided yield	2.20%	2.19%	1.99%
Expected volatility	26.7%	19.03%	21.9%
Risk-free interest rate	4%	1.20%	1.34%
Expected life	4 years	6 years	6 years

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Y. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount reported in the balance sheet for cash and cash equivalents, short-term bank deposits, trade receivables, short-term bank credit and loans and trade payables approximate their fair values due to the short-term maturities of such instruments.

The carrying amount of the available for sale marketable securities is recorded according to its fair market value, as determined by quoted market prices on stock exchange.

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

The fair value of foreign currency contracts (used for hedging purposes) is estimated by obtaining current quotes from investment bankers.

It was not practicable to estimate the fair value of the Group's investments in shares of non-public companies that are accounted for under the cost and equity method because of the lack of a quoted market price and the inability to obtain valuation of each company without incurring excessive costs. The carrying amounts of these companies as of December 31, 2003 and 2004 were \$38,223 and \$44,869, respectively, and represent the original cost of acquisition, and in the case of affiliates also the Company's equity in the earnings/losses of the affiliates and its share in the changes of the affiliates' equity since the dates of acquisition.

Z. BASIC AND DILUTED NET EARNINGS PER SHARE

Basic net earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted net earnings per share is computed based on the weighted average number of ordinary shares outstanding during each year, plus dilutive potential ordinary shares considered outstanding during the year. Outstanding stock options are excluded from the calculation of the diluted net earnings per ordinary share when such securities are anti-dilutive. In all the years presented no stock options were excluded.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

AA. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

- (1). In February 2004, the FASB issued EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). This EITF was issued to determine the meaning of other-than-temporary impairment and its application to investments in debt and equity securities within the scope of SFAS 115. EITF 03-1 also applies to investments in equity securities that are both outside SFAS 115's scope and are not accounted for by the equity method, which are defined as "cost method investments". The impairment measurement and recognition guidance prescribed in EITF 03-1 is delayed until the final issuance of FSP EITF 03-01-a. The disclosure requirements for investments accounted for under SFAS 115 are effective for annual reporting periods ending after June 15, 2003 and for costs method investments for annual reporting periods ending after June 15, 2004. The Company does not expect that the adoption of the provisions of EITF 03-1 will have a material effect on its financial position or results of operations.
- (2). In November 2004, the FASB issued Statement of Financial Accounting Standard No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4." ("SFAS 151"). SFAS 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of SFAS 151 will have a material effect on its financial position or results of operations.
- (3). On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004) ("123(R)", "Share-Based Payment", which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation". Statement 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", and amends FASB Statement No. 95, "Statement of Cash Flows". Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. Statement 123(R) must be adopted no later than July 1, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt Statement 123(R) on July 1, 2005. Since, as noted in Note 2(AA) below, the Company adopted, effective January 1, 2004, the fair-value-based method of accounting for share-based payments, the adoption of Statement 123(R) is not expected to have a material impact on the Company's results of operation or its financial position.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

AA. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS (CONT.)

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

- A “modified prospective” method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of Statement 123(R) for all awards granted to employees prior to the effective date of Statement 123(R) that remains unvested on the effective date.
- A “modified retrospective” method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt Statement No. 123(R) using the modified prospective method.

The Company adopted the fair-value-based method of accounting for share-based payments effective January 1, 2004 using the “modified prospective method” described in FASB Statement No. 148, “Accounting for Stock-Based Compensation – Transition and Disclosure”. Currently, the Company uses the Black-Scholes-Merton formula to estimate the value of stock options granted to employees and expects to continue to use this acceptable option valuation model upon the required adoption of Statement 123(R) on July 1, 2005. The Company does not anticipate that adoption of Statement 123(R) will have a material impact on its results of operations or its financial position. However, Statement 123(R) also requires that the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior periods for such excess tax deductions was \$1,179, \$758, and \$648 in 2004, 2003 and 2002, respectively.

AB. RECLASSIFICATIONS

Certain financial statement data for prior years has been reclassified to conform to current year financial statement presentation.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 3 - TRADE RECEIVABLES, NET

Trade receivables

	December 31,	
	2004	2003
Open accounts (*)	\$ 181,995	\$ 170,287
Unbilled receivables	35,885	36,855
Less - allowance for doubtful accounts	(3,064)	(3,861)
	<u>\$ 214,816</u>	<u>\$ 203,281</u>
(*) Includes affiliated companies	<u>\$ 10,823</u>	<u>\$ 6,668</u>

Note 4 - OTHER RECEIVABLES AND PREPAID EXPENSES

	December 31,	
	2004	2003
Deferred income taxes	\$ 20,603	\$ 21,908
Prepaid expenses	17,914	14,310
Government institutions	5,719	5,826
Employees	1,204	513
Others	6,895	5,806
	<u>\$ 52,335</u>	<u>\$ 48,363</u>

Note 5 - INVENTORIES, NET OF ADVANCES

	December 31,	
	2004	2003
Cost incurred on long-term contracts in progress	\$ 254,009	\$ 254,910
Raw materials	71,813	78,504
Advances to suppliers and subcontractors	21,164	20,137
	<u>346,986</u>	<u>353,551</u>
Less -		
Cost incurred on contracts in progress deducted from customer advances	14,533	14,581
	<u>332,453</u>	<u>338,970</u>
Less -		
Advances received from customers (*)	75,776	77,482
Provision for losses	7,636	12,263
	<u>\$ 249,041</u>	<u>\$ 249,225</u>

The Company has transferred legal title of inventories to certain customers as collateral for advances received.

(*) Advances are allocated to the relevant inventories on a per-project basis. In cases (projects) where the advances are in excess of the inventories, the net amount is presented as a liability. In cases where the inventories are in excess of advances received, the net amount is presented as an asset.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 6 - INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES

A. Investments in companies accounted for under the equity method:

	December 31,	
	2004	2003
SCD (1)	\$ 19,186	\$ 17,347
VSI (2)	6,966	6,149
RedC (5)	3,100	-
Opgal (3)	2,873	2,390
Others (4)	999	592
	<u>\$ 33,124</u>	<u>\$ 26,478</u>

- (1) Semi Conductor Devices ("SCD") is an Israeli partnership, held 50% by the Company and 50% by Rafael Armaments Development Authority Ltd. ("Rafael"). SCD is engaged in the development and production of various thermal detectors and laser diodes. SCD is jointly controlled and therefore is not consolidated in the Company's financial statements.
- (2) Vision Systems International LLC ("VSI") based in San Jose, is a California limited liability company that is held 50% by EFW and 50% by a subsidiary of Rockwell Collins Inc. VSI operates in the area of helmet mounted display systems for fixed wing military and paramilitary aircraft. VSI is jointly controlled and therefore is not consolidated in the Company's financial statements.
- (3) Opgal Optronics Industries Ltd. ("Opgal") is an Israeli company owned 50.1% by the Company and 49.9% by a subsidiary of Rafael. Opgal focuses mainly on commercial applications of thermal imaging and electro-optic technologies. The Company jointly controls Opgal with Rafael, and therefore Opgal is not consolidated in the Company's financial statements.
- (4) Mediguide Inc. ("Mediguide") and its Israeli subsidiary, Mediguide Ltd., were established in 2000 as a spin-off from the Company. The share capital of Mediguide consists of Common shares and Preferred A, B, C and D shares. The Common shares and the Preferred shares, both have voting rights. The Company holds all of the Common shares of Mediguide which constitute approximately 55% (43% on a fully diluted basis) of the voting rights of Mediguide. During 2001 - 2004, Mediguide issued Preferred shares to other investors in consideration for approximately \$34,355. The Preferred shares issued entitle the other investors to preference rights senior to all other classes of shares previously issued by Mediguide in a liquidation or a deemed liquidation event. Therefore, the Company did not record any gain as a result of the above transaction. In addition, the Preferred shares entitle their holders to certain participating rights. Accordingly, based on the guidance in EITF 96-16, the Company does not consolidate Mediguide. The carrying value of the investment in Mediguide is zero.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 6 - INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES (CONT.)

A. Investments in companies accounted for under the equity method (cont.)

- (5) RedC Optical Networks Inc. ("RedC"), a company registered in Delaware, is engaged in the multi-focal optic communications sector and as of December 31, 2003 was held 36.5% by El-Op. RedC designs develops and manufactures optical amplifiers for dense wave-length multiplexing optical networks for telecommunications. In the year ended December 31, 2002, the Company recorded a provision for loss on its investment in RedC of \$2,500. This provision has been presented in the Consolidated Statements of Income under "Equity in net earnings of affiliated companies and partnership".

In November 2004, El-Op acquired all of the outstanding voting Preferred A shares of RedC from MRV Communications Inc. for a consideration of \$2,000, in accordance with El-Op's right of first refusal based on the Preferred A shares investment agreement. Prior to the acquisition, El-Op held 57% of the Ordinary shares of RedC which reflected 36.5% of its voting rights. Following the acquisition, El-Op held 57% of the Ordinary shares and 100% of the Preferred A shares, which reflected 72.5% of RedC's voting rights.

In December 2004, El-Op signed a Transfer Agreement for selling all of its holdings in RedC, including the Ordinary shares and Preferred A shares, in consideration for \$3,100, which was paid in cash on the closing date in January 2005. The closing was subject to certain conditions, which were all met by January 21, 2005.

El-Op allocated the purchase price to the fair value of the assets acquired and liabilities assumed.

Such allocation resulted in negative goodwill amounting to approximately to \$1,100. Since RedC had no assets which could be reduced by the negative goodwill, according to the provisions of FAS 141, this goodwill was recorded as other income in the financial statements.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 6 - INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES (CONT.)

A. Investments in companies accounted for under the equity method (cont.)

- (6) The summarized aggregate financial information of companies accounted for under the equity method is as follows:

Balance Sheet Information:

	December 31,	
	2004	2003
Current assets	\$ 124,352	\$ 105,457
Non-current assets	21,646	15,799
Total assets	<u>145,998</u>	<u>121,256</u>
Current liabilities	68,655	59,076
Non-current liabilities	3,868	4,584
Shareholders' equity	73,475	57,596
	<u>\$ 145,998</u>	<u>\$ 121,256</u>

Income Statement Information:

	Year ended December 31,		
	2004	2003	2002
Revenues	\$ 213,680	\$ 183,426	\$ 138,493
Gross profit	55,285	45,616	36,278
Net income	15,195	13,976	6,904

- (7) See Note 16(F) for guarantees.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 6 - INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES (CONT.)

B. Investments in companies accounted for under the cost method

	December 31,	
	2004	2003
Sultam (1)	\$ 3,500	\$ 3,500
ISI (2)	7,230	7,230
AAI (3)	1,000	1,000
Others	15	15
	<u>\$ 11,745</u>	<u>\$ 11,745</u>

- (1) Sultam Systems Ltd. ("Sultam"), held 10%, is an Israeli company engaged in the development and manufacturing of military systems in the artillery sector.
- (2) ImageSat International N.V. ("ISI"), held 14% (10% on a fully diluted basis), is engaged in the operation of satellite photography formations and commercial delivery of satellite photography for civil purposes.
- (3) AeroAstro Inc. ("AAI") - In January 2003, the Company purchased 8.33% (on a fully diluted basis) of the common stock of AAI, a Delaware corporation in consideration for \$1,000. AAI is engaged in innovative micro and nanospacecraft applications. AAI manufactures low-cost satellite systems and components, used in its own spacecraft and for spacecraft development in and outside the U.S.

Note 7 - LONG-TERM BANK DEPOSITS AND TRADE RECEIVABLES

	December 31,	
	2004	2003
Deposits with banks for loans granted to employees (*)	\$ 1,603	\$ 1,901
Long-term trade receivables	452	393
Other deposits with banks	47	53
	<u>\$ 2,102</u>	<u>\$ 2,347</u>

- (*) The deposits are linked to the Israeli CPI, bear annual interest of 4% and are presented net of current maturities of \$534 (2003 - \$633).

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 8 - PROPERTY, PLANT AND EQUIPMENT, NET

	December 31,	
	2004	2003
Cost (1):		
Land, buildings and leasehold improvements (2)	\$ 151,285	\$ 140,812
Instruments, machinery and equipment (3)	222,153	196,229
Office furniture and other	26,828	25,254
Motor vehicles	37,308	29,776
	437,574	392,071
Accumulated depreciation	(193,286)	(162,850)
Depreciated cost	<u>\$ 244,288</u>	<u>\$ 229,221</u>

Depreciation expenses for the years ended December 31, 2004, 2003 and 2002 amounted to \$35,001, \$30,775 and \$26,525, respectively.

- (1) Net of investment grants received (mainly for instruments, machinery and equipment) in the amounts of approximately \$29,800 as of both December 31, 2004 and 2003.
- (2) Includes, rights in approximately 9,225 square meters of land in Tirat Hacarmel, Israel. The land is leased from the Israel Land Administration until the years 2014 to 2024 with a renewal option for additional periods of up to 49 years. The Company's rights in the land have not yet been registered in its name.

Includes, rights in approximately 10,633 square meters of land in Rehovot, Israel. The land is leased from the Israel Land Administration until the year of 2043 with a renewal option for additional periods of up to 49 years. The Company's rights in the land have not yet been registered in its name.

- (3) Includes equipment produced by the Group for its own use in the aggregate amount of \$69,146 and \$59,318 as of December 31, 2004 and 2003, respectively.
- (4) As for pledges of assets – see Note 16(I).

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 9 - INTANGIBLE ASSETS, NET

A.

	Weighted average number of years of amortization	December 31,	
		2004	2003
Original cost:			
Technology (1)	15	\$ 85,413	\$ 82,449
Trade marks (2)	17	8,000	8,000
Goodwill (3)		37,884	37,613
		<u>131,297</u>	<u>128,062</u>
Accumulated amortization:			
Technology		28,365	21,555
Trade marks		1,908	1,458
Goodwill		5,037	5,037
		<u>35,310</u>	<u>28,050</u>
Amortized cost		<u>\$ 95,987</u>	<u>\$ 100,012</u>

- (1) The technology acquired consists of four major items as follows:

In 2000, the Company completed a merger with El-Op. A portion of the purchase price was allocated to technology (\$45,000), based on an independent appraisal. The technology acquired in the merger with El-Op comprises various technologies relating to:

- Diode pumped and other advanced solid-state lasers incorporating add-on eye-safety options.
- Detectors for thermal imaging devices, including 2-D arrays for second and third generation forward looking infrared sensors.
- Line of sight command, control and stabilization systems employing computerized digital controllers.
- Sophisticated image and signal processing, utilizing the modern equipment and software.
- High precision mechanical and optical component design and manufacturing for the visible, ultraviolet and infrared-spectra, including special and exotic materials, diffractive and planar optics, space borne lightweight optics and multi-layer coatings.
- Aviation instruments such as precision altimeters and air speedometer.

In 2000, EFW acquired from Honeywell Inc., Honeywell's business relating to head-up displays and tracking systems for pilot helmets. An amount of \$9,300 was allocated to the acquired technology based on its estimated fair value as prepared by the Company.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 9 - INTANGIBLE ASSETS, NET (CONT.)

In 2001 and 2002, the Company acquired a Brazilian company which serves as a center for the production and logistic support of defense electronics programs in Brazil. An amount of \$5,500 was allocated to technology related to the maintenance and support of avionic equipment.

In 2002, the Company acquired the business of the Defense Systems Division of Elron Telesoft as detailed in Note 1(C) above in consideration for \$5,700. An amount of \$5,100 was allocated to the technology related to the government information technology control systems software developed by Elron Telesoft.

- (2) Includes trade marks acquired in the merger with El-Op in 2000.
- (3) Includes mainly goodwill resulting from the merger with El-Op (\$34,200) in 2000 and goodwill acquired from Honeywell Inc. (\$1,800) in 2000. Until January 1, 2002, goodwill was amortized at an annual rate of 5% - 10%. The change in goodwill results from an acquisition of the business of CIC (See Note 1(F) above).
- B. Amortization expenses amounted to \$7,260, \$7,222 and \$6,412 for the years ended December 31, 2004, 2003 and 2002, respectively.
- C. The annual amortization expense relating to intangible assets existing as of December 31, 2004 is estimated to be approximately as follows:

2005	\$ 6,900
2006	5,600
2007	5,400
2008	5,200
2009	4,900
Thereafter	35,140
Total	<u>\$ 63,140</u>

Note 10 - SHORT-TERM BANK CREDIT AND LOANS

	December 31,			
	2004	2003	2004	2003
Short-term bank loans:	Interest Rate			
In U.S. dollars	4.2-4.6%	3.3-4.75%	\$ 3,967	\$ 533
In Euro	-	3.5%	-	1,927
			<u>3,967</u>	<u>2,460</u>
Short-term bank credit:				
In NIS unlinked	5.7-8.1%	7.2%	2,120	4,684
In U.S. dollars	4.4%	2.6%	2,505	1,365
			<u>4,625</u>	<u>6,049</u>
			<u>\$ 8,592</u>	<u>\$ 8,509</u>
Weighted Average Interest Rate	4.7%	5.4%		

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 11 - OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2004	2003
Payroll and related expenses	\$ 42,491	\$ 33,382
Provision for vacation pay	26,936	25,280
Government institutions (*)	31,619	25,243
Provision for warranty	9,477	9,692
Cost provisions and others (**)	59,179	64,223
	<u>\$ 169,702</u>	<u>\$ 157,820</u>

(*) Includes a provision for income taxes net of advances paid and provision for royalties to the Office of the Chief Scientist of Israel (See Note 16(A)).

(**) Includes provisions for estimated future costs in respect of basic design and system operating difficulties, arising subsequent to delivery and acceptance by the customer. The calculation of the provision is based on past experience. In addition, these amounts include unbilled services of services provided.

Note 12 - CUSTOMERS ADVANCES AND AMOUNTS IN EXCESS OF COSTS INCURRED ON CONTRACTS IN PROGRESS

	December 31,	
	2004	2003
Advances received	\$ 180,738	\$ 199,273
Less -		
Advances presented under long-term liabilities	10,320	7,592
Advances deducted from inventories	75,776	77,482
	<u>94,642</u>	<u>114,199</u>
Less -		
Costs incurred on contracts in progress	14,533	14,581
	<u>\$ 80,109</u>	<u>\$ 99,618</u>

As for guarantees and liens see Note 16(F).

Note 13 - LONG-TERM LOANS

	Currency	Interest %	Years of maturity	December 31,	
				2004	2003
Banks	U.S. dollars	Libor +	mainly		
		0.75%-1.25%	2-3	\$ 83,469	\$ 57,574
Banks	NIS-unlinked	Israeli Prime	-	-	3,599
Office of Chief Scientist	NIS-linked to the Israeli-CPI	4.4%	3	4,131	7,683
Other				290	-
				<u>87,890</u>	<u>68,856</u>
Less-current maturities				<u>1,656</u>	<u>6,532</u>
				<u>\$ 86,234</u>	<u>\$ 62,324</u>

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 13 - LONG-TERM LOANS (CONT.)

The Libor rate as of December 31, 2004 was 2.56%.

The maturities of these loans after December 31, 2004 are as follows:

2005 – current maturities	\$ 1,656
2006	40,527
2007	42,550
2008	165
2009	170
2010 and thereafter	2,822
	<u>\$ 87,890</u>

See Note 16(G) for covenants.

Note 14 - BENEFIT PLANS

EFW, the Company's subsidiary in the U.S., has adopted for its employees in the U.S. benefits plans as follows:

Defined Benefit Retirement Plan

EFW has two defined benefit pension plans (the "Plans") substantially covering its employees in the U.S. Monthly benefits are based on years of benefit service and annual compensation. Annual contributions to the Plans are determined using the unit credit actuarial cost method and are equal to or exceed the minimum required by law. Pension fund assets of the Plans are invested primarily in stock, bonds and cash by a financial institution, as the investment manager of the Plans' assets.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 14 - BENEFIT PLANS (Cont.)

The following table reconciles the benefit obligations, Plans assets, funded status and net asset (liability) information of the Plans:

	December 31,	
	2004	2003
Benefit obligation at beginning of year	\$ 34,965	\$ 28,439
Service cost	3,000	2,480
Interest cost	2,191	1,921
Actuarial losses	2,307	2,825
Unrecognized transition obligation	1,056	-
Benefits repaid	(822)	(700)
Benefit obligation at end of year	<u>42,697</u>	<u>34,965</u>
Plans assets at beginning of year	21,196	15,558
Actual return on Plan assets	1,756	2,689
Contributions by employer	2,971	3,649
Benefits repaid	(822)	(700)
Plans assets at end of year	<u>25,101</u>	<u>21,196</u>
Funded status of Plans (underfunded)	(17,595)	(13,769)
Unrecognized prior service cost	(180)	(195)
Unrecognized transition obligation	1,056	-
Unrecognized net actuarial loss	11,447	9,395
Net amount recognized	<u>\$ (5,272)</u>	<u>\$ (4,569)</u>
Net asset (liability) consists of:		
Accrued benefit liability	\$ (13,899)	\$ (11,011)
Intangible asset	895	51
Accumulated other comprehensive income	7,732	6,391
Net amount recognized	<u>\$ (5,272)</u>	<u>\$ (4,569)</u>
Weighted average assumptions:		
Discount rate as of December 31,	6.00%	6.25%
Expected long-term rate of return on Plan's assets	8.50%	9.00%
Rate of compensation increase	3.00%	3.00%

	Year ended December 31,		
	2004	2003	2002
Components of net periodic pension cost:			
Service cost	\$ 3,000	\$ 2,480	\$ 2,067
Interest cost	2,191	1,921	1,678
Expected return on Plans' assets	(1,951)	(1,573)	(1,597)
Amortization of prior service cost	(15)	(15)	28
Recognized net actuarial loss	451	339	-
Net periodic pension cost	<u>\$ 3,676</u>	<u>\$ 3,152</u>	<u>\$ 2,176</u>

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 14 - BENEFIT PLANS (Cont.)

Defined Contribution Plan

The 401(k) savings plan ("401(k) plan") is a defined contribution retirement plan that covers all eligible employees, as defined in section 401(k) of the U.S. Internal Revenue Code. EFW's employees may elect to contribute a percentage of their annual gross compensation to the 401(k) plan. EFW may make discretionary matching contributions as determined by the subsidiary. Total expense under the 401(k) plan amounted to \$1,744 for the year ended December 31, 2004 (2003 - \$1,629, 2002 - \$1,369).

Note 15 - TAXES ON INCOME

A. APPLICABLE TAX LAWS

(1) Measurement of taxable income under Israel's Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes for the Company and certain of its Israeli subsidiaries are measured and reflected in accordance with the change in the Israeli Consumer Price Index ("CPI"). As explained above in Note 2(B), the consolidated financial statements are presented in U.S. dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate cause a difference between taxable income and the income before taxes reflected in the consolidated financial statements.

In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on the above differences resulting from changes in exchange rates and indexing for tax purposes.

(2) Tax benefits under Israel's Law for the Encouragement of Industry (Taxes), 1969:

The Company and certain subsidiaries in Israel (mainly El-Op and Cyclone Aviation Products Ltd.) are "Industrial Companies", as defined by the Law for the Encouragement of Industry (Taxes), 1969, and as such, these companies are entitled to certain tax benefits, mainly amortization of costs relating to know-how and patents over eight years, accelerated depreciation and the right to deduct public issuance expenses for tax purposes.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 15 - TAXES ON INCOME (CONT.)

(3) Tax benefits under Israel's Law for the Encouragement of Capital Investments, 1969:

Several expansion programs of the Company and certain of its Israeli subsidiaries ("the companies") have been granted "Approved Enterprise" status under Israel's Law for the Encouragement of Capital Investments, 1959. For some expansion programs, the companies have elected the grants track and for others they have elected the alternative tax benefits track, waiving grants in return for tax exemptions.

Accordingly, certain income of the companies, derived from the "Approved Enterprise" expansion programs is tax exempt for two-year to ten-year period and subject to reduced tax rates of 25% for a five-year to eight-year period commencing in the year in which the companies had taxable income (limited to twelve years from commencement of production or fourteen years from the date of approval, whichever is earlier). As of December 31, 2004, the tax benefits for these exiting expansion programs will expire within the period of 2005 to 2012.

The entitlement to the above benefits is subject to the companies fulfilling the conditions specified in the above referred law, regulations published hereunder and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the companies may be required to refund the amount of the benefits, in whole or in part, including interest. (For liens – see Note 16(J)). As of December 31, 2004, Management believes that the companies are meeting all conditions of the approvals.

As of December 31, 2004, retained earnings included approximately \$116,500 in tax-exempt profits earned by the companies' "Approved Enterprises". If the retained tax-exempt income is distributed, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected the alternative tax benefits track (currently - 25%) and an income tax liability would be incurred of approximately \$29,100 as of December 31, 2004.

The companies' boards of directors have decided that their policy is not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the companies' "Approved Enterprises".

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 15 - TAXES ON INCOME

(3) Tax benefits under Israel's Law for the Encouragement of Capital Investments, 1969 (Cont.):

In Israel, income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 35%.

Since the companies are operating under more than one approval, and since part of their taxable income is not entitled to tax benefits under the above mentioned law and is taxed at the regular tax rate of 35%, the effective tax rate is the result of a weighted combination of the various applicable rates and tax exemptions, and the computation is made for income derived from each approval on the basis of formulas specified in the law and in the approvals.

B. NON – ISRAELI SUBSIDIARIES

Non-Israeli subsidiaries are taxed based on tax laws in their countries of residence (mainly in the U.S.).

C. INCOME BEFORE TAXES ON INCOME

	Year ended December 31,		
	2004	2003	2002
Income before taxes on income:			
Domestic	\$ 43,642	\$ 38,423	\$ 42,317
Foreign	16,985	11,090	11,977
	<u>\$ 60,627</u>	<u>\$ 49,513</u>	<u>\$ 54,294</u>

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 15 - INCOME TAXES (CONT.)

D. TAXES ON INCOME

	Year ended December 31,		
	2004	2003	2002
Taxes on income:			
Current taxes:			
Domestic	\$ 6,661	\$ 12,346	\$ 11,654
Foreign	7,651	718	6,114
	<u>14,312</u>	<u>\$ 13,064</u>	<u>\$ 17,768</u>
Deferred income taxes:			
Domestic	1,463	(4,672)	(3,561)
Foreign	(556)	2,942	(2,059)
	<u>907</u>	<u>(1,730)</u>	<u>(5,620)</u>
Taxes in respect of prior years	-	-	(2,800) (*)
	<u>\$ 15,219</u>	<u>\$ 11,334</u>	<u>\$ 9,348</u>

(*) A reduction of tax expenses due to adjustments of estimated tax provision pursuant to the completion of prior years' tax assessments in respect of various Group companies with the tax authorities.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 15 - INCOME TAXES (CONT.)

E. DEFERRED INCOME TAXES

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of net deferred tax assets and liabilities are as follows:

	Total	Deferred Tax asset (liability)(1)	
		Current	Non-current
As of December 31, 2004			
Deferred tax assets:			
Reserves and allowances	\$ 12,797	\$ 13,191	\$ (394)
Inventory	5,376	5,376	-
Net operating loss carryforwards	5,395	149	5,246
	<u>23,568</u>	<u>18,716</u>	<u>4,852</u>
Valuation allowance	(3,445)	-	(3,445)
Net deferred tax assets	<u>20,123</u>	<u>18,716</u>	<u>1,407</u>
Deferred tax liabilities:			
Property, plant and equipment	(12,999)	-	(12,999)
Intangible assets	(10,285)	2,639	(12,924)
Available for sale securities	(752)	(752)	-
	<u>(24,036)</u>	<u>1,887</u>	<u>(25,923)</u>
Net deferred tax assets (liabilities)	<u>\$ (3,913)</u>	<u>\$ 20,603</u>	<u>\$ (24,516)</u>
As of December 31, 2003			
Deferred tax assets:			
Reserves and allowances	\$ 11,149	\$ 11,187	\$ (38)
Inventory	7,952	7,952	-
Net operating loss carryforwards	6,606	439	6,167
	<u>25,707</u>	<u>19,578</u>	<u>6,129</u>
Valuation allowance	(3,879)	-	(3,879)
Net deferred tax assets	<u>21,828</u>	<u>19,578</u>	<u>2,250</u>
Deferred tax liabilities:			
Property, plant and equipment	(12,769)	-	(12,769)
Intangible assets	(12,067)	2,330	(14,397)
	<u>(24,836)</u>	<u>2,330</u>	<u>(27,166)</u>
Net deferred tax assets (liabilities)	<u>\$ (3,008)</u>	<u>\$ 21,908</u>	<u>\$ (24,916)</u>

(1) The current tax asset is included in other receivables. Noncurrent tax liability is included as a long-term liability.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 15 - INCOME TAXES (CONT.)

- F. As of December 31, 2004, The Group's Israeli subsidiaries have estimated total available carryforward tax losses of approximately \$16,700, and the Group's non-Israeli subsidiaries have estimated available carryforward tax losses of approximately \$7,300. These losses can be offset against future taxable profits for an indefinite period. Deferred tax assets in respect of the above carryforward losses amount to approximately \$5,400 in respect of which a valuation allowance has been recorded in the amount of approximately \$3,400.
- G. Reconciliation of the theoretical tax expense, assuming all income is taxed at the statutory rate applicable to income of the Group, and the actual tax expense as reported in the statements of operations, is as follows:

	Year ended December 31,		
	2004	2003	2002
Income before taxes as reported in the consolidated statements of operations	\$ 60,627	\$ 49,513	\$ 54,294
Statutory tax rate	35%	36%	36%
Theoretical tax expense	\$ 21,219	\$ 17,825	\$ 19,546
Tax benefit arising from reduced rate as an "Approved Enterprise" and other tax benefits	(7,196)	(8,391)	(9,054)
Tax adjustment in respect of different tax rates for foreign subsidiaries	496	279	(461)
Operating carryforward losses for which valuation allowance was provided	(434)	126	2,189
Increase (decrease) in taxes resulting from nondeductible expenses	1,095	993	(263)
Difference in basis of measurement for financial reporting and tax return purposes	(210)	846	458
Taxes in respect of prior years	-	-	(2,800)
Other differences, net	248	(344)	(267)
Actual tax expenses	\$ 15,219	\$ 11,334	\$ 9,348
Effective tax rate	25.1%	22.9%	17.2%

H. AMENDMENT TO THE INCOME TAX ORDINANCE

On September 29, 2004, the Israeli Parliament approved the Amendment to the Income Tax Ordinance (No. 140 and Temporary Provision) (the "Amendment") which reduces the corporate tax rate from 36% to 35% in 2004 and to a rate of 30% in 2007 progressively. The Amendment was signed and published in July 2004 and is therefore considered enacted in July 2004. The adoption of the Amendment did not have a significant effect on the Company's financial statements.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 16 - COMMITMENTS AND CONTINGENT LIABILITIES

A. ROYALTY COMMITMENTS

1. The Company and certain Israeli subsidiaries partially finance their research and development expenditures under programs sponsored by the OCS for the support of research and development activities conducted in Israel. At the time the participations were received, successful development of the related projects was not assured.

In exchange for participation in the programs by the OCS, the Company and the subsidiaries agreed to pay 2% - 5% of total sales of products developed within the framework of these programs. The royalties will be paid up to a maximum amount equaling 100% to 150% of the grants provided by the OCS, linked to the dollar and for grants received after January 1, 1999, also bearing annual interest at a rate based on LIBOR. The obligation to pay these royalties is contingent on actual sales of the products, and in the absence of such sales payment of royalties is not required.

In some cases, the Government of Israel participation (through the OCS) is subject to export sales or other conditions. The maximum amount of royalties is increased in the event of production outside of Israel.

The Company and certain of its subsidiaries may also be obligated to pay certain amounts to the Israeli Ministry of Defense and others on certain sales including sales resulting from the development of certain technologies.

Royalties expensed amounted to \$5,802, \$7,812 and \$14,471 in 2004, 2003 and 2002, respectively.

2. In September 2001, the OCS issued "Regulations for the Encouragement of Research and Development in Industry" (rules for determining the level and payment of royalties) (the "regulations"). The regulations allow large R&D intensive companies to reach certain agreements with the OCS regarding determination of the amount and payment schedule of royalties, subject to certain conditions.

If the Company elects to adopt the regulations, it will have to record a significant one-time expense resulting from accruing a liability for an absolute amount of royalties.

In May 2002, El-Op's Board of Directors approved an arrangement, proposed by the OCS, according to which El-Op pays commencing in 2002, an agreed amount of \$10,632 in exchange for a release from all obligations to pay royalties in the future. As a result, El-Op recorded an expense for the agreed amount net of the accrual for royalties previously recorded by El-Op in the amount of \$9,801. This expense is included cost of revenues.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 16 - COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

B. COMMITMENTS IN RESPECT OF LONG-TERM PROJECTS

In connection with long-term projects in certain countries, the Company and certain subsidiaries undertook to use their respective best efforts to make or facilitate purchases or investments in those countries at certain percentages of the amount of the projects. The companies' obligation to make or facilitate third parties making such investments and purchases is subject to commercial conditions in the local market, typically without a specific financial penalty. The maximum aggregate undertaking as of December 31, 2004 amounted to \$673,000 to be performed over a period of up to 11 years. This amount is typically tied to a percentage (up to 100%) of the amount of a specific contract.

In the opinion of the Company's Management, the actual amount of the investments and purchases is anticipated to be less than that mentioned above, since certain investments and purchases can result in reducing the overall undertaking on more than a one-to-one basis.

C. LEGAL CLAIMS

The Company and its subsidiaries are involved in legal claims arising in the ordinary course of business, including claims by employees, consultants and others. Company's Management, based on the opinion of its legal counsel, believes that the financial impact for the settlement of such claims in excess of the accruals recorded in the financial statements will not have a material adverse effect on the financial position or results of operations of the Group.

D. LEASE COMMITMENTS

The future minimum lease commitments of the Group under various non-cancelable operating lease agreements in respect of premises, motor vehicles and office equipment are as of December 31, 2004 as follows:

2005	\$ 6,655
2006	5,939
2007	4,547
2008	3,022
2009 and thereafter	13,060
	<u>\$ 33,223</u>

Rent expenses for the years ended December 31, 2004, 2003 and 2002 amounted to \$6,842, \$9,177, and \$9,215, respectively.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 16 - COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

E. PUT OPTION

Three founding employees (the "Founders"), who collectively hold approximately 32.3% of the outstanding shares of Kinetics Ltd. ("Kinetics"), a 51%-owned Israeli subsidiary, have a put option to jointly sell all of their shares in Kinetics to the Company. Two private investors holding in the aggregate approximately 16.7% of Kinetics' outstanding shares have "tag along" rights in the event the Founders exercise the put option.

The put option is exercisable from January 1, 2005 until December 31, 2005 at a price equal to the higher of the Founder's pro-rata share (corresponding to the Founder's shareholding percentage) of:

- (1) The value of Kinetics as of the option exercise date as determined by a third party appraiser mutually acceptable to the Founders and to the Company. The appraiser will value Kinetics as if Kinetics had distributed as dividends net profits accumulated up to the option exercise date; or
- (2) \$12,077, reduced by 3% per annum, or pro-rata part thereof, for the period beginning on July 1, 2003 and ending on the option exercise date.

As of December 31, 2004, the fair value of the aforementioned option was immaterial.

F. GUARANTEES

1. Guarantees in the amount of approximately \$380,000 were issued by banks on behalf of Group companies in order to secure certain advances from customers and performance bonds.
2. The Company has provided, on a proportional basis to its ownership interest, guarantees for two of its investees in respect of credit lines granted to them from banks amounting to \$12,000 (2003- \$13,900), of which \$11,500 (2003 - \$13,400) relates to a 50%-owned foreign investee. The guarantees will exist as long as the credit lines are in effect. The Company would be liable under the guarantee for any debt for which the investee would be in default under the terms of the credit line.

G. COVENANTS

In connection with bank credits and loans, including performance guarantees issued by banks and bank guarantees in order to secure certain advances from customers, the Company and certain subsidiaries are obligated to meet certain financial covenants. Such covenants include requirements for shareholders' equity, current ratio, operating profit margin, tangible net worth, EBITDA, interest coverage ratio and total leverage. As of December 31, 2004 the Company and its subsidiaries were in full compliance with all covenants.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 16 - COMMITMENTS AND CONTINGENT LIABILITIES (CONT.)

H. CONTRACTUAL OBLIGATIONS

Substantially all of the purchase commitments relate to obligations under purchase orders and subcontracts entered into by the Company. These purchase orders and subcontracts are typically in a standard format proposed by the Company, with the subcontracts and purchase orders also reflecting provisions from the Company's applicable prime contract that are appropriate to flow down to subcontractors and vendors. The terms typically included in these purchase orders and subcontracts are consistent with Uniform Commercial Code provisions in the United States for sales of goods, as well as with specific terms called for by its customers in international contracts. These terms include the Company's right to terminate the purchase order or subcontract in the event of the vendors' or subcontractors' default, as well as the Company's right to terminate the order or subcontract for the Company's convenience (or if the Company's prime contractor has so terminated the prime contract). Such purchase orders and subcontracts typically are not subject to variable price provisions. As of December 31, 2004 and 2003 the purchase commitments were \$345,000 and \$348,400 respectively.

- I. In order to secure bank loans and bank guarantees in the amount of \$10,019 as of December 31, 2004, certain Group companies recorded fixed charges on most of their machinery and equipment, mortgages on most of their real estate and floating charges on most of their assets.
- J. A lien on the Group's Approved Enterprises has been registered in favor of the State of Israel. Grants received in respect of projects which have not yet been approved amount to approximately \$220 (see Note 15 (A) (3) above).

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands, except share and per share data)

Note 17 - SHAREHOLDER'S EQUITY

A. SHARE CAPITAL

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

B. 2000 EMPLOYEE STOCK OPTION PLAN

In 2000, the Company adopted an employee stock option plan for employees comprising options to purchase up to 2,500,000 ordinary shares. The exercise price approximates the market price of the shares at the grant date. The plan includes an additional 2,500,000 options to be issued as "phantom" share options that grant the option holders a number of shares reflecting the benefit component of the options exercised, as calculated at the exercise date, in consideration for their par value only. Options vest over a period of one to four years from the date of grant and expire no later than six years from the date of grant.

Any options which are canceled or forfeited before expiration become available for future grants. As of December 31, 2004, 453,794 options of the Company were still available for future grants.

C. "PHANTOM" SHARE OPTIONS

Until January 1, 2004, the Company applied the provision of APB No. 25, under which the phantom share options were considered to be part a variable awards as defined in APB No. 25, and accordingly the compensation cost of the options was measured at the end of each reporting period and amortized by the accelerated method over the remaining vesting period. Starting January 1, 2004, the Company accounts for its stock based compensation awards under the fair value based method.

D. A summary of the Company's share option activity under the plans is as follows:

	2004		2003		2002	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding - beginning of the year	3,735,602	\$ 12.30	4,511,724	\$ 12.26	5,107,634	\$ 11.93
Granted	130,500	15.67	13,000	14.91	27,000	14.92
Exercised	(1,666,774)	12.12	(757,947)	12.13	(558,901)	9.45
Forfeited	(69,071)	12.10	(31,175)	12.29	(64,009)	11.33
Outstanding - end of the year	<u>2,130,257</u>	<u>\$ 12.60</u>	<u>3,735,602</u>	<u>\$ 12.30</u>	<u>4,511,724</u>	<u>\$ 12.26</u>
Options exercisable at the end of the year	<u>1,950,903</u>	<u>\$ 12.36</u>	<u>2,547,196</u>	<u>\$ 12.23</u>	<u>2,287,790</u>	<u>\$ 12.18</u>

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands, except share and per share data)

Note 17 - SHAREHOLDER'S EQUITY (CONT.)

- E. The options outstanding as of December 31, 2004, have been separated into ranges of exercise prices, as follows:

Exercise price	Options outstanding			Options exercisable	
	Number outstanding as of December 31, 2004	Weighted average remaining contractual life (years)	Weighted average exercise price per share	Number outstanding as of December 31, 2004	Weighted average exercise price per share
\$10.61-\$12.16	1,500	0.82	\$ 12.16	1,500	\$ 12.16
\$12.18-\$18.99	1,050,427	2.17	12.60	960,750	12.36
\$12.18-\$18.99(*)	1,078,330	2.23	12.59	988,563	12.35
	<u>2,130,257</u>	<u>2.20</u>	<u>\$ 12.60</u>	<u>1,950,903</u>	<u>\$ 12.36</u>

(*) Phantom share options.

Compensation expense (income) amounted to \$3,387, \$4,741 and \$(926) were recognized during the years ended December 31, 2004, 2003 and 2002, respectively. All the compensation expenses (income) in the years 2002 and 2003 were related to the Phantom share options under the stock option plan. The expenses in 2004 were recorded based on SFAS No. 123 and SFAS No. 148 according to the modified prospective method. The expenses (income) were recorded as follows:

	Year ended December 31,		
	2004	2003	2002
Cost of revenues	\$ 1,863	\$ 2,608	\$ (509)
R&D and marketing expenses	677	948	(185)
General and administration expenses	847	1,185	(232)
	<u>\$ 3,387</u>	<u>\$ 4,741</u>	<u>\$ (926)</u>

- F. The weighted average exercise price and fair value of options granted during the years ended December 31, 2004, 2003 and 2002 were:

	Less than market price		
	Year ended December 31,		
	2004	2003	2002
Weighted average exercise price	\$ 15.67	\$ 14.91	\$ 14.92
Weighted average fair values on grant date	\$ 6.62	\$ 4.63	\$ 4.31

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands, except share and per share data)

Note 17 - SHAREHOLDER'S EQUITY (CONT.)

G. Computation of basic and diluted net earnings per share:

	Year ended December 31, 2004			Year ended December 31, 2003			Year ended December 31, 2002		
	Net income to shareholders of Ordinary shares	Weighted averaged number of shares (*)	Per share amount	Net income to shareholders of ordinary shares	Weighted averaged number of shares (*)	Per share amount	Net income to shareholders of ordinary shares	Weighted averaged number of shares (*)	Per share amount
Basic net earnings	\$ 52,993	39,952	\$1.33	\$ 45,945	39,061	\$1.18	\$ 45,113	38,489	\$ 1.17
Effect of dilutive securities:									
Employee stock options	-	1,089		-	1,169		-	1,374	
Diluted net earnings	<u>\$ 52,993</u>	<u>41,041</u>	<u>\$1.29</u>	<u>\$ 45,945</u>	<u>40,230</u>	<u>\$1.14</u>	<u>\$ 45,113</u>	<u>39,863</u>	<u>\$1.13</u>

* In thousands

H. TREASURY SHARES

The Company's shares held by the Company and its subsidiaries are presented at cost and deducted from shareholder's equity.

I. DIVIDEND POLICY

Dividends declared by the Company are paid subject to statutory limitations. The Company's board of directors has determined not to declare dividends out of tax exempt earnings.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 18 - MAJOR CUSTOMER AND GEOGRAPHIC INFORMATION

The Group applies Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information", ("SFAS No. 131"). The Group operates in one reportable segment (see Note 1 for a brief description of the Group's business).

- A. Revenues are attributed to geographic areas based on location of the end customers as follows:

	Year ended December 31,		
	2004	2003	2002
Europe	\$ 124,130	\$ 109,409	\$ 144,862
U.S.	348,509	332,323	267,686
Israel	241,601	255,742	225,674
Others	225,685	200,506	189,234
	<u>\$ 939,925</u>	<u>\$ 897,980</u>	<u>\$ 827,456</u>

- B. Revenues are generated by the following product lines:

	Year ended December 31,		
	2004	2003	2002
Airborne systems	\$ 367,927	\$ 373,580	\$ 372,756
Land vehicles systems	199,224	199,800	135,700
Command, control, communications, computers, intelligence, surveillance and reconnaissance systems (C ⁴ ISR)	108,925	133,900	122,700
Electro-optical systems	200,322	140,500	148,200
Others	63,527	50,200	48,100
	<u>\$ 939,925</u>	<u>\$ 897,980</u>	<u>\$ 827,456</u>

- C. Revenues from single customers, which exceed 10% of total revenues in the reported years:

	Year ended December 31,		
	2004	2003	2002
IMOD	17%	21%	20%
U.S. Government	10%	*	*

*Less than 10%

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 18 - MAJOR CUSTOMER AND GEOGRAPHIC INFORMATION (CONT.)

D. Long-lived assets by geographic areas:

	Year ended December 31,		
	2004	2003	2002
Israel	\$ 237,887	\$ 229,396	\$ 211,256
U.S.	84,701	81,261	83,814
Others	17,687	18,576	13,660
	<u>\$ 340,275</u>	<u>\$ 329,233</u>	<u>\$ 308,730</u>

Note 19 - RESEARCH AND DEVELOPMENT COSTS, NET

	Year ended December 31,		
	2004	2003	2002
Total expenses	\$ 86,368	\$ 65,487	\$ 62,560
Less – participations	(19,522)	(10,568)	(5,550)
	<u>\$ 66,846</u>	<u>\$ 54,919</u>	<u>\$ 57,010</u>

Note 20 - FINANCIAL EXPENSES, NET

	Year ended December 31,		
	2004	2003	2002
Expenses:			
On long-term bank debt	\$ (1,544)	\$ (2,215)	\$ (2,765)
On short-term bank credit and loans	(2,309)	(2,182)	(2,435)
Others	(3,181)	(3,905)	(1,899)
	<u>\$ (7,034)</u>	<u>(8,302)</u>	<u>(7,099)</u>
Income:			
Interest on cash, cash equivalents and bank deposits	628	309	1,547
Others	1,115	4,397	1,063
	<u>1,743</u>	<u>4,706</u>	<u>2,610</u>
Gain (loss) from exchange rate differences	(561)	(1,274)	1,454
	<u>\$ (5,852)</u>	<u>\$ (4,870)</u>	<u>\$ (3,035)</u>

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 21 - RELATED PARTIES TRANSACTIONS AND BALANCES

	Year ended December 31,		
	2004	2003	2002
Income -			
Sales to affiliated companies (*)	\$ 56,346	\$ 34,674	\$ 37,924
Participation in expenses	\$ 2,594	\$ 1,773	\$ 902
Cost and expenses -			
Supplies and services from affiliated companies (**)	\$ 16,338	\$ 21,606	\$ 10,457
Participation in expenses	\$ 627	\$ 1,751	\$ 1,498
Financial expenses	\$ 3	\$ 23	\$ 110
	December 31,		
	2004	2003	
Trade receivables and other receivables (*)	\$ 13,214	\$ 6,668	
Trade payables (**)	\$ 5,445	\$ 4,975	

(*) The significant sales include sales of helmet mounted cueing systems purchased from the Company by VSI.

(**) Includes electro-optics components and sensors purchased by the Company from SCD and electro-optics products purchased by the Company from Opgal.

Note 22 - RECONCILIATION TO ISRAELI GAAP

As described in Note 1, the Company prepares its financial statements in accordance with U.S. GAAP. The effects of the differences between U.S. GAAP and generally accepted accounting principles in Israel ("Israeli GAAP") on the Company's financial statements are detailed below.

A building purchased from Elbit Ltd.

According to Israeli GAAP, the Company charged to additional paid-in capital reserves the excess of the amount paid over net book value of a building acquired from Elbit Ltd in 1999. According to U.S. GAAP, the entire amount paid is considered as the cost of the building acquired.

Proportional consolidation method

According to Israeli GAAP, a jointly controlled company should be included according to the proportional consolidation method. According to U.S. GAAP, the investment in such a company is recorded according to the equity method.

ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

Note 22 - RECONCILIATION TO ISRAELI GAAP (cont.)

Tax benefit in respect of options exercised

According to Israeli GAAP, tax benefits from employee options exercised are recorded as a reduction of tax expense. According to U.S. GAAP, the difference between the above mentioned tax benefits and the benefits recorded in respect of compensation expense in the financial statements are credited to additional paid-in capital.

Goodwill

Effective January 1, 2002, the Company adopted SFAS 142, "Goodwill and Other Intangible Assets" according to which goodwill and intangible assets with indefinite lives are no longer amortized periodically but are reviewed annually for impairment (or more frequently if impairment indicators arise). According to Israeli GAAP, all intangibles, including goodwill should be amortized.

Investment in marketable securities – Tadiran

Pursuant to SFAS 115, marketable securities which are available-for-sale are presented on the basis of their market value and changes in such value are charged (or credited) to other comprehensive income. According to Israeli GAAP non-current investments in marketable securities are presented at cost

1. Effect on net income and earnings per share

	Year ended December 31,		
	2004	2003	2002
Net income as reported according to U.S. GAAP	\$ 52,993	\$ 45,945	\$ 45,113
Adjustments to Israeli GAAP	(458)	595	(4,227)
Net income according to Israeli GAAP	<u>\$ 52,535</u>	<u>\$ 46,540</u>	<u>\$ 40,886</u>

2. Effect on shareholders' equity

	As reported	Adjustments	As per Israeli GAAP
As of December 31, 2004			
Shareholders' equity	<u>\$ 434,700</u>	<u>\$ (13,124)</u>	<u>\$ 421,576</u>
As of December 31, 2003			
Shareholders' equity	<u>\$ 432,079</u>	<u>\$ (10,367)</u>	<u>\$ 421,712</u>

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Elbit Systems Ltd.
Management's Report
For the Year Ended December 31, 2004

This report should be read together with the audited consolidated financial statements and related notes of Elbit Systems Ltd. ("Elbit Systems" and together with its subsidiaries, the "Company" or the "Group"), for the year ended December 31, 2004 and the Company's Form 20-F for the year ended December 31, 2003, filed by the Company with the U.S. Securities and Exchange Commission ("SEC") and with the Israeli Securities Authority.

Forward looking statements with respect to the Company's business, financial condition and results of operations in this document are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward looking statements, including, but not limited to, product demand, pricing, market acceptance, changing economic conditions, risks in product and technology development, the effect of the Company's accounting policies as well as certain other risk factors which are detailed from time to time in the Company's SEC filings.

A. Executive Overview

Business Description

Elbit Systems operates in the area of upgrading existing airborne, ground and naval defense platforms and is engaged in projects involving the design, development, manufacture and integration of advanced integrated defense systems, electronic systems, electro-optic systems and products and software intensive programs and products for the defense and homeland security sectors. In addition, the Company provides support services for such platforms, systems and products.

The Company is engaged in leading projects in Israel and worldwide, in areas such as air, ground and naval command, control, communication, computers, intelligence, surveillance and reconnaissance ("C⁴ISR") systems, digital maps, night vision systems, pilot helmet mounted systems, display and data processing systems, unmanned air vehicles ("UAVs"), computerized simulators, communication systems, thermal imaging products, laser products, optical systems for space applications, airborne reconnaissance systems, optic communication systems and products, security systems and products, surveillance products and systems and electric drive systems.

The Company provides a wide range of logistic support services, including operation of pilot training services for the Israeli Air Force on a private financing initiative ("PFI") basis. Several of the Group's companies also provide advanced engineering and manufacturing services to various customers, utilizing their significant manufacturing capabilities. The Company often cooperates with industries in Israel and in various other countries.

The Company tailors and adapts its technologies, integration skills, market knowledge and battle-proven systems to each customer's individual requirements in both existing and new platforms. By upgrading existing platforms with advanced electronic and electro-optic technologies, the Company provides customers with cost-effective solutions, and its customers are able to improve their technological and operational capabilities within limited defense budgets.

The Company operates in a competitive environment for most of its projects, systems and products. Competition is based on product and program performance, price, reputation, reliability, maintenance costs and responsiveness to customer requirements. This includes the ability to respond to rapid changes in technology. In addition, its competitive position sometimes is affected by specific requirements in particular markets.

Recent Events

- On December 13, 2004, the Company announced that it signed an agreement with the Israeli Ministry of Defense (“IMOD”) for the Digital Army Program (“DAP”) in an amount of approximately \$200 million. The DAP, which will also include an additional material amount of U.S. Military Funding (“FMF”), will be performed over a ten-year period.
- On January 11, 2005, the Company reported that its subsidiary Elop has recently been selected to supply advanced Imagery Intelligence Systems (“IMINT”) to various customers at a total value of over \$100 million.
- On January 26, 2005, the Company announced that its U.S. subsidiary has been awarded a follow-on contract to supply Enhanced Vision Systems (“EVS”) to Gulfstream for all their large cabin aircraft models. The multi-year contract is valued at approximately \$20 million.
- On February 16, 2005, the Company reported that it has been awarded a contract, valued at over \$30 million, to provide the Israeli Air Force with a command and control mission management systems for airborne platforms.

Acquisition of Tadiran Communication Ltd. shares

On December 27, 2004, the Company announced that it reached an agreement with Koor Industries Ltd. (“Koor”) to purchase all of Koor’s approximately 32% holdings in Tadiran Communications Ltd. (“Tadiran”). This purchase will be made concurrently with Koor’s purchase of approximately 9.8% of Elbit Systems’ shares from Federmann Enterprises Ltd. (“Federmann”) based on agreements reached between Federmann and Koor. The transaction will be executed in two stages as described below.

In the first stage, the Company will purchase from Koor approximately 13.8% of Tadiran’s shares, and Koor will purchase from Federmann approximately 5.3% of the Company’s shares. The Company already holds, as of March 1, 2005, approximately 6% of Tadiran’s shares acquired through prior purchases on the market, and therefore, following completion of the first stage will own approximately 20% of Tadiran’s shares. Koor will support the Company’s appointment of the greater of 3 members or 20% of Tadiran’s board of directors, and Federmann will support Koor’s appointment of a member of the Company’s board of directors.

In the second stage, the Company will purchase the balance of Koor's holdings in Tadiran. Koor will purchase an additional approximately 4.5% of the Company's shares from Federmann, and Federmann will support Koor's appointment of an additional member to the Company's board, including the Board's Vice Chairman. The second stage is subject to Koor completing the sale to Tadiran of Koor's 70% holdings in Elisra Electronic Systems Ltd. ("Elisra") on agreed upon terms. Subject to those terms the Company agreed to support the purchase of the Elisra shares by Tadiran at Tadiran's general shareholders meeting. In the event that the sale of the Elisra shares to Tadiran is not made within 16 months of the signing of the transaction agreements, then Koor and the Company will have equal representation on Tadiran's board of directors, and an agreement regarding joint control of Tadiran will enter into effect between the Company and Koor.

The Company will purchase from Koor the 32% of the Tadiran shares at a price of \$37 per share, resulting in a total purchase price of approximately \$146 million. Koor will purchase from Federmann the 9.8% of the shares in the Company at a price of \$24.70 per share, resulting in a total purchase price of approximately \$99 million.

Under the Koor-Federmann shareholders agreement, which will become effective upon the completion of the first stage of the Koor-Federmann transaction, Koor will obtain certain tag along rights in the event of Federmann's sale of shares in the Company, and Koor will be subject to certain restrictions on the transfer of its shares in the Company. Also, Koor has agreed to vote at general shareholders meetings of the Company in accordance with Federmann's instructions, with certain exceptions, and Koor will receive certain additional non-transferable rights.

On January 5, 2005, the Company's Audit Committee and board of directors approved the agreements with Koor relating to the Company's purchase of Koor's shares in Tadiran. On February 28, 2005, the Company's shareholders at an extraordinary general shareholders meeting approved the agreement with Koor relating to the Company's purchase of Koor's shares in Tadiran. The parties are currently in the process of obtaining the remaining approvals for the transaction.

The Company's Proxy Statement dated February 7, 2005, filed with the SEC, contains a detailed description of the transaction and the related agreements.

Financial Highlights

The Company's revenues increased by 4.7% and reached \$939.9 million in 2004. The main increase in revenues was in the electro-optics area of operations.

The Company's net earnings increased by 15.3% and were \$53 million. The diluted earnings per share ("EPS") were \$1.29 in 2004, as compared to \$1.14 in 2003. The net earnings and net earnings per share were effected by a non-cash expense related to the Company's stock option plan. Excluding that effect, net earnings and diluted net earnings per share in 2004 were \$55.7 million and \$1.36, respectively, as compared to \$49.7 million and \$1.24 in 2003.

Effective January 1, 2004, the Company adopted the fair value recognition provision according to SFAS No. 123. The Company uses the Black-Scholes-Merton formula to estimate the fair value of stock options granted to employees at the grant date. Compensation cost is recorded over the vesting period on a straight-line basis.

The Company's backlog increased by 22.9% and as of December 31, 2004 reached \$2.15 billion, as compared to \$1.75 billion as of December 31, 2003.

The Company's cash flow generated from operations in the year ended December 31, 2004 was \$81.5 million, as compared to \$91.4 million in the year ended December 31, 2003.

The Board of Directors declared a dividend of \$0.13 per share for the last quarter of 2004.

B. Market Trends

Trends in the defense electronics and homeland security markets in which the Company operates have been impacted by the nature of recent conflicts and terrorism activities throughout the world. Lessons learned in Operation Iraqi Freedom, Afghanistan, and the attacks of September 11, 2001, among other events, have increased the focus of defense forces on low intensity conflicts and homeland security.

In the defense electronics market, there is an increasing demand for products and systems in the areas of C⁴ISR. Accordingly, while the Company continues to perform platform upgrades, more emphasis is being placed on C⁴ISR, including information systems, intelligence gathering, situational awareness, precision guidance, all weather and day/night operations, border and perimeter security, UAV's, space and satellite based defense capabilities and homeland security systems.

The Company believes that its core technologies and abilities will enable it to take advantage of many of these emerging trends, as well as to continue to participate in the "Current Force" legacy operations of its customers.

In recent years consolidations in the defense industry have affected competition. This has decreased the number but increased the relative size and resources of the Company's competitors. The Company adapts to evolving market conditions by adjusting its business strategy to changing defense market conditions. It also anticipates continued competition in defense markets due to declining defense budgets in many countries.

The Company believes in its ability to compete on the basis of its systems development and technological expertise, combat-proven performance and policy of offering customers overall solutions to technological, operational and financial needs.

C. Backlog of Orders

The Company's backlog of orders as of December 31, 2004 reached \$2,154 million, of which 66% were for orders outside Israel. The Company's backlog as of December 31, 2003 was \$1,752 million, of which 63% were for orders outside Israel. The backlog includes only part of the DAP contract signed with the IMOD in December 2004 (see "Recent Events" above).

Approximately 74% of the Company's backlog as of December 31, 2004 is scheduled to be performed during 2005 and 2006. The majority of the 26% balance is scheduled to be performed in 2007 and 2008.

D. Operating Subsidiaries and Affiliated Entities

- Elop Electro-Optics Industries, Ltd. (“El-Op”) - a wholly-owned subsidiary registered in Israel, is engaged in the field of advanced electro-optical products for defense, homeland security and civil applications. El-Op’s main areas of activity include development and production of thermal imaging products, laser products, optical systems for space applications, airborne reconnaissance systems, optical communications systems, fire control systems for combat vehicles, homeland security products and other systems for defense applications.
- EFW Inc. (“EFW”) – a wholly-owned subsidiary registered in the United States, serves as the base for the Group’s activities in the United States, mainly in the area of development, production and maintenance of advanced defense products and systems.
- Vision Systems International LLC (“VSI”) – an affiliated company in the United States, owned in equal parts each of EFW and Rockwell Collins Inc., is engaged in the area of helmet mounted systems primarily for fighter aircraft.
- Cyclone Aviation Products Ltd. (“Cyclone”) – a wholly-owned subsidiary registered in Israel, provides logistic support and maintenance services for aircraft and helicopters and manufactures structure components and sub-assemblies for aircraft.
- Silver Arrow LP – a wholly-owned limited partnership registered in Israel, is engaged in the business of UAV systems and products.
- Ortek Ltd. (“Ortek”) – a wholly-owned subsidiary registered in Israel, is engaged mainly in the area of security products and systems and night vision equipment.
- Kinetics Ltd. (“Kinetics”) – a 51%-owned subsidiary registered in Israel, is involved mainly in the development and production of systems and components for combat vehicles.
- Semi-Conductor Devices (“SCD”) – an Israeli affiliated partnership held in equal part by each of the Company and Rafael Armaments Development Authority Ltd. (“Rafael”), is engaged in the development and production of infrared detectors and laser diodes.
- Opgal Optronics Industries Ltd. (“Opgal”) – an Israeli affiliated company, owned 50.1% by the Company and 49.9% by Galram Technologies Ltd., a wholly-owned subsidiary of Rafael, is engaged mainly in the area of thermal imaging systems for commercial applications.
- European subsidiary – a wholly-owned subsidiary registered in Belgium, is involved mainly in development, manufacturing and support of electro-optical products for defense and space markets. The results of this subsidiary’s operations have been included in the Company’s results from the third quarter of 2003.

The Company has holdings, directly and indirectly, in several relatively small companies in various countries. These companies are engaged mainly in the manufacturing, marketing and servicing of defense avionics and electronics as well as defense related software.

The Company also has holdings, directly and indirectly, in several non-defense technology spin-off companies whose activities are based on technologies that were developed by the Company. The spin-off companies are involved primarily in the areas of medical equipment, optical communications and space satellites.

The Company evaluates investments in affiliates, partnerships and other companies, and when relevant factors indicate other than temporary decline in the fair value of the investments below their carrying value, the Company adjusts the investment to the estimated fair value. The value of these companies is subject to ongoing changes resulting from their business conditions.

E. Critical Accounting Policies and Estimates

The Company's significant accounting policies are described in Note 2 to the audited consolidated financial statements for the year ended December 31, 2004.

The Company's results of operations and financial condition are based on the preparation of consolidated financial statements in conformity with generally accepted accounting principles in the U.S. ("U.S. GAAP"). The preparation of the consolidated financial statements requires management to select accounting policies for critical accounting areas as well as estimates and assumptions that affect the amounts reported in the consolidated financial statements. Significant changes in assumptions and/or conditions and changes in critical accounting policies could materially impact the Company's operating results and financial condition.

The most critical accounting policy applicable to the Company relates to revenue recognition as described below.

The Company generates revenues from long-term contracts involving the design, development, manufacture and integration of defense systems and products and providing support and services for such systems and products.

Revenues from long-term contracts are recognized based on Statement of Position 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" ("SOP 81-1") according to which revenues are recognized on the percentage of completion basis.

Sales under long-term fixed-price contracts which provide for a substantial level of development efforts in relation to total contract efforts are recorded using the cost-to-cost method of accounting as the basis to measure progress toward completing the contract and recognizing revenues. According to this method, sales and profits are recorded based on the ratio of costs incurred to estimated total costs at completion. In certain circumstances, when measuring progress toward completion, the Company considers other factors, such as achievement of performance milestones.

Sales and anticipated profit under long-term fixed-price contracts that involve both development and production are recorded on a percentage of completion basis, using the cost-to-cost method and units-of-delivery method, as applicable. In certain circumstances, when measuring progress toward completion under the development portion of the contract, the Company considers other factors, such as achievement of performance milestones.

Estimated contract profit is included in earnings in proportion to recorded sales.

The percentage-of-completion method of accounting requires management to estimate the cost and gross profit margin for each individual contract. Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original estimated forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis. Anticipated losses on contracts are charged to earnings when determined to be probable.

Sales under cost-reimbursement-type contracts are recorded as costs are incurred. Applicable estimated profits are included in earnings in the proportion that incurred costs bear to total estimated costs.

Amounts representing contract change orders, claims or other items are included in sales only when they can be reliably estimated and realization is probable. Penalties and awards applicable to performance on contracts are considered in estimating sales and profit rates and are recorded when there is sufficient information to assess anticipated contract performance.

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

In cases where the contract involves the delivery of products and performance of services, the Company follows the guidelines specified in EITF 00-21, "Revenue Arrangements with Multiple Deliveries" in order to allocate the contract fees between the products accounted for under SOP 81-1 and the services accounted for under SAB 104. The services are recognized throughout the service period.

F. Impairment of Goodwill and Other Long-Lived Assets

Consistent with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," goodwill is not amortized and is tested at least annually for impairment. According to SFAS 142, an impairment loss will be recognized when the carrying value of the goodwill is not recoverable and exceeds its fair value.

The methods commonly used to value a closely held company are the Income, Market and Cost approaches. The Company's reported units fair market value was estimated using two valuation methodologies: the Income Approach and the Market Approach.

As of December 31, 2004, the Company's goodwill amounted to \$32.8 million. The Company tested its goodwill as of December 31, 2004, and concluded that no assessment of impairment loss was necessary.

Consistent with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Company evaluates long-lived assets for impairment and assesses their recoverability based upon anticipated future cash flows. As of December 31, 2004, the Company's long-lived assets amounted to \$307.4 million, including \$63.1 million in intangible assets, and the Company concluded that no impairment loss was necessary.

Should future impairment tests made by the Company determine that impairment has occurred in the value of the Company's goodwill or long-lived assets, such impairment may have a material effect on the financial results of the Company in the period in which the impairment is determined.

G. Sarbanes-Oxley Act

According to Section 404 of the U.S. Sarbanes-Oxley Act of 2002, the Company is required to include in its annual report for the fiscal year ending December 31, 2006 an assessment, as of the end of the fiscal year, of the effectiveness of its internal controls over financial reporting. (On March 2, 2005, the SEC extended the period for implementation of Section 404 by Foreign Private Issuers such as the Company from 2005 until 2006.)

During 2004, the Company took steps to assure compliance of its documentation and internal controls over financial reporting with the guidelines stipulated in the Sarbanes-Oxley Act. The Company plans to continue with these steps during 2005 and 2006.

H. New Accounting Standards

The significant accounting policies applied in the preparation of these statements are identical to those applied in preparation of the latest annual financial statements except as indicated below:

On December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004) ("123(R)", "Share-Based Payment", which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation". Statement 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", and amends FASB Statement No. 95, "Statement of Cash Flows". Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

The Company adopted the fair-value-based method of accounting for share-based payments effective January 1, 2004 using the "modified prospective method" described in FASB Statement No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure". The Company does not anticipate that adoption of Statement 123(R) will have a material impact on its results of operations or its financial position.

I. Stock Based Compensation

Up until December 31, 2003, the Company followed Accounting Principles Board Opinion No. 25 ("APB 25") "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44 ("FIN 44") "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. The change in the Company's share price affected the Company's financial results due to the impact of the employee stock option plan adopted in 2000. The plan is comprised of options for 5 million shares, divided into options to purchase up to 2.5 million shares and an additional 2.5 million "phantom" options. The phantom options grant the option holders a number of shares corresponding to the benefit component of the options exercised, as calculated on the exercise date, in consideration for their par value only, and are considered as a variable option plan.

Under APB No. 25, the total compensation is computed periodically according to the change in the share price and amortized as compensation expense, or income, based on the vesting period of the options. The effect was allocated mainly to the Company's cost of goods sold and general and administrative expenses, with smaller amounts allocated to R&D and sales and marketing expenses. The amounts of the expenses related to the stock option compensation are included in the "Non-U.S. GAAP Disclosure" below.

As noted above, effective January 1, 2004, the Company adopted the fair value recognition provision of SFAS No. 123. The Company uses the Black-Scholes-Merton formula to estimate the fair value of stock options granted to employees. Compensation cost is recorded over the vesting period on a straight-line basis.

Following the adoption of SFAS No. 123, the financial results will no longer be materially effected by the impact of changes in the Company's share price on employee stock based compensation.

The following pro forma information shows the impact of SFAS No. 123, had it been in effect in 2002 and 2003:

	Year ended December 31,		
	2004	2003	2002
Net income as reported	<u>\$ 52,993</u>	<u>\$ 45,945</u>	<u>\$ 45,113</u>
Pro forma net income	<u>\$ 52,993</u>	<u>\$ 46,782</u>	<u>\$ 41,416</u>
Net earnings per share:			
Diluted net earnings per share as reported	<u>\$ 1.29</u>	<u>\$ 1.14</u>	<u>\$ 1.13</u>
Pro forma diluted net earnings per share	<u>\$ 1.29</u>	<u>\$ 1.16</u>	<u>\$ 1.04</u>

As result of the adoption of SFAS No. 123 from January 1, 2004, the net income and diluted net earnings per share of the three previous quarterly reports of 2004 are restated as follows:

	Q1/04	Q2/04	Q3/04	Total
Net income as reported	<u>\$ 12,727</u>	<u>\$ 11,311</u>	<u>\$ 13,708</u>	<u>\$ 37,746</u>
Net income according to SFAS No. 123	<u>\$ 12,251</u>	<u>\$ 13,301</u>	<u>\$ 13,316</u>	<u>\$ 38,868</u>
Diluted net earnings per share as reported	<u>\$ 0.31</u>	<u>\$ 0.28</u>	<u>\$ 0.33</u>	<u>\$ 0.92</u>
Diluted net earnings per share according to SFAS No. 123	<u>\$ 0.30</u>	<u>\$ 0.33</u>	<u>\$ 0.32</u>	<u>\$ 0.95</u>

J. Off Balance Sheet and Other Long-Term Arrangements and Commitments

1. In connection with long-term projects in certain countries, the Company and certain subsidiaries undertook to use their respective best efforts to make or facilitate purchases or investments in those countries at certain percentages (typically up to 100%) of the amount of the specific contract. The Company's obligations to make or facilitate third parties making such investments and purchases are subject to commercial conditions in the local market, usually without a specific financial penalty. The maximum aggregate undertaking as of December 31, 2004 amounted to \$673 million to be performed over a period of up to 11 years. In the opinion of management, the actual amount of the investments and purchases is anticipated to be less than that mentioned above, since certain investments and purchases can result in reducing the overall undertaking on more than a one-to-one basis.
2. The Company and certain Israeli subsidiaries partially finance their research and development expenditures under programs sponsored by the Office of the Chief Scientist in Israel ("OCS") for the support of research and development activities conducted in Israel. At the time the participations were received, successful development of the related projects was not assured.

In exchange for participation in the programs by the OCS, the Company and the subsidiaries agreed to pay 2%-5% of total sales of products developed within the framework of these programs. The obligation to pay these royalties is contingent on actual sales of the products.

The Company and certain of its subsidiaries are also obligated to pay certain amounts to the IMOD and others on specific sales including sales resulting from the development of certain technologies.

3. Future minimum lease commitments of the Group under various non-cancelable operating lease agreements in respect of premises, motor vehicles and office equipment as of December 31, 2004 are as follows: \$6.7 million for 2005, \$5.9 million for 2006, \$4.5 million for 2007, \$3 million for 2008 and \$13.1 million for 2009 and thereafter.
4. Three founding employees (the "Founders"), who collectively hold approximately 32.3% of the outstanding shares of Kinetics Ltd. ("Kinetics"), a 51%-owned Israeli subsidiary, have a put option to jointly sell all of their shares in Kinetics to the Company. Two private investors holding in the aggregate approximately 16.7% of Kinetics' outstanding shares have "tag along" rights in the event the Founders exercise the put option.

The put option is exercisable from January 1, 2005 until December 31, 2005 at a price equal to the higher of: (a) the Founder's pro-rata share (corresponding to the Founder's shareholding percentage) of the value of Kinetics as of the option exercise date as determined by a third party appraiser mutually acceptable to the Founders and to the Company, (the appraiser will value Kinetics as if Kinetics had distributed as dividends net profits accumulated up to the option exercise date) or (b) \$12,077,077, reduced by 3% per annum, or pro-rata part thereof, for the period beginning on July 1, 2003 and ending on the option exercise date.

5. The Company had, as of December 31, 2004, approximately \$380 million in guarantees issued on its behalf by banks, mainly in respect of advance payment and performance guarantees provided in the regular course of business.

6. In connection with bank credits and loans, including performance guarantees issued by banks and bank guarantees securing certain advances from customers, the Company and certain subsidiaries are obligated to meet certain covenants. Such covenants include requirements for shareholders' equity, current ratio, operating profit margin, tangible net worth, EBITDA, interest coverage ratio and total leverage. As of December 31, 2004, the Company and its subsidiaries are in full compliance with all covenants.
7. As of December 31, 2004 and 2003, the Company had purchase commitments which amounted to \$345 and \$348 million, respectively. These purchase orders and subcontracts are typically in a standard format proposed by the Company, with the subcontracts and purchase orders also reflecting provisions from the Company's applicable prime contract that are appropriate to flow down to subcontractors and vendors. The terms typically included in these purchase orders and subcontracts are consistent with Uniform Commercial Code provisions in the United States for sales of goods, as well as with specific terms called for by its customers in international contracts. These terms include the Company's right to terminate the purchase order or subcontract in the event of the vendors' or subcontractors' default, as well as the Company's right to terminate the order or subcontract for the Company's convenience (or if the Company's prime contractor has so terminated the prime contract). Such purchase orders and subcontracts typically are not subject to variable price provisions.

K. Acquisitions During 2004

In the third quarter of 2004, the Company (through a subsidiary of EFW) acquired a business from Computer Instruments Corporation Inc. ("CIC") of Westbury, New York in consideration for approximately \$2.3 million in cash. The acquired assets relate to the design and manufacture of aviation pressure transducers, air data probes and air data computers.

L. Summary of Financial Results

The following table sets forth the consolidated statements of operations of the Company and its subsidiaries for the three-month periods and years ended December 31, 2004 and December 31, 2003.

	For the year ended on December 31				For the three months ended on December 31			
	2004		2003		2004		2003	
	\$	%	\$	%	\$	%	\$	%
	(In thousands of U.S. dollars except per share data)							
Total revenues	939,925	100.0	897,980	100.0	270,775	100.0	262,757	100.0
Cost of revenues	689,626	73.4	672,711	74.9	198,198	73.2	208,649	79.4
Gross profit	250,299	26.6	225,269	25.1	72,577	26.8	54,108	20.6
Research and development expenses, net	66,846	7.1	54,919	6.1	23,277	8.6	11,913	4.5
Marketing and selling expenses	69,912	7.4	69,943	7.8	19,190	7.0	19,247	7.3
General and administrative expenses	47,832	5.1	46,077	5.1	12,876	4.8	12,153	4.6
	184,590	19.6	170,939	19.0	55,343	20.4	43,313	16.5
Operating profit	65,709	7.0	54,330	6.1	17,234	6.5	10,795	4.1
Financing expenses, net	(5,852)	(0.6)	(4,870)	(0.5)	(2,974)	(1.1)	(1,403)	(0.5)
Other income (expenses), net	770	0.1	53	0.0	831	0.3	542	0.2
Income before income taxes	60,627	6.4	49,513	5.5	15,091	5.6	9,934	3.8
Provision for income taxes	15,219	1.6	11,334	1.3	3,507	1.3	832	0.3
	45,408	4.8	38,179	4.2	11,584	4.3	9,102	3.5
Minority interest	(180)	0.0	557	0.1	(639)	(0.2)	101	-
Company's share of income of affiliated entities	7,765	0.8	7,209	0.8	3,180	1.2	3,271	1.2
Net earnings	52,993	5.6	45,945	5.1	14,125	5.2	12,474	4.7
Diluted earnings per share	1.29		1.14		0.34		0.31	
Weighted average number of shares used in computation	41,041		40,230		41,399		40,327	

Non –U.S. GAAP Disclosure

The Company records non-cash expenses related to its employees' option plans. (See Note 17 to the audited consolidated financial statements for the year ended December 31, 2004). Up until December 31, 2003, the option plan expenses were calculated according to APB No. 25 based on the vesting period and the exercise price (set on the date of the options grant) and the Company share price at the end of each period and were not affected directly from the results of operations or the condition of the Company. As of January 1, 2004, the Company adopted the fair value based method for share based payments using the "modified prospective method" described in FASB No. 148. The Company uses the Black-Scholes-Merton formula to estimate the value of stock options granted to employees. This value is calculated on the grant date and also is not affected directly by the results of operations or the condition of the Company.

The Company believes that prior to the adoption of the modified prospective method as of January 1, 2004 as described above, the non-cash expenses (income) related to the employees' option plans, did not reflect properly the Company's performance on a period-to-period basis.

For comparison purposes, the following table sets forth the Company's results of operations, excluding the effect of the Company's share option plan, reflecting the manner in which the Company's management evaluates its results of operations.

	For the year ended December 31				For the three months ended December 31			
	2004		2003		2004		2003	
	\$	%	\$	%	\$	%	\$	%
	(In thousands of U.S. dollars except per share data)							
Net earnings as reported	52,993	5.6	45,946	5.1	14,125	5.2	12,474	4.8
Non-cash expense related to option plan	<u>2,710</u>	<u>0.3</u>	<u>3,793</u>	<u>0.4</u>	<u>493</u>	<u>0.2</u>	<u>1,083</u>	<u>0.4</u>
Net earnings excluding option plan effect	<u>55,703</u>	<u>5.9</u>	<u>49,739</u>	<u>5.5</u>	<u>14,618</u>	<u>5.4</u>	<u>13,557</u>	<u>5.2</u>
Diluted net earnings per share as reported	<u>1.29</u>		<u>1.14</u>		<u>0.34</u>		<u>0.31</u>	
Diluted net earnings per share excluding option plan effect	<u>1.36</u>		<u>1.24</u>		<u>0.35</u>		<u>0.34</u>	

Revenues

The Company's consolidated revenues increased by 4.7%, from \$898.0 million in 2003 to \$939.9 million in 2004.

The following table sets forth the Company's revenue distribution by areas of operation:

	Year ended			
	December 31, 2004		December 31, 2003	
	\$ millions	%	\$ millions	%
Airborne systems	367.9	39.1	373.6	41.6
Land vehicle systems	199.2	21.2	199.8	22.2
C ⁴ ISR systems	108.9	11.6	133.9	14.9
Electro-optics	200.3	21.3	140.5	15.7
Other (mainly non-defense engineering and production services)	<u>63.6</u>	<u>6.8</u>	<u>50.2</u>	<u>5.6</u>
Total	<u>939.9</u>	<u>100.0</u>	<u>898.0</u>	<u>100.0</u>

C⁴ISR systems sales decreased by 19% from \$133.9 million to \$108.9 million. The decrease in revenues resulted mainly from the delay in the receipt of certain orders for new projects, which were received but for which revenues were not yet recognized.

Electro-optics sales increased by 43% from \$140.5 million to \$200.3 million. The increase in revenues resulted from increased sales of homeland security systems for international customers, night sights for various customers, the Night Targeting System ("NTS") to the U.S. Marine Corps and other customers, as well as sales of electro-optic products by a European subsidiary.

Other sales increased by 27% from \$50.2 million to \$63.6 million. The increase in revenues was mainly from the manufacture of medical instrumentation.

The following table sets forth the Company's distribution of revenues by geographical regions:

	Year ended			
	December 31, 2004		December 31, 2003	
	\$ millions	%	\$ millions	%
Israel	241.6	25.7	255.8	28.5
United States	348.5	37.1	332.3	37.0
Europe	124.1	13.2	109.4	12.2
Other countries	<u>225.7</u>	<u>24.0</u>	<u>200.5</u>	<u>22.3</u>
Total	<u>939.9</u>	<u>100.0</u>	<u>898.0</u>	<u>100.0</u>

The Company's sales are primarily to governmental entities and prime contractors under government defense programs. Accordingly, the level of the Company's revenues is subject to governmental budgetary constraints.

Revenues from customers in Europe increased by 13% from \$109.4 million to \$124.1 million. The increase in revenues in Europe resulted mainly from the inclusion of a European subsidiary's revenues, starting only in the third quarter of 2003 and for the entire year in 2004.

Revenues also increased in the United States and in other countries, mainly in Latin America and Asia, while revenues in Israel declined as deliveries under certain major programs entered final phases.

Gross Profit

The Company's gross profit represents the aggregate results of the Company's activities and projects and is based on the mix of programs in which the Company is engaged during the reported period.

Reported gross profit in 2004 was \$250.3 million (with gross profit margin of 26.6%), as compared to \$225.3 million (gross profit margin of 25.1%) in 2003.

The increase in the gross profit percentage was caused mainly by the sale of a mix of products and projects with improved profitability.

Research and Development ("R&D")

The Company continually invests in R&D in order to maintain and further advance its technologies, in accordance with a long-term plan, based on its estimate of future market needs.

The Company's R&D activities in the reported period are coordinated with, and partially funded by, third parties, including the IMOD and the OCS. These programs were mainly in the areas of advanced airborne systems, cutting edge electro-optics technology and products for surveillance, aerial reconnaissance, lasers and space based sensors.

Gross R&D expenses in 2004 totaled \$86.4 million (9.2% of revenues), as compared with \$65.5 million (7.3% of revenues) in 2003.

Net R&D expenses (after deduction of third party participation, including the IMOD and the OCS) in 2004 totaled \$66.8 million (7.1% of revenues), as compared to \$54.9 million (6.1% of revenues) in 2003.

During the second half of 2004, and especially during the fourth quarter, the Company has invested significant R&D efforts to support strategic business opportunities by developing products and technologies for U.S. airborne programs and additional efforts relating to the electro-optics systems. In support of these activities and additional R&D projects, the Company was successful in obtaining additional funding from external sources, to provide for the development of advanced technologies and related products.

Marketing and Selling Expenses

The Company maintains its activities in developing new markets and pursues various business opportunities according to the Company's plans.

Marketing and selling expenses in 2004 were \$69.9 million (7.4% of revenues), as compared to a similar amount of \$69.9 million (7.8% of revenues) in 2003.

General and Administrative (“G&A”) Expenses

G&A expenses in 2004 were \$47.8 million (5.1% of revenues), as compared to \$46.1 million (5.1% of revenues) in 2003.

The increase in G&A expenses in 2004 compared to 2003 were related to the cost of various exploratory merger and acquisition, legal, audit and control activities, including expenses related to compliance with the Sarbanes-Oxley Act.

Operating Profit

As a result of all of the above, reported operating income in 2004 was \$65.7 million (7.0% of revenues), as compared to \$54.3 million (6.1% of revenues) in 2003.

Financing Expenses (Net)

Net financing expenses in 2004 were \$5.9 million, as compared to \$4.9 million in 2003.

The increase in the net finance expense resulted mainly from a decrease in finance income as a result of a lower level of cash and cash equivalents as well as costs incurred in hedging with regards to Great Britain Pounds (“GBP”).

Taxes on Income

The Company’s tax rate represents a weighted average of the tax rates to which the various companies in the Group are subject.

Provision for taxes in 2004 was \$15.2 million (effective tax rate of 25.1%), as compared to a provision for taxes of \$11.3 million (effective tax rate of 22.9%) in 2003.

The change in the effective tax rate is attributable to the mix of the tax rates in the various tax jurisdictions in which the Group’s companies generating the taxable income operate.

Company’s Share in Earnings of Affiliated Entities

In 2004, the Company had net income of \$7.8 million from its share in earnings of affiliated entities, as compared to \$7.2 million in 2003.

The companies and partnerships, in which the Company holds 50% or less in shares or voting rights and are therefore not consolidated in its financial statements, operate in complementary areas to the Company’s core business activities, including electro-optics and airborne systems. The Company believes that its affiliates will continue to contribute significantly to the Company’s earnings.

Net Earnings and Earnings per Share (“EPS”)

Reported net earnings in 2004 were \$53 million (5.6% of revenues), as compared to reported net earnings of \$45.9 million (5.1% of revenues) in 2003. Reported fully diluted EPS was \$1.29 in 2004, as compared to \$1.14 in 2003.

Excluding the option plan non-cash expenses in year ended December 31, 2004, net earnings in 2004 were \$55.7 million (5.9% of revenues) and the EPS was \$1.36, as compared to \$49.7 million (5.5% of revenues), and an EPS of \$1.24 in year ended December 31, 2003.

The number of shares used for computation of diluted EPS in the year ended December 31, 2004 was 41,041 thousand shares, as compared to 40,230 thousand shares in the year ended December 31, 2003. The increase in the number of shares used for computation of diluted EPS was due mainly to exercise of options by employees during 2003 and 2004, and the change in the Company's share price.

M. Liquidity and Capital Resources

The Company's cash flows are effected by the cumulative cash flows of its various projects in the reported periods. Project cash flows are affected by the timing of the receipt of advances and the collection of accounts receivable from customers, which relate to specific events during the project, while expenses are on-going. As a result, the Company's cash flows may vary from one period to another.

The Company's policy is to invest its cash surplus primarily in interest bearing deposits in accordance with its projected needs.

The resources available to the Company include mainly profits, collection of accounts receivable, advances from customers, as well as Government of Israel grants and participation and bank financing in Israel and elsewhere based on its capital, assets and activities. In addition, the Company has the ability to raise funds through the offering of shares and debentures to the public from time to time.

The Company's net cash flow generated from operating activities in 2004 was \$81.5 million, resulting mainly from net income for the period and increase of accounts payable, which was partly offset by a decrease in advances from customers.

Net cash flows used for investment activities in the year ended December 31, 2004 were \$70.9 million, which were used mainly for procurement of property, plant and equipment and investment in Tadiran's shares. The investments in fixed assets were made primarily in equipment for the Group's various manufacturing plants and in a building constructed at Elbit Systems' facility in Haifa, Israel.

Net cash flow used for financing activities in 2004 was \$52.6 million, which were used mainly for paying dividends.

On December 31, 2004, the Company had total borrowings in the amount of \$96.5 million, including \$86.2 million in long-term loans, and \$380 million in guarantees issued on its behalf by banks, mainly in respect of advance payment and performance guarantees provided in the regular course of business. On December 31, 2004, the Company had a cash balance amounting to \$34.1 million.

The Company and some of its subsidiaries operate with loan and credit agreements that contain certain covenants. Such covenants include requirements for shareholders' equity, current ratio, operating profit margin, tangible net worth, EBITDA, interest coverage ratio and total leverage. As of December 31, 2004, the Company and its subsidiaries are in full compliance with all such covenants.

As of December 31, 2004, the Company had working capital of \$172.6 million, and its current ratio was 1.46. The Company's ratio of equity to total assets was 41.8%.

N. Derivatives and Hedges

Market risks relating to the Company's operations result primarily from changes in interest rates and exchange rates. The Company typically uses financial instruments to limit its exposure to those changes. The Company also typically enters into forward contracts in connection with transactions that are denominated in currencies other than U.S. dollars and New Israeli Shekels ("NIS"). The Company may enter from time to time into forward contracts and other hedging instruments related to NIS, based on market conditions.

On December 31, 2004, the Company's liquid assets were comprised of bank deposits. The Company's deposits and loans are based on variable interest rates, and their value as of December 31, 2004 was therefore not exposed to changes in interest rates. Should interest rates either increase or decrease, such change may affect the Company's results of operations due to changes in the cost of its liabilities and the return on its assets that are based on variable rates.

The Company's functional currency is the U.S. dollar. On December 31, 2004, the Company had exposure due to liabilities denominated in NIS of \$57 million in excess of its NIS denominated assets. These liabilities represent mostly wages and trade payables. The amount of the Company's exposure to the changes in the NIS-U.S. dollar exchange rate varies from time to time.

Most of the Company's assets and liabilities which are denominated in currencies other than the NIS and the U.S. dollar were covered as of December 31, 2004 by forward contracts and options. On December 31, 2004, the Company had forward contracts for the sale and purchase of such foreign currencies totaling \$30.9 million (\$20.8 million in Euro, \$5.4 million in GBP and \$4.8 million in other currencies). The results of financial derivative activities in this quarter were not material.

On December 31, 2004, the Company had options for hedging future cash flows denominated in GBP in the amount of \$154 million. The fair market value of the options as of December 31, 2004 and 2003 was not material.

O. Dividends

The Board of Directors declared on March 14, 2005 a dividend of \$0.13 per share. The total dividend declared for 2004 was \$2.17 per share.

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