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א.ג.נ.,

**הנדון: אלביט מערכות בע"מ ("החברה") – דוחות כספיים לרבעון השני של שנת 2006**

מצ"ב הדוחות הכספיים ודו"ח ההנהלה על תוצאות פעילות החברה ברבעון השני של שנת 2006.  
בכוונתנו להגיש דוחות אלה לרשות ניירות ערך בארה"ב.

בכבוד רב,  
אילן פכולדר  
מזכיר החברה

**ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**  
**CONDENSED CONSOLIDATED**  
**FINANCIAL STATEMENTS**

**AS OF JUNE 30, 2006**  
(Unaudited)  
(In thousands of U.S. dollars)

# **ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**

## **CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF JUNE 30, 2006**  
(Unaudited)  
(In thousands of U.S. dollars)

### **C O N T E N T S**

	<b><u>P a g e</u></b>
CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS	
Consolidated Balance Sheets	2 - 3
Consolidated Statements of Income	4
Consolidated Statements of Changes in Shareholders' Equity	5 - 7
Consolidated Statements of Cash Flows	8 - 9
Notes to the Consolidated Financial Statements	10 - 12

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# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

U.S. dollars (in thousands)

	<b>June 30, 2006</b>	<b>December 31, 2005</b>
	<b>(Unaudited)</b>	<b>(Audited)</b>
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 117,949	\$ 93,887
Short-term bank deposits	1,868	742
Trading securities	2,314	2,282
Trade receivables, (net of allowance for doubtful accounts in the amount of \$3,591 and \$3,221 as of June 30, 2006 and December 31, 2005, respectively)	344,963	346,689
Other receivables and prepaid expenses	74,294	67,096
Inventories, net of advances	369,567	328,428
Total current assets	<u>910,955</u>	<u>839,124</u>
<b>INVESTMENTS AND LONG-TERM RECEIVABLES:</b>		
Investments in affiliated companies and a partnership	225,112	194,994
Investments in other companies	6,345	6,345
Compensation receivable in respect of fire damages, net	15,530	15,530
Long-term bank deposits and trade receivables	5,895	2,457
Severance pay fund	145,004	136,663
	<u>397,886</u>	<u>355,989</u>
<b>PROPERTY, PLANT AND EQUIPMENT, NET</b>	<u>285,447</u>	<u>284,997</u>
<b>INTANGIBLE ASSETS:</b>		
Goodwill	58,593	58,593
Other intangible assets, net	74,645	78,771
	<u>133,238</u>	<u>137,364</u>
	<u><u>\$ 1,727,526</u></u>	<u><u>\$ 1,617,474</u></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)

	<b>June 30, 2006 (Unaudited)</b>	<b>December 31, 2005 (Audited)</b>
<b>CURRENT LIABILITIES:</b>		
Short-term bank credit and loans	\$ 14,994	\$ 30,296
Current maturities of long-term loans	13,609	7,355
Trade payables	134,947	120,260
Other payables and accrued expenses	254,181	216,539
Customers advances and amounts in excess of costs incurred on contracts in progress	307,887	237,718
Total current liabilities	<u>725,618</u>	<u>612,168</u>
<b>LONG-TERM LIABILITIES:</b>		
Long-term loans	219,129	224,982
Advances from customers	109,475	122,263
Deferred income taxes	24,171	26,060
Accrued termination liability	<u>173,375</u>	<u>168,317</u>
	<u>526,150</u>	<u>541,622</u>
<b>MINORITY INTERESTS</b>	<u>12,782</u>	<u>12,907</u>
<b>SHAREHOLDERS' EQUITY:</b>		
Share capital		
Ordinary shares of New Israeli Shekels (NIS) 1 par value;		
Authorized – 80,000,000 shares as of June 30, 2006		
and December 31, 2005;		
Issued - 41,625,707 and 41,375,545 shares as of June 30, 2006		
and December 31, 2005 respectively;		
Outstanding - 41,216,786 and 40,966,624 shares as of June 30,		
2006 and December 31, 2005, respectively	11,670	11,636
Additional paid-in capital	280,682	278,679
Accumulated other comprehensive loss	(8,916)	(1,340)
Retained earnings	183,861	166,123
Treasury shares - 408,921 shares as of June 30, 2006 and		
December 31, 2005	(4,321)	(4,321)
	<u>462,976</u>	<u>450,777</u>
	<u>\$ 1,727,526</u>	<u>\$ 1,617,474</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)

	Six months ended June 30,		Three months ended June 30,		Year ended December 31,
	2006	2005	2006	2005	2005
	(Unaudited)		(Unaudited)		(Audited)
Revenues	\$ 679,185	\$ 474,470	\$ 344,815	\$ 243,782	\$ 1,069,876
Cost of revenues	502,067	346,821	255,237	177,695	786,616
Restructuring expenses	-	-	-	-	3,488
Gross profit	177,118	127,649	89,578	66,087	279,772
Research and development costs, net	39,789	32,961	18,351	17,795	71,903
Marketing and selling expenses	53,630	34,386	27,382	17,740	78,648
General and administrative expenses	37,727	25,424	18,720	12,652	54,417
In-process research and development write-off	-	-	-	-	7,490
	131,146	92,771	64,453	48,187	212,458
Operating income	45,972	34,878	25,125	17,900	67,314
Financial expenses, net	(10,918)	(3,197)	(6,677)	(1,465)	(11,472)
Other income (expenses), net	160	(185)	(748)	(354)	(5,326)
Income before taxes on income	35,214	31,496	17,700	16,081	50,516
Taxes on income	9,366	8,043	4,762	4,056	16,335
	25,848	23,453	12,938	12,025	34,181
Equity in net earnings (losses) of affiliated companies and partnership	3,614	(127)	1,347	(1,169)	(1,636)
Minority interests in losses (earnings) of subsidiaries	77	273	786	53	(58)
Net income	\$ 29,539	\$ 23,599	\$ 15,071	\$ 10,909	\$ 32,487
Earnings per share					
Basic net earnings per share	\$ 0.72	\$ 0.58	\$ 0.37	\$ 0.27	\$0.80
Diluted net earnings per share	\$ 0.71	\$ 0.57	\$ 0.36	\$ 0.26	\$0.78
Number of shares used in computation of basic net earnings per share	41,067	40,675	41,125	40,705	40,750
Number of shares used in computation of diluted net earnings per share	41,772	41,617	41,808	41,617	41,623

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

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

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

	Number of outstanding shares	Share capital	Additional paid-in capital	Accumulated other comprehensive loss	Retained earnings	Treasury shares	Total shareholders' equity	Total comprehensive income
<b>Balance as of January 1, 2005</b>								
<b>(Audited)</b>	40,561,026	\$ 11,548	\$ 274,432	\$ (4,742)	\$ 155,267	\$ (4,321)	\$ 432,184	
Exercise of options	405,598	88	3,423	-	-	-	3,511	
Tax benefit in respect of options exercised	-	-	652	-	-	-	652	
Stock based compensation	-	-	172	-	-	-	172	
Dividends paid	-	-	-	-	(21,631)	-	(21,631)	
Other comprehensive income (loss) net of tax:								
Unrealized gains on derivative instruments	-	-	-	6,412	-	-	6,412	\$ 6,412
Foreign currency translation differences	-	-	-	(924)	-	-	(924)	(924)
Minimum pension liability adjustment	-	-	-	(2,086)	-	-	(2,086)	(2,086)
Net income	-	-	-	-	32,487	-	32,487	32,487
Total comprehensive income								<u>\$ 35,889</u>
<b>Balance as of December 31, 2005</b>								
<b>(Audited)</b>	40,966,624	\$ 11,636	\$ 278,679	\$ (1,340)	\$ 166,123	\$ (4,321)	\$ 450,777	
Exercise of options	250,162	34	1,863	-	-	-	1,897	
Tax benefit in respect of options exercised	-	-	140	-	-	-	140	
Dividends paid	-	-	-	-	(11,801)	-	(11,801)	
Other comprehensive income (loss), net of tax:								
Unrealized losses on derivative instruments	-	-	-	(7,628)	-	-	(7,628)	\$ (7,628)
Foreign currency translation differences	-	-	-	52	-	-	52	52
Net income	-	-	-	-	29,539	-	29,539	29,539
Total comprehensive income								<u>\$ 21,963</u>
<b>Balance as of June 30, 2006</b>								
<b>(Unaudited)</b>	<u>41,216,786</u>	<u>\$ 11,670</u>	<u>\$ 280,682</u>	<u>\$ (8,916)</u>	<u>\$ 183,861</u>	<u>\$ (4,321)</u>	<u>\$ 462,976</u>	

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

**ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

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

	<u>Number of outstanding shares</u>	<u>Share capital</u>	<u>Additional paid-in capital</u>	<u>Accumulated other comprehensive income (loss)</u>	<u>Retained earnings</u>	<u>Treasury shares</u>	<u>Total shareholders' equity</u>	<u>Total comprehensive income (loss)</u>
<b>Balance as of January 1, 2005</b>								
<b>(Audited)</b>	40,561,026	\$ 11,548	\$ 274,432	\$ (4,742)	\$ 155,267	\$ (4,321)	\$ 432,184	
Exercise of options	184,685	42	1,545	-	-	-	1,587	
Tax benefit in respect of options exercised	-	-	484	-	-	-	484	
Stock-based compensation	-	-	-	-	-	-	-	
Dividends paid	-	-	-	-	(10,559)	-	(10,559)	
Other comprehensive income (loss):								
Unrealized gains on derivative instruments	-	-	-	293	-	-	293	\$ 293
Foreign currency translation differences	-	-	-	(615)	-	-	(615)	(615)
Net income	-	-	-	-	23,599	-	23,599	23,599
Total comprehensive income								<u>\$23,277</u>
<b>Balance as of June 30, 2005</b>								
<b>(Unaudited)</b>	<u>40,745,711</u>	<u>\$ 11,590</u>	<u>\$ 276,461</u>	<u>\$ (5,064)</u>	<u>\$ 168,307</u>	<u>\$ (4,321)</u>	<u>\$ 446,973</u>	
<b>Balance as of April 1, 2006</b>								
<b>(Unaudited)</b>	41,042,692	\$ 11,653	\$ 279,039	\$ (3,081)	\$ 174,773	\$ (4,321)	\$ 458,063	
Exercise of options	174,094	17	1,425	-	-	-	1,442	
Tax benefit in respect of options exercised	-	-	218	-	-	-	218	
Dividends paid	-	-	-	-	(5,983)	-	(5,983)	
Other comprehensive income (loss):								
Unrealized gains on derivative instruments	-	-	-	(5,840)	-	-	(5,840)	\$ (5,840)
Foreign currency translation differences	-	-	-	5	-	-	5	5
Net income	-	-	-	-	15,071	-	15,071	15,071
Total comprehensive income								<u>\$ 9,236</u>
<b>Balance as of June 30, 2006</b>								
<b>(Unaudited)</b>	<u>41,216,786</u>	<u>\$ 11,670</u>	<u>\$ 280,682</u>	<u>\$ (8,916)</u>	<u>\$ 183,861</u>	<u>\$ (4,321)</u>	<u>\$ 462,976</u>	

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



**ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

U.S. dollars (in thousands, except share data)

	<u>Number of outstanding shares</u>	<u>Share capital</u>	<u>Additional paid-in capital</u>	<u>Accumulated other comprehensive income (loss)</u>	<u>Retained earnings</u>	<u>Treasury shares</u>	<u>Total shareholders' equity</u>	<u>Total comprehensive income (loss)</u>
<b>Balance as of April 1, 2005</b>								
<b>(Unaudited)</b>	40,682,842	\$ 11,576	\$ 275,766	\$ (4,705)	\$ 162,661	\$ (4,321)	\$ 440,977	
Exercise of options	62,869	14	498	-	-	-	512	
Tax benefit in respect of options exercised	-	-	197	-	-	-	197	
Dividends paid	-	-	-	-	(5,263)	-	(5,263)	
Other comprehensive income (loss):								
Unrealized gains on derivative instruments	-	-	-	81	-	-	81	\$ 81
Foreign currency translation differences	-	-	-	(440)	-	-	(440)	(440)
Net income	-	-	-	-	10,909	-	10,909	10,909
Total comprehensive income								<u>\$ 10,550</u>
<b>Balance as of June 30, 2005</b>								
<b>(Unaudited)</b>	<u>40,745,711</u>	<u>\$ 11,590</u>	<u>\$ 276,461</u>	<u>\$ (5,064)</u>	<u>\$ 168,307</u>	<u>\$ (4,321)</u>	<u>\$ 446,973</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)

	Six months ended June 30,		Year ended December 31,
	2006	2005	2005
	(Unaudited)		(Audited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 29,539	\$ 23,599	\$ 32,487
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	28,130	24,102	57,718
Purchased in process R&D	-	-	7,490
Stock based compensation	-	-	172
Deferred income taxes	(3,515)	(1,804)	6,551
Accrued severance pay, net	(3,283)	(1,725)	(6,707)
Gain on sale of property and equipment	(1,160)	(304)	(731)
Tax benefit in respect of options exercised	140	484	652
Minority interests in earnings (losses) of subsidiaries	(77)	(273)	58
Equity in net losses (earnings) of affiliated companies and partnership, net of dividend received (*)	2,533	4,265	13,805
Changes in operating assets and liabilities:			
Decrease (increase) in short and long-term receivables and prepaid expenses	(14,819)	25,732	(43,420)
Increase in inventories	(45,706)	(63,529)	(43,679)
Increase (decrease) in trade payables, other payables and accrued expenses	50,647	(21,262)	(37,859)
Increase in advances received from customers	61,948	96,507	202,450
Settlement of royalties with the Office of the Chief Scientist	-	-	(1,371)
Other adjustments	(16)	45	-
Net cash provided by operating activities	104,361	85,837	187,616
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchase of property, plant and equipment	(26,314)	(30,017)	(58,735)
Acquisition of subsidiaries and businesses (Schedule A)	-	(318)	(28,331)
Investments in affiliated companies	(30,950)	(74,782)	(160,861)
Proceeds from sale of property, plant and equipment	3,020	1,001	2,712
Proceeds from sale of investment	-	3,100	3,100
Investment in long-term bank deposits	(261)	(551)	(1,089)
Proceeds from sale of long-term bank deposits	168	945	1,501
Short-term bank deposits, net	(1,158)	(458)	(4)
Net cash used in investing activities	(55,495)	(101,080)	(241,707)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from exercise of options	1,897	1,587	3,511
Repayment of long-term bank loans	(101,962)	(51,652)	(85,035)
Receipt of long-term bank loans	102,853	95,500	216,500
Dividends paid	(11,801)	(10,559)	(21,631)
Change in short-term bank credit and loans, net	(15,791)	113	524
Net cash provided by (used in) financing activities	(24,804)	34,989	113,869
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	24,062	19,746	59,778
<b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD</b>	93,887	34,109	34,109
<b>CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD</b>	<u>\$ 117,949</u>	<u>\$ 53,855</u>	<u>\$ 93,887</u>
* Dividend received	<u>\$ 6,147</u>	<u>\$ 4,138</u>	<u>\$ 12,169</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)

Six months ended June 30,		Year ended December 31,
2006	2005	2005
(Unaudited)		(Audited)

**SUPPLEMENTARY CASH FLOWS  
ACTIVITIES:**

Cash paid during the period for:

Income taxes	\$ 11,523	\$ 13,233	\$ 21,475
Interest	\$ 8,694	\$ 3,193	\$ 13,151

**SCHEDULE A:**

Subsidiaries and businesses acquired

Estimated net fair value of assets acquired and liabilities  
assumed at the date of acquisition:

Working capital, net (excluding cash and cash  
equivalents)

Property, plant and equipment	-	\$ (3,281)	\$ 39,273
Other long-term assets	-	-	(28,875)
Goodwill and other intangible assets	-	-	(74,363)
In-process R&D	-	(1,514)	(53,291)
Deferred income taxes	-	-	(7,490)
Long-term liabilities – mainly advances from customers	-	-	5,404
Minority interest	-	4,477	82,730
	-	-	8,281
	-	\$ (318)	\$ (28,331)

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

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

U. S. dollars (In thousands)

### Note 1 - GENERAL

- A. The accompanying financial statements have been prepared in a condensed format as of June 30, 2006, and for the six and three months then ended, in accordance with generally accepted accounting principles in the United States (U.S. GAAP) relating to the preparation of financial statements for interim periods. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP but which are not required for interim reporting purposes, have been condensed or omitted. See Note 4 for the reconciliation from U.S. GAAP to accounting principles generally accepted in Israel (Israeli GAAP).

These statements should be read in conjunction with the Company's annual financial statements and accompanying notes as of December 31, 2005.

The interim financial statements reflect all adjustments, which are, in the opinion of management, necessary for a fair presentation. All such adjustments were of a normal recurring nature. Reclassifications have been made to comparative data in the balance sheet as of December 31, 2005 in order to conform to the current year's presentation.

Operating results for the six and three months ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

- B. On May 31, 2006, the Company's U.S. subsidiary Kollsman, Inc. ("Kollsman") acquired a 20% interest in Sandel Avionics, Inc. ("Sandel") in consideration for \$12.5 million (represented by a \$10.5 million cash payment, a \$1 million subscription and payment of a bridge loan and a \$1 million holdback to be paid within 12 months). Sandel, based in Vista, California, produces specialized integrated display systems and other products for the commercial aviation market.

Kollsman has an option to buy the remaining 80% interest in Sandel for a period of 30 months after the initial investment. During the option period, Kollsman has the right to representation on the Sandel board of directors, as well as several specific minority rights. In addition, Kollsman and Sandel have formed an alliance to cooperate on product development and marketing.

Based on a purchase price allocation analysis ("PPA") performed by an independent advisor, the excess of the amounts paid for the Sandel shares over their book value was attributed as follows:

		<u>Expected useful lives</u>
In-Process R&D ("IPR&D")	\$ 1,200	immediate write-off
Technology and customers base	3,200	7 years
Deffered taxes	(1,300)	7 years
Goodwill	10,100	indefinite—subject to annual impairment test
Total excess of consideration over book value	<u>\$13,200</u>	

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

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

#### Note 1 - GENERAL (Cont.)

- C. On June 5, 2006, the Company acquired 4.37% of Tadiran Communication Ltd.'s ("Tadiran") outstanding shares in consideration for approximately \$18.3 million (of which \$13.5 million was paid on the acquisition date and the balance was paid in July 2006). Following the acquisition, the Company holds approximately 43% of Tadiran's shares.

Based on a PPA performed by an independent advisor, the excess of the amounts paid for the above mentioned Tadiran shares acquired over their book value was attributed as follows:

		<u>Expected useful lives</u>
IPR&D	\$ 1,000	immediate write-off
Inventory	300	up to a quarter
Other tangible assets and liabilities	100	5 years
Brand name	800	15 years
Customer base and backlog	4,000	2-12 years
Technology	2,400	10 years
Goodwill	3,300	indefinite—subject to annual impairment test
Total excess of consideration over book value	<u>\$11,900</u>	

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES

- A. The significant accounting policies followed in the preparation of these statements are identical to those applied in preparation of the latest annual financial statements, except for the adoption of FASB Statement No. 123 (revised 2004), "Share-Based Payments" ("Statement 123(R)") as follows:

Through December 31, 2005, the Company adopted the fair value based method of recording stock options for all employee stock option grants consistent with SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123"). Effective January 1, 2006, the Company adopted the provisions of Statement 123(R), using the modified prospective method. The adoption of Statement 123(R) did not have a material effect on the Company's financial position and results of operations.

- B. On June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also requires de-recognition of income tax assets and liabilities, and provides guidance on classification of current and deferred income tax assets and liabilities, interest and penalties associated with tax positions, accounting for income taxes in interim periods and income tax disclosures. This Interpretation is effective as of January 1, 2007. The Company is currently evaluating the impact of FIN 48 on its financial statements.
- C. The accompanying financial statements have been prepared in U.S. dollars since the U.S. dollar is the functional currency of the primary economic environment in which the operations of the Group (which includes Elbit Systems Ltd. and its subsidiaries) are conducted.

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

U. S. dollars (In thousands)

### Note 3 - INVENTORIES, NET OF ADVANCES

	<b>June 30, 2006 (Unaudited)</b>	<b>December 31, 2005 (Audited)</b>
Cost of long-term contracts in progress	\$ 353,334	\$ 311,800
Raw materials	91,338	84,343
Advances to suppliers and subcontractors	38,757	40,095
	<u>483,429</u>	<u>436,238</u>
Less - Cost incurred on contracts in progress deducted from customer advances	23,869	16,178
	<u>459,560</u>	<u>420,060</u>
Less -Advances received from customers	80,959	84,083
Provision for losses	9,034	7,549
	<u>\$ 369,567</u>	<u>\$ 328,428</u>

### Note 4 - RECONCILIATION TO ISRAELI GAAP

As described in Note 1, the Company prepares its financial statements in accordance with U.S. GAAP. See Note 23 to the 2005 annual financial statements for a description of the differences between U.S. GAAP and Israeli GAAP in respect to the Company. The effects of the differences between U.S. GAAP and Israeli GAAP on the Company's financial statements are detailed below.

#### A. Effect on net income

	<b>Three months ended June 30, 2006 (Unaudited)</b>	<b>June 30, 2005 (Unaudited)</b>	<b>Year ended December 31, 2005 (Audited)</b>
Net income as reported according to U.S. GAAP	\$ 29,539	\$ 23,599	\$ 32,487
Adjustments to Israeli GAAP	<u>2,027</u>	<u>(3,004)</u>	<u>(9,637)</u>
Net income according to Israeli GAAP	<u>\$ 31,566</u>	<u>\$ 20,595</u>	<u>\$ 22,850</u>

#### B. Effect on shareholders' equity

	<b>As reported</b>	<b>Adjustments</b>	<b>As per Israeli GAAP</b>
<b>As of June 30, 2006 (Unaudited)</b>			
Shareholders' equity	<u>\$ 462,976</u>	<u>(17,739)</u>	<u>\$ 445,237</u>
<b>As of December 31, 2005</b>			
Shareholders' equity	<u>\$ 450,777</u>	<u>(19,279)</u>	<u>\$ 431,498</u>

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**Elbit Systems Ltd.**  
**Management's Report**  
**For The Three and Six-Month Period Ended June 30, 2006**

This report should be read together with the unaudited financial statements for the quarter ended June 30, 2006 of Elbit Systems Ltd. ("Elbit Systems" or the "Company"), the Company's audited consolidated financial statements and related notes for the year ended December 31, 2005, the Company's management report for the year ended December 31, 2005 and the Company's Form 20-F for the year ended December 31, 2005, filed by the Company with the U.S. Securities and Exchange Commission 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 and its subsidiaries (the "Group") operate in the areas of aerospace, land and naval systems, command, control, communications, computers, intelligence, surveillance and reconnaissance ("C<sup>4</sup>ISR"), advanced electro-optic and space technologies, EW suites, airborne warning systems, ELINT systems, data links and military communications systems and equipment. The Group also focuses on the upgrading of existing military platforms and developing new technologies for defense and homeland security applications.

The Group provides support services for the platforms it upgrades as well as the systems and products it supplies. In addition, the Group provides a wide range of logistic support services, including operation of pilot training services for the Israeli Air Force on a private financing initiative basis. Several of the Group's companies also provide advanced engineering and manufacturing services to various customers, utilizing their significant manufacturing capabilities. The Group often cooperates with industries in Israel and in various other countries.

The Group 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 Group provides customers with cost-effective solutions, and its customers are able to improve their technological and operational capabilities within limited defense budgets.

The Group 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.

### **Financial Highlights**

The Company's revenues increased by 41% and reached \$344.8 million in the second quarter of 2006, as compared to \$243.8 million in the second quarter of 2005.

Net earnings in the second quarter of 2006 were \$15.1 million and the diluted earnings per share were \$0.36, as compared to \$10.9 million and \$0.26 in the second quarter of 2006.

The Company's results reflect In-Process Research and Development ("IPR&D") write-offs of \$2.2 million, related to the acquisitions of Tadiran Communications Ltd.'s ("Tadiran") and Sandel Avionics, Inc.'s ("Sandel") shares in the second quarter of 2006.

The Company's backlog increased by 7.5% and reached \$3.6 billion as of June 30, 2006, as compared to \$3.35 billion as of December 31, 2005.

The Company's cash flow generated from operations in the six-month period ended June 30, 2006 was \$104.3 million, as compared to \$85.8 million in the six-month period ended June 30, 2005.

The Board of Directors declared a dividend of \$0.15 per share for the second quarter.

### **B. Recent Events**

- On May 18, 2006, the Company announced that Vision Systems International LLC, ("VSI"), its joint venture with Rockwell Collins, was awarded several new contracts with a total value of more than \$80 million. The Boeing Company awarded VSI a contract for the delivery of more than 400 additional Joint Helmet Mounted Cueing Systems ("JHMCS"). VSI also received direct contracts from the United States Navy and Air Force for spares parts and test equipment in support of the JHMCS program.
- On June 28, 2006, the Company reported that EFW Inc., an Elbit Systems of America company, received a contract valued at approximately \$50 million from the U.S. Marine Corps Systems Command for the supply of military systems.
- Since July 12, 2006, the north of Israel has been effected by the on-going military conflict in the region. The Company has been operating continuously throughout the recent events, and continues to maintain its ability to meet its commitments to its international and Israeli customers. The Company is also supported as may be necessary by its domestic and international subsidiaries. Accordingly, the Company's plans for 2006 and beyond remain unchanged.

### **C. Backlog of Orders**

The Company's backlog of orders as of June 30, 2006 reached \$3,599 million, of which 74% was for orders outside Israel. The Company's backlog as of December 31, 2005 was \$3,347 million, of which 72% was for orders outside Israel.

Approximately 56% of the Company's backlog as of June 30, 2006 is scheduled to be performed in the following two quarters of 2006 and during 2007. The majority of the 44% of the Company's backlog balance is scheduled to be performed in 2008 and 2009.



**D. 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, 2005. See also the Company's management report for the year ended December 31, 2005.

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a more likely than not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also requires de-recognition of income tax assets and liabilities and provides guidance on classification of current and deferred income tax assets and liabilities, interest and penalties associated with tax positions, accounting for income taxes in interim periods and income tax disclosures. This Interpretation is effective as of January 1, 2007. The Company is currently evaluating the impact of FIN 48 on its financial statements.

**E. Acquisitions during the second quarter of 2006**

- On May 31, 2006, the Company's U.S. subsidiary, Kollsman, Inc. ("Kollsman") acquired a 20% interest in Sandel in consideration for \$12.5 million (represented by a \$10.5 million cash payment, a \$1 million subscription and payment of a bridge loan and a \$1 million holdback to be paid within 12 months). Sandel, based in Vista, California, produces specialized integrated display systems and other products for the commercial aviation market.

Kollsman has an option to buy the remaining 80% interest in Sandel for a period of 30 months after the initial investment. During the option period, Kollsman has the right to representation on the Sandel board of directors, as well as several specific minority rights. In addition, Kollsman and Sandel have formed an alliance to cooperate on product development and marketing.

Based on a purchase price allocation analysis ("PPA") performed by an independent advisor, the excess of the amounts paid for the Sandel shares over their book value was attributed as follows:

	<u>\$M</u>	<u>Expected useful lives</u>
IPR&D	1.2	immediate write-off
Technology and customers base	3.2	7 years
Deferred taxes	(1.3)	7 years
Goodwill	10.1	indefinite—subject to annual impairment test
Total excess of consideration over book value	<u>13.2</u>	

- On June 5, 2006, the Company acquired approximately 4.3% of Tadiran's outstanding shares in consideration for \$18.3 million (of which \$13.5 million was paid on the acquisition date and the balance was paid in July 2006). Following the acquisition, the Company holds approximately 43% of Tadiran's shares.

Based on a PPA performed by an independent advisor, the excess of the amounts paid for the above mentioned Tadiran shares acquired over their book value was attributed as follows:

	<u>\$M</u>	<u>Expected useful lives</u>
IPR&D	1.0	immediate write-off
Inventory	0.3	up to a quarter
Other tangible assets and liabilities	0.1	5 years
Brand name	0.8	15 years
Customer base and backlog	4.0	2-12 years
Technology	2.4	10 years
Goodwill	<u>3.3</u>	indefinite—subject to annual impairment test
Total excess of consideration over book value	<u>11.9</u>	

**F. Summary of Financial Results**

The following table sets forth the reported consolidated statements of operations of the Company for the three and six-month periods ended June 30, 2006 and June 30, 2005.

	For the six months ended June 30				For the three months ended June 30			
	2006		2005		2006		2005	
	\$	%	\$	%	\$	%	\$	%
	(In thousands of U.S. dollars except per share data)							
Total revenues	<b>679,185</b>	100.0	<b>474,470</b>	100.0	<b>344,815</b>	100.0	<b>243,782</b>	100.0
Cost of revenues	<b>502,067</b>	73.9	<b>346,821</b>	73.1	<b>255,237</b>	74.0	<b>177,695</b>	72.9
Gross profit	<b>177,118</b>	26.1	<b>127,649</b>	26.9	<b>89,578</b>	26.0	<b>66,087</b>	27.1
Research and development (R&D) expenses	<b>52,747</b>	7.8	<b>42,053</b>	8.9	<b>24,169</b>	7.0	<b>22,153</b>	9.1
Less – participation	<b>(12,958)</b>	(1.9)	<b>(9,092)</b>	(1.9)	<b>(5,818)</b>	(1.7)	<b>(4,358)</b>	(1.8)
R&D expenses, net	<b>39,789</b>	5.9	<b>32,961</b>	7.0	<b>18,351</b>	5.3	<b>17,795</b>	7.3
Marketing and selling expenses	<b>53,630</b>	7.9	<b>34,386</b>	7.2	<b>27,382</b>	7.9	<b>17,740</b>	7.3
General and administrative expenses	<b>37,727</b>	5.5	<b>25,424</b>	5.4	<b>18,720</b>	5.5	<b>12,652</b>	5.2
	<b>131,146</b>	19.3	<b>92,771</b>	19.6	<b>64,453</b>	18.7	<b>48,187</b>	19.8
Operating income	<b>45,972</b>	6.8	<b>34,878</b>	7.3	<b>25,125</b>	7.3	<b>17,900</b>	7.3
Finance expenses, net	<b>(10,918)</b>	(1.6)	<b>(3,197)</b>	(0.7)	<b>(6,677)</b>	(1.9)	<b>(1,465)</b>	(0.6)
Other income (expenses), net	<b>160</b>	-	<b>(185)</b>	-	<b>(748)</b>	(0.2)	<b>(354)</b>	-
Income before taxes on income	<b>35,214</b>	5.2	<b>31,496</b>	6.6	<b>17,700</b>	5.2	<b>16,081</b>	6.7
Taxes on income	<b>9,366</b>	1.4	<b>8,043</b>	1.7	<b>4,762</b>	1.4	<b>4,056</b>	1.7
	<b>25,848</b>	3.8	<b>23,453</b>	4.9	<b>12,938</b>	3.8	<b>12,025</b>	5.0
Minority interest in losses of subsidiaries	<b>77</b>	-	<b>273</b>	0.1	<b>786</b>	0.2	<b>53</b>	-
Equity in net earnings (losses) of affiliated companies and partnership	<b>3,614</b>	0.5	<b>(127)</b>	-	<b>1,347</b>	0.4	<b>(1,169)</b>	(0.5)
Net earnings	<b>29,539</b>	4.3	<b>23,599</b>	5.0	<b>15,071</b>	4.4	<b>10,909</b>	4.5
Diluted earnings per share	<b>0.71</b>		<b>0.57</b>		<b>0.36</b>		<b>0.26</b>	

## **Revenues**

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.

### **Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005**

The consolidated revenues increased by 41% from \$243.8 million in the second quarter of 2005 to \$344.8 million in the second quarter of 2006.

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

	Three-Month Period ended			
	June 30, 2006		June 30, 2005	
	\$ millions	%	\$ millions	%
Airborne systems	140.4	40.7	93.4	38.3
Land systems	57.0	16.5	33.2	13.6
C <sup>4</sup> ISR systems	68.5	19.9	44.1	18.1
Electro-optics	45.7	13.3	56.3	23.1
Other (mainly non-defense engineering and production services)	<u>33.2</u>	<u>9.6</u>	<u>16.8</u>	<u>6.9</u>
Total	<u>344.8</u>	<u>100.0</u>	<u>243.8</u>	<u>100.0</u>

The changes in revenues distribution by areas of operation, other than ordinary quarterly fluctuations, were in the area of C<sup>4</sup>ISR systems sales, which increased mainly as a result of the revenues derived from the Watchkeeper project in 2006. The revenues derived from Elisra are included in the Company's various areas of operation. Elisra's EW systems revenues are included in the Airborne systems area of operation. Electro-optics revenues decreased mainly as a result of temporary delay in some projects that the Company believes will be sold during 2006.

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

	Three-Month Period ended			
	June 30, 2006		June 30, 2005	
	\$ millions	%	\$ millions	%
Israel	119.3	34.6	77.9	31.9
United States	119.0	34.5	87.9	36.1
Europe	53.8	15.6	18.4	7.5
Other countries	<u>52.7</u>	<u>15.3</u>	<u>59.6</u>	<u>24.5</u>
Total	<u>344.8</u>	<u>100.0</u>	<u>243.8</u>	<u>100.0</u>

The changes in revenues by geographic distribution, other than standard quarterly fluctuations, were in the revenues from customers in Europe, due mainly as a result of the revenues derived from the Watchkeeper project in 2006.

Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

The Company's consolidated revenues increased by 43%, from \$474.5 million in the first six months of 2005 to \$679.2 million in the first six months of 2006.

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

	Six-Month Period ended			
	June 30, 2006		June 30, 2005	
	\$ millions	%	\$ millions	%
Airborne systems	279.1	41.1	194.4	41.0
Land systems	98.8	14.6	59.2	12.5
C <sup>4</sup> ISR systems	151.5	22.3	88.1	18.5
Electro-optics	89.8	13.2	99.5	21.0
Other (mainly non-defense engineering and production services)	<u>60.0</u>	<u>8.8</u>	<u>33.3</u>	<u>7.0</u>
Total	<u>679.2</u>	<u>100.0</u>	<u>474.5</u>	<u>100.0</u>

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

	Six-Month Period ended			
	June 30, 2006		June 30, 2005	
	\$ millions	%	\$ millions	%
Israel	213.5	31.4	145.1	30.6
United States	230.0	33.9	177.5	37.4
Europe	108.5	16.0	34.5	7.3
Other countries	<u>127.2</u>	<u>18.7</u>	<u>117.4</u>	<u>24.7</u>
Total	<u>679.2</u>	<u>100.0</u>	<u>474.5</u>	<u>100.0</u>

**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.

Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005

The Company's gross profit in the quarter ended June 30, 2006 was \$89.6 million as compared to \$66.1 million in the quarter ended June 30, 2005. The gross profit margin in the second quarter of 2006 was 26% as compared to 27.1% in the same period last year. The difference in the gross profit was as a result of the mix of programs generating revenues in the applicable periods, which included in the second quarter of 2005 certain programs with a relatively higher gross profit.

Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

The Company's gross profit in the six months ended June 30, 2006 was \$177.1 million as compared to \$127.6 million in the six months ended June 30, 2005. The gross profit margin in the six months ended June 30, 2006 was 26.1% as compared to 26.9% in the corresponding period of the previous year. The difference in the gross profit was the result of the mix of programs generating revenues in the applicable periods.

## **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 included programs which are coordinated with, and partially funded by, third parties, including the Israeli Ministry of Defense (“IMOD”), the Office of the Chief Scientist (“OCS”) and bi-national and European Development funds. The R&D was performed in all major areas of core technological activities of the Company and mainly in the areas of advanced airborne systems, cutting edge electro-optics technology and products for surveillance, aerial reconnaissance, lasers, space based sensors and homeland security technologies and products.

### **Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005**

Gross R&D expenses in the quarter ended June 30, 2006 totaled \$24.2 million (7.0% of revenues), as compared to \$22.2 million (9.1% of revenues) in the quarter ended June 30, 2005.

Net R&D expenses (after deduction of third party participation) in the quarter ended June 30, 2006 totaled \$18.4 million (5.3% of revenues), as compared to \$17.8 million (7.3% of revenues) in the quarter ended June 30, 2005.

### **Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005**

Gross R&D expenses in the six months ended June 30, 2006 totaled \$52.7 million (7.8% of revenues), as compared to \$42.1 million (8.9% of revenues) in the six months ended June 30, 2005.

Net R&D expenses (after deduction of third party participation) in the six-month period ended June 30, 2006 totaled \$39.8 million (5.9% of revenues), as compared to \$33.0 million (7.0% of revenues) in the six-month period ended June 30, 2005.

## **Marketing and Selling Expenses**

The Company maintains its activities in developing new markets and pursues at any given time various business opportunities according to the Company’s plan.

### **Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005**

Marketing and selling expenses in the quarter ended June 30, 2006 were \$27.4 million (7.9% of revenues), as compared to \$17.8 million (7.3% of revenues) in the quarter ended June 30, 2005.

### **Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005**

Marketing and selling expenses in the six months ended June 30, 2006 were \$53.6 million (7.9% of revenues), as compared to \$34.4 million (7.2% of revenues) in the six months ended June 30, 2005.

## **General and Administrative (“G&A”) Expenses**

### **Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005**

G&A expenses were \$18.7 million (5.5% of revenues) in the quarter ended June 30, 2006, as compared to \$12.7 million (5.2% of revenues) in the quarter ended June 30, 2005.

Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

G&A expenses were \$37.7 million (5.5% of revenues) in the six months ended June 30, 2006, as compared to \$25.4 million (5.4% of revenues) in the six months ended June 30, 2005.

**Finance Expense (Net)**

The increase in the net finance expense resulted mainly from a higher level of long-term loans and an increase in market interest rates.

Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005

Net finance expense in the quarter ended June 30, 2006 was \$6.7 million, as compared to \$1.5 million of finance expense in the quarter ended June 30, 2005.

Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

Net finance expense in the six months ended June 30, 2006 was \$10.9 million, as compared to \$3.2 million of finance expense in the six months ended June 30, 2005.

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

Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005

Provision for taxes in the quarter ended June 30, 2006 was \$4.8 million (effective tax rate of 26.9%), as compared to a provision for taxes of \$4.1 million (effective tax rate of 25.2%) in the quarter ended June 30, 2005.

Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

Provision for taxes in the six months ended June 30, 2006 was \$9.4 million (effective tax rate of 26.6%), as compared to a provision for taxes of \$8.0 million (effective tax rate of 25.5%) in the six months ended June 30, 2005.

**Company's Share in Earnings of Affiliated Entities**

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, airborne systems and communications.

The Company's share in earnings of affiliated entities includes IPR&D write-offs of \$2.2 million, related to the acquisition of Tadiran's and Sandel's shares in the second quarter of 2006. The Company's share in earnings of affiliated entities in 2005 includes a \$3.5 million IPR&D write-off related to the acquisition of Tadiran's shares in the second quarter of 2005.

#### Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005

In the second quarter of 2006 the Company had net income of \$1.3 million from its share in earnings of affiliated companies and partnership, as compared to net expense of \$1.2 million in the second quarter of 2005.

#### Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

In the six months ended June 30, 2006 the Company had net income of \$3.6 million from its share in earnings of affiliated companies and partnership, as compared to net expense of \$0.1 million in the six months ended June 30, 2005.

#### **Net Earnings and Earnings Per Share ("EPS")**

##### Three Months Ended June 30, 2006, Compared to Three Months Ended June 30, 2005

Net earnings in the quarter ended June 30, 2006 were \$15.1 million (4.4% of revenues), as compared to reported net earnings of \$10.9 million (4.5% of revenues) in the quarter ended June 30, 2005. Diluted EPS in the quarter ended June 30, 2006 was \$0.36, as compared to \$0.26 in the quarter ended June 30, 2005.

The number of shares used for computation of diluted EPS in the quarter ended June 30, 2006 was 41,808 thousand shares, as compared to 41,617 thousand shares in the quarter ended June 30, 2005.

##### Six Months Ended June 30, 2006, Compared to Six Months Ended June 30, 2005

Net earnings in the six months ended June 30, 2006 were \$29.5 million (4.3% of revenues), as compared to net earnings of \$23.6 million (5.0% of revenues) in the six months ended June 30, 2005. Diluted EPS in the six months ended June 30, 2006 was \$0.71, as compared to \$0.57 per share in the six months ended June 30, 2005.

The number of shares used for computation of diluted EPS in the six months ended June 30, 2006 was 41,772 thousand shares, as compared to 41,617 thousand shares in the six months ended June 30, 2005.

Net earnings in 2006 include \$2.2 million in IPR&D write-offs, related to the acquisitions of Tadiran's and Sandel's shares in the second quarter of 2006. Net earnings in 2005 include \$3.5 million in an IPR&D write-off, related to the acquisition of Tadiran's shares in the second quarter of 2005.

#### **G. Liquidity and Capital Resources**

The Company's net cash flow generated from operating activities in the six months ended June 30, 2006 was \$104.4 million, resulting mainly from net income and advances received from customers. The cash inflows were partially offset, mainly by an increase in inventories.

Net cash flow used for investment activities in the six months ended June 30, 2006 was \$55.5 million, which was used mainly for acquisition of Tadiran's and Sandel's shares and purchase of various assets and equipment.



Net cash flow used for financing activities in the six months ended June 30, 2006 was \$24.8 million, which was mainly for dividends paid and decrease in short-term bank credit and loans.

On June 30, 2006, the Company had total borrowings in the amount of \$247.7 million, including \$219.1 million in long-term loans, and \$722.8 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 June 30, 2006, the Company had a cash balance amounting to \$117.9 million.

As of June 30, 2006, the Company had working capital of \$185.3 million, and its current ratio was 1.26.

#### **H. 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 related to NIS, based on market conditions.

On June 30, 2006, the Company's liquid assets were comprised of bank deposits, and it had no investments in liquid equity securities that were subject to market fluctuations, except for its shareholdings in Tadiran. The Company's deposits and loans are based on variable interest rates, and their value as of June 30, 2006 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 the liabilities and the return on the assets that are based on variable rates.

The Company's functional currency is the U.S. dollar. On June 30, 2006, the Company had exposure due to liabilities denominated in NIS of \$83 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 June 30, 2006 by forward contracts and options. On June 30, 2006, the Company had forward contracts for the sale and purchase of such foreign currencies totaling \$344 million (\$136 million in Euro, \$200 million in GBP and \$8 million in other currencies). The financial derivative activities in the second quarter of 2006 resulted in an unrealized net loss of approximately \$9.1 million, which was recorded as other comprehensive loss.

On June 30, 2006, the Company had options for hedging future cash flow denominated in NIS in the amount of \$6 million. The fair market value of the options as of June 30, 2006 was not material.

#### **I. Dividends**

The Board of Directors declared on August 7, 2006 a dividend of \$0.15 per share.

\* \* \* \* \*