

**Remark:**

For the reader's information, it is important to state that the said report is a translation of the original one in Hebrew and there might be some misinterpretations.

**The Board of Directors Report**  
**on Corporate Affairs**  
**for the Year of Report Ended December 31, 2009**

**Payton Industries Ltd. and its consolidated companies**

**The Board of Directors Report**  
**on Corporate Affairs**  
**for the year of report ended December 31, 2009**

We are honored to present the Statement of the Board of Directors on the State of Affairs of Payton Industries Ltd. and its consolidated companies for the year ended December 31, 2009

The Statement was drawn up in conformity with the Securities Regulations (Periodic and Immediate Reports) 5730 – 1970.

**a. Financial status**

**1. Significant changes in balance sheet items**

**a. General**

Payton Planar prepares its statements on a USD (“**United States Dollar**”) basis, and its assets and liabilities items are consolidated with the financial statements of Payton Industries while being translated into the USD exchange rate at the end of the period of report. Changes in the USD exchange rate compared to the New Israeli Shekel (“**NIS**”) cause a decrease or an increase in the assets and liabilities of Payton Planar while being translated into NIS in the balance sheet of Payton Industries.

**b. Significant changes in balance sheet items as at December 31, 2009 compared to December 31, 2008**

- ◆ Increase in cash, in securities held for trading and in short term deposits at a total amount of NIS 1,159 thousands. In addition, the said increase does not include an amount of NIS 7,601 thousands which is presented under long term deposits (see below).
- ◆ Decrease of NIS 5,268 thousands in trade receivables which stems mainly from Payton Planar (NIS 4.7 million) due to a decline in the average credit of trade receivables and a decrease in sales (close to the balance sheet date) in Payton Technologies.
- ◆ On December 31, 2009, long term deposits totaled NIS 7,601 thousands and they are tri-annual deposits with once-a-year exit stations.
- ◆ Securities available for sale (long term) – an increase of NIS 506 thousands as a result of an increase in their fair value. See also Clause

c below with respect to the use of a fair value valuation as a basis for determining the value of the securities available for sale.

- ◆ Dividend payable – on November 26, 2009, the Company's Board of Directors decided on the distribution of an interim dividend in the amount of USD 1,360 thousands (USD 0.20 per share which were actually paid in January 2010). In addition, on the same date, the Board of Directors of the Subsidiary decided on a distribution of a dividend in the amount of USD 1,679 (USD 0.095 per share which were actually paid in January 2010), out of which approximately 66% are a commitment for paying the dividend to the Parent Company and therefore are not reflected in the Company's consolidated balance sheet.

On January 2010, the said dividends were approved in the general meetings as a final dividend.

- ◆ Decrease in current tax liabilities in the amount of NIS 1,808 which is mainly a result of paying an income tax liability accumulated for 2007 (in the amount of approximately NIS 2.3 millions) which was actually paid in May 2009.
- ◆ Increase in long-term benefits for employees totaled NIS 579 thousands. The estimation of the said liability is based on an actuary assumption. The said increase in liabilities is mainly a result of an acute decline of the market interest according to which the current value of the future liabilities is capitalized. See also Note 15 to the financial statements.

**c. Use of fair value evaluation as a basis to determine the value of securities available for sale**

Auction Rate Securities (hereinafter: "ARS") is a type of an American security issued for long term periods (highly above 10 years) by local authorities, academic institutions and others for the securitization of their assets. The interest on the said securities varies and is determined once every 7 or 28 days in an auction. On the auction day, the investor can continue and hold the security's nominal value, should the offered interest be in line with its expectations or, alternately, sell the ARS (should a buyer be found).

As from 2008, due to the liquidity crisis encountered by the US capital market and due to the failure of such securities in auctions, the Company decided on implementing a fair value evaluation for the remaining ARS it holds.

In accordance with the fair value evaluation received by Payton Planar as at December 31, 2009, it was determined that the fair value of the ARS held thereby was estimated at USD 2,813 thousands (NIS 10,621 thousands); as at December 31, 2008 – USD 2,660 thousands (NIS 10,115

thousands). The nominal value of the said securities is USD 2,975 thousands. The Company carries its share in the change of the fair value to the capital fund. According to the fair value evaluation, the change in the fair value of the aforementioned securities stems from changes in market conditions and in liquidity and not from financial difficulties or liquidity problems of the issuer of the instrument.

As at December 31, 2008 and 2009, the said ARS were presented in the 'Long term securities available for sale' item at their fair value due to the liquidity crisis encountered by the American market which, in the Company's opinion, does not enable their short-term practical exercise and due to the Company's decision to wait for an additional increase of the nominal value or approximate thereto.

Nevertheless, in March 2010, subsequent to the date of the financial statements, the Company accepted an offer to sell one of the securities held thereby. As at December 31, 2009, the fair value of the said security was estimated at USD 950 thousands (NIS 3,586 thousands) compared to its nominal value – USD 1,000 thousands (NIS 3,775 thousands). In March 2010, the said security was sold for USD 961 thousands.

As set forth in Regulation 8B, Sub-Regulation 5, the provisions mentioned above will be expressed in the table:

1	Identifying the valuation	Securities available for sale
2	Timing of the valuation	The valuation relates to the value of the securities as at December 31, 2009.
3	The value of the subject of the valuation is close to the date of the valuation, if the generally accepted accounting principles, including depreciation and amortizations, did not require the change of its value in accordance with the fair value evaluation	The nominal value of the ARS is USD 2,975 thousands, i.e., NIS 11,231 thousands (based on the new rate dated December 31, 2009).
4	The value of the subject of the valuation determined according to the valuation	The fair value of the ARS securities is USD 2,813 thousands, i.e., NIS 10,621 thousands (based on the new rate dated December 31, 2009).

5	Identifying and characterizing the valuator	<p>Houlihan Smith &amp; Company Inc., a company for investment banking specializing in providing valuations of assets and financial valuations to private and public companies. Houlihan Smith implemented fair value evaluation with respect to ARS securities for a number of the large companies traded in NYSE, AMEX and NASDAQ.</p> <p>The valuator of assets and the Company do not depend on each other.</p> <p>In the engagement agreement with the valuator of assets there is a limited indemnification clause. The indemnification does not apply on the Company's claims against the valuator of assets due to third party claims with respect to the validity and the correctness of the valuation. In any event, no indemnification will apply in cases of negligence, illegal affairs, malice, etc., caused by the valuator.</p>
6	The valuation model according to which the valuator of assets acted	<p>The valuation was implemented according to a trinomial model based on a probability tree which takes into account probabilities with respect to a number of natural situations where in every situation a separate calculation of value is prepared under the Cash Flow Capitalization (DFC) method. The trinomial model takes into account the following probabilities:</p> <ul style="list-style-type: none"> <li>▪ Probability for success in an auction (and selling the ARS instrument).</li> <li>▪ Probability for insolvency.</li> <li>▪ Probability for failure in an auction (which will cause higher interest payments).</li> </ul> <p>Each probability in the trinomial model presents a different result which was capitalized to the date of the fair value evaluation through a capitalization rate estimated by the valuator.</p>
7	The assumptions according to which the valuator of assets implemented the valuation	<p>Under its work, the valuator made assumptions which related to the following subjects:</p> <ul style="list-style-type: none"> <li>▪ Quality of collateral</li> <li>▪ The complexity level of the financial instrument.</li> <li>▪ The extra interest payments paid in the event of failure in the auction.</li> <li>▪ Recovery rate – the share from the nominal value to be repaid to the investors in case of insolvency.</li> <li>▪ The capitalization rate implemented in the trinomial model.</li> </ul>

See also Note 7 to the financial statements.

## 2. Exposure of currency

### a. Data on linkage terms

1. All the Group's sales in the period of report are linked from the order date to the shipment date as follows:

1-12 / 09	1-12 / 08	1-12 / 09	1-12 / 08	1-12 / 09	1-12 / 08
\$ linked		Euro linked		Other linkage	
About 89%	About 87%	About 10%	About 12%	About 1%	About 1%

2. The following are the costs of raw materials purchased by the Group during the period of report – in percentages according to linkage bases:

Euro	\$	Other
4%	93%	3%

3. The following are data which relate to assets and liabilities according to linkage bases as at December 31, 2009 and as reflected in Note 18 to the financial statements with respect to the linkage terms of financial balances:

- a. Total assets, net, linked to the US dollar, totaled NIS 64,791 thousands.
- b. Total assets, net, linked to the Euro, totaled NIS 4,428 thousands and comprise mainly cash balance and debt of trade receivables.
- c. Total liabilities in NIS (unlinked), net, totaled NIS 781 thousands and comprise, inter alia, liabilities to trade account payables less liabilities to vendors and other payables.

It will be clarified that liabilities quoted in NIS for benefits to employees and current taxes are not defined as financial liabilities and therefore are not included in the balance of assets in NIS (unlinked), net.

- d. Total liabilities, net, linked to other foreign currencies, totaled NIS 549 thousands which mainly comprise a cash balance.

**b. Quality report with respect to exposure to market risks and their way of management**

1. *The person in charge of market risks in the Corporation:* Michal Lichtenstein, VP Finance.

2. *Detailed description of market risks which the Corporation is exposed to:*

2.1 General – the Group's operations are managed by two main branches:

2.1.1 Payton Planar and a company consolidated therewith – Payton America – manage their businesses on a USD basis and report on a USD basis.

2.1.2 Payton Technologies reports according to the reported NIS basis.

2.2 Interest risks – exposing the Corporation in relation to the change in the relevant interest rate mainly with respect to dollar deposits.

Most of the Group's funds are held in USD bank deposits, and therefore they are exposed to the change in the interest rates as updated by the banks from time to time.

2.3 Currency risks – the Group is exposed in two areas:

2.3.1 In the balance sheet – as at December 31, 2009, the Group was mainly exposed to a NIS-USD revaluation with respect to a balance of NIS 64,791 thousands.

2.3.2 In the statement of income –

2.3.2.1 Payton Technologies – most of the sales of Payton Technologies are priced on the dollar basis and are translated into NIS when the sales invoice is issued and the credit term period of the customers is in NIS. Therefore, Payton Technologies is exposed to a revaluation in NIS-USD exchange rate during the period of the customers' credit. A major part of the products purchased by Payton Technologies is in USD and is paid in USD.

In addition, with respect to the inventory in Payton Technologies, as its major part is purchased in USD or in prices linked thereto, Payton Technologies is exposed to changes in the USD exchange rate for the period of the consumption of its inventory.

2.3.2.2 Payton Planar – some of the purchases carried out by Payton Planar from vendors in Israel are priced on the USD basis but translated into NIS on the date of issuing the purchase invoice. Here, Payton Planar is exposed to the NIS-dollar revaluation.

2.3.2.3 Most payroll expenses in the Payton Group are in NIS. Therefore, in Payton Planar, whose functional currency of operation is USD, the revaluation in the NIS-USD representative rate causes a relative increase in labor costs.

2.4 Description of the Corporation's policy with respect to managing market risks:

The Company takes a number of actions in order to reduce the exposure to the aforementioned risks:

2.4.1 The main hedging of the currency risks is inherent in the way the Company manages its current activities. The Group conducts its business on a dollar basis and prices both its sales and its purchases on that basis.

2.4.2 From time to time, the Group uses financial derivatives which are not recognized from the accounting aspect for purposes of hedging payroll costs and other NIS costs.

2.4.3 The Group's CEO makes decisions with respect to the way of treating exposures and hedging, while consulting with the person in charge.

2.4.4 Supervision of the market risks management policy – the Company's Management makes decisions with respect to managing market risks and investments of liquid funds, and, from time to time, it is presented to the Board of Directors for discussion and decision making.

**3. *Linkage bases report***

See Note 18 to the financial statements.

#### 4. *Maximum holding of derivatives and positions from derivatives:*

Positions in derivatives as at December 31, 2009

The Company has two open future option transactions as at the balance sheet date:

<b>Purchasing* / Writing</b>	<b>CALL currency</b>	<b>CALL amount</b>	<b>PUT currency</b>	<b>PUT amount</b>	<b>Expiration date</b>	<b>Market value (NIS)</b>
Writing	USD	250,000	NIS	962,500	February 5, 2010	(2,984)
Purchasing	NIS	950,000	USD	250,000	February 5, 2010	13,862

\* Options for hedging purposes – are not recognized from the accounting aspect.

Effective as of December 31, 2008, the Company did not have open positions in the derivatives.

#### Maximum holding of the derivatives

In the year of report, the highest value of the total PUT options in the derivatives is approximately NIS 6 millions (USD 1.5 millions).

#### 5. *Sensitivity tests:*

##### Sensitivity to changes in the NIS / \$ exchange rate

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	+10%	+5%		-5%	-10%
	4.153	3.964	3.775	3.586	3.398
	NIS / \$	NIS / \$	NIS / \$	NIS / \$	NIS / \$
Exposure in linkage balance*	6,479	3,240	64,791	(3,240)	(6,479)
PUT option (purchasing)	-	-	14	54	101
CALL options (writing)	(76)	(29)	(3)	-	-

\* The major part of the income / (loss) is carried to shareholders' equity and part thereof - to income and loss. See Note 18 to the Financial Reports.

Sensitivity to changes in the NIS / € exchange rate

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	+10%	+5%		-5%	-10%
	5.986	5.714	5.442	5.170	5.898
	NIS / €	NIS / €	NIS / €	NIS / €	NIS / €
Exposure in linkage balance*	443	221	4,428	(221)	(443)

\* The major part of the income / (loss) is carried to shareholders' equity and part thereof - to income and loss. See Note 18 to the Financial Reports.

Sensitivity to changes in the USD interest rate

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	10% increase in interest rate	5% increase in interest rate		5% decrease in interest rate	10% decrease in interest rate
	1.62%	1.55%	1.48%	1.4%	1.33%
Short-term bank deposits in USD*	25	13	17,110	(13)	(25)

\* The balance does not include deposits for a term shorter than 3 months (presented in cash and cash equivalents).

	Income (loss) from changes		Fair value	Income (loss) from changes	
	10% increase in interest rate	5% increase in interest rate		5% decrease in interest rate	10% decrease in interest rate
	2.75%	2.63%	2.5%	2.38%	2.25%
Long-term bank deposits in USD**	19	10	7,601	(10)	(19)

\*\* See Note 8 to the financial statements.

As a result of the financial crisis in the global markets (see Chapter 2 – Clause 2b to the Corporate Business Description), the interest rate paid for USD deposits acutely declined. Effective as of the date of writing the said report, the USD Labor interest for three months declined from an average level of approximately 4% in 2008 to approximately 1.22% in 2009.

Sensitivity to changes in the NIS interest rate

As at December 31, 2009, the Group has a balance of daily bank deposits which bear interest of NIS 691 thousands. Therefore, the effect of the changes in the NIS interest rate is negligible.

Sensitivity to changes in securities held for trading (in USD)\*\*:

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	10% increase in interest rate 6.05%	5% increase in interest rate 5.78%		5% decrease in interest rate 5.23%	10% decrease in interest rate 4.95%
Securities held for trading in USD	(35)	(17)	6,352	17	35

\*\* Securities are mainly composed of USD Bonds and of USD "Preferred Stocks" with an assured return rate, the volatility in the value of which is mainly derived from changes in the interest of the USD market.

Sensitivity to changes in securities available for sale (in USD)\*\*\*:

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	10% increase in interest rate 1.90%	5% increase in interest rate 1.82%		5% decrease in interest rate 1.64%	10% decrease in interest rate 1.56%
Securities available for sale in USD	(18)	(9)	10,621	9	18

\*\*\* The aforementioned securities are composed of Auction Rate Securities (ARS). See comprehensive explanation in Clause a.1.c mentioned above - "Use of fair value evaluation as a basis to determine the value of securities available for sale" and Note 7 to the Financial Statements.

### **3. Critical accounting estimates**

Due to the preparation of the financial statements in accordance with accepted accounting principles, the Company's Management is obligated to carry out estimates which affect the reported values of the assets, liabilities, income and expenses, conditional assets and contingent liabilities.

The Company's estimates are based on past experience and on additional factors, which, in its opinion, are relevant considering the circumstances of the matter. The actual results may be difference from these estimates under different assumptions or conditions.

The Company did not identify critical accounting estimates which should be particularly detailed.

**b. Operational results**

**Payton Industries Ltd.**  
**Condensed Consolidated Quarterly Income Statements**  
**Reported Amounts, in NIS thousands**

	<b>Annual 2009</b>	<b>Annual 2008</b>	<b>Quarter of 10-12 / 09</b>	<b>Quarter of 7-9 / 09</b>	<b>Quarter of 4-6 / 09</b>	<b>Quarter of 1-3 / 09</b>
Sales revenues	64,067	63,963	16,159	17,529	17,172	13,207
Cost of sales	40,593	40,239	10,315	11,011	10,784	8,483
Gross profit	<u>23,474</u>	<u>23,724</u>	<u>5,844</u>	<u>6,518</u>	<u>6,388</u>	<u>4,724</u>
Development costs	(2,595)	(2,536)	(623)	(700)	(678)	(594)
Selling & marketing expenses	(4,797)	(5,217)	(1,498)	(1,342)	(1,067)	(890)
General & administrative expenses	(9,544)	(8,617)	(2,867)	(2,312)	(2,307)	(2,058)
Other income (expenses)	8	23	-	-	1	7
Operating income	<u>6,546</u>	<u>7,377</u>	<u>856</u>	<u>2,164</u>	<u>2,337</u>	<u>1,189</u>
Financing income (expenses), net	2,427	768	430	900	1,360	(263)
Profit before income taxes	<u>8,973</u>	<u>8,145</u>	<u>1,286</u>	<u>3,064</u>	<u>3,697</u>	<u>926</u>
Income taxes	(2,024)	(1,956)	(246)	(870)	(1,105)	197
Net profit for the year / period	<u>6,949</u>	<u>6,189</u>	<u>1,040</u>	<u>2,194</u>	<u>2,592</u>	<u>1,123</u>
Attributed to:						
Company's capital holders	4,774	4,362	713	1,398	1,816	847
Minority rights	2,175	1,827	327	796	776	276
	<u>6,949</u>	<u>6,189</u>	<u>1,040</u>	<u>2,194</u>	<u>2,592</u>	<u>1,123</u>

- 1. General** - the operational results of Payton Planar, the Subsidiary, and its consolidated companies were included in the Group's Income Statement in NIS while being translated into the USD exchange rate each quarter. The average exchange rate for the first, second, third and fourth quarters of 2008 was 4.058, 4.077, 3.830 and 3.765, respectively. The volatility of the exchange rate affected the presentation of the operational results of Payton Planar while being translated into NIS in the consolidated statements of Payton Industries.

It will be mentioned, that the average exchange rate in 2009 was NIS 3.933 per USD compared to an average exchange rate of NIS 3.588 per USD in 2008 (a 10% increase). The increase in the USD exchange rate affects the Group's operational results (see detailed explanation in the said chapter to the report, Clause 2.b.2 – "Detailed description of market risks which the Corporation is exposed to", mentioned above).

2. **Sales** – in 2009, the Group's sales maintained a level similar to previous year and totaled NIS 64,067 thousands compared to sales in the amount of NIS 63,963 thousands in 2008.

Sales are composed as follows:

	<b>2009</b>	<b>Δ%</b>	<b>2008</b>
Sales of Payton Planar (and its consolidated companies)	54,931	1%	54,582
Sales of the rest of the Group	9,136	(3%)	9381
Total	64,067	-	63,963

3. **Gross profit** – in 2009, the Group's gross profit totaled NIS 23,474 thousands (a rate of 37%). The aforementioned rate is identical with the gross profit of NIS 23,724 thousands in 2008.
4. **Sales and marketing expenses** – totaled NIS 4,797 thousands in 2009 (a rate of approximately 7% of sales) compared to NIS 5,217 in 2008 (a rate of approximately 8% of sales). In 2009, the decrease in the aforementioned expenses was mainly a result of a decrease in distribution commissions and in expenses of participation in exhibitions.
5. **General & administrative expenses** – totaled NIS 9,544 thousands in 2009 compared to NIS 8,617 thousands last year. The increase in the said expenses stemmed mainly from an increase in payroll-related expenses (severance pay) as a result of an increase of the actuary liability for severance pay due to the decline of the market interest for its capitalization and from an increase in incentives for the Group's employees.

### c. **Liquidity**

#### 1. **Cash flow from operating activities** –

The Group's cash flow provided by operating activities totaled NIS 10,468 thousands in 2009 compared to its cash flow provided by operating activities in the amount of NIS 7,729 thousands in 2008. The increase in cash provided by operating activities stemmed mainly from the decrease in trade receivables which was partly setoff by tax payments.

The following are financial ratios in the balance sheet:

	<b>December 31, 2009*</b>	<b>December 31, 2009*</b>
Current ratio	3.6	4.7
Quick ratio	3.1	4.1

\* As at December 31, 2009, a balance of NIS 7,601 thousands was reflected under long-term deposits. The said balance reflects tri-annual bank deposits with once-a-year exit stations (without fine).

## **2. Cash flow used for investing activities –**

In 2009, the Group has cash flow used for investing activities in the amount of NIS 10,354 thousands. During the aforementioned period, the cash was used mainly for an investment in long-term bank deposits and for the acquisition of fixed assets.

### **d. Directors with accounting and financial qualifications**

While taking into consideration the Group's volume of operations, the nature of the accounting and financial issues which arise during the preparation of the financial statements and the accounting support provided by the Company's accountants during the preparation of the financial statements, the Company decided that it needs one director with accounting and financial qualifications.

Mr. Ron Alkalay, whose level of qualifications is high and who has vast experience and understanding in accounting and business issues, is the Director who can be seen as the person with accounting and financial qualifications correct as of the date of signing this report.

### **e. Process of approval of financial statements**

The Company's Board of Directors is the organ responsible for the highest level of control.

In the framework of the procedure of the Board of Directors' approval of the financial statements, a few days before the regular meeting for the statements' approval takes place, a draft copy of the Company's financial statements, including the Statement of the Board of Directors, is transferred for the perusal of the members of the Board of Directors.

During the meeting of the Board of Directors, where the financial statements are discussed and approved, the Company's CEO and V.P. Finance review the key points of the financial statements as well as significant issues in financial reporting, data probability, accounting policy applied and changes implemented therein, should there be any, and the application of the principle of proper disclosure in the financial statements and the related information.

In the meeting of the Company's Board of Directors the directors receive answers to their questions.

The Company's auditors are invited and attend the meeting of the Board of Directors where the financial statements are discussed and approved. They also add their comments and clarifications with respect to the financial statements and stand at the disposal of the members of the Board of Directors for every question and clarification to these statements prior to their approval.

After the aforementioned discussion, a vote relating to the financial statements takes place.

e. **Effectiveness of internal audit**

In December 2009, the Securities Regulations (Periodic and Immediate Reports) (Amendment No. 3), 5790 – 2009 (hereinafter: "**The Regulations**") were published with respect to the effectiveness of the internal audit on the financial report and the disclosure. The said regulations commenced on the periodic report as at December 31, 2010, while providing a disclosure on the details of the Company's organization and advancement while implementing the directives of the aforementioned regulations in the Board of Directors Reports during 2010.

In the second half of the year, the Company prepares for the implementation of the directives of the said regulations and for that purpose it set an implementation organization plan.

The Company appointed Michal Lichtenstein, VP Finance, as the factor in the Company responsible for the implementation of the project.

Under the plan, the subsidiaries to be included in the project, proceedings in the Company which are extremely material to the financial report and the disclosure and material items in the Company's consolidated financial statements were mapped. The Company's Board of Directors held a discussion with respect to the Company's organization in accordance with the said regulations.

Under the organization for the implementation of the regulations, an evaluation of the effectiveness of the internal audit will be carried out in the following areas:

- Audits in the Organization level
- Process of closing the financial statements
- General controls of the information system
- Examination of the Company's material business processes

For the purpose of determining the processes extremely material for the financial report and the disclosure, quantity- and quality-related criteria were taken into account. The main criteria used by the Company for mapping the extremely material processes were, inter alia:

- The level of discretion used during the measurement and estimation process
- The complexity level of the process and the level of expertise required to process the information
- The complexity level of the infrastructure of the information systems used by the process
- The latent risk level for embezzlements and frauds and/or errors in the process

- The risk level for errors or a material misrepresentation in the financial report and the disclosure
- The qualifications of the people engaged in the process
- The volume of movements going through the process
- Past experience with respect to the process

Based on the aforementioned criteria, the Company decided that the extremely material processes for the financial report are:

1. Finance Department – cash management process
2. Sales process
3. Inventory process.

The Company continues with the actions to organize toward compliance with the milestones mentioned in the regulations for 2010.

**g. Disclosure with respect to the Internal Auditor**

**Name of Auditor:** Daniel Assa

**Date of the beginning of his service:** April 14, 1997

**His qualifications:** Certified Public Accountant

**The Auditor is not an employee of the Corporation.** He was personally appointed by his Firm, "Daniel Assa, C.P.A." to provide internal auditing services.

**Scope of employment:** The extent of the services rendered to the Company by the Internal Auditor is approximately 200 hours.

**Audit plan:** The work plan is an annual plan, which was prepared by the Auditor while consulting with the Chairman of the Board of Directors. The plan was discussed in the Auditing Committee and received its approval.

The following factors are considered, inter alia, while deciding on the annual audit topics:

- Exposure to the risk of the topic
- Holding built-in controls in the aforementioned topic and the information available on the effectiveness or the weakness of these controls
- Findings of previous audits

- The managerial, operational or economic significance of the topic from the aspect of internal control

**Audit in investee corporations:** The audit plan relates to the Company and to investee companies as well as to activities which take place abroad. The Audit plan in the previous year (2008) focused on the Group's system of fixed assets and included control and audit with respect to the way of conduct, documentation, identification and maintenance of fixed assets. The audit plan for 2009 dealt with the examination of ways for optimizing costs for the Organization and the consideration for the employee with respect to social benefits granted to the Group's employees.

**Performing the audit:** The Internal Auditor reported to the Company that he performed the internal audit in accordance with the professional standards mentioned in the Internal Audit Law, 5752-1992

**Access to information:** The Internal Auditor received continuous and direct free access to data, to documents and to the Corporation's information systems, including financial data as mentioned in Section 9 to the Internal Audit Law, 5752-1992.

**Internal Auditor's report:** The audit reports are submitted in writing to the Chairman of the Board of Directors and the Company's CEO, the V.P. Finance and the Audit Committee.

**The Board of Directors evaluating the activities of the Internal Auditor:** In our opinion, the scope, the nature and the continuity of the activities of the Internal Auditor and his work plan are reasonable within the circumstances of the matter and the fulfillment of the main objectives of the Company's internal auditing are embedded therein.

**Internal Auditor's award:** In consideration for his work, the Company paid an award of NIS 40 thousands to the Internal Auditor. In the opinion of the Company's Board of Directors, the benefit is reasonable and it will not affect his professional discretion while performing the audit.

#### **h. Disclosure with respect to the fee of the Auditor**

The overall fee of the auditors is detailed below:

C.P.A. / Performer	Type of service	2009		2008	
		Fee in USD thousands	Hours	Fee in UDS thousands	Hours
KPMG Somekh Chaikin *	Auditing services and tax services	50	1,458	50	1,723
KPMG Somekh Chaikin	Consultation services	1	20	-	-
Ribotsky, Levine & Company CPAs (Florida)**	Auditing services and tax services	12	80	14	105

\* The detailed fee also includes the fee for consolidated companies in Israel.

\*\* The detailed fee is a fee for a second tier subsidiary in U.S.A. (Payton America Inc.).

#### **i. Independent directors**

Out of all directors, three independent directors (50%) hold positions in the Company. Under these circumstances, the Company decided not to adopt in its Articles a directive which relates to the rate of independent directors.

#### **j. Proceeds for interested parties and senior officeholders (Regulation 21)**

The Board of Directors estimates that the proceeds for senior officeholders are reasonable and fair as detailed in Regulation 21 to the additional details which are an integral part of the Company's 2008 periodic report, inter alia, while taking into account the contribution of each of the aforementioned officeholders to the Company.

#### **k. Effect of external factors subsequent to the balance sheet date**

There is an acute volatility in the exchange rate of the Euro and the USD against the NIS. As mentioned above, the Group manages most of its transactions on a dollar basis. Most of the Group's sales are carried out in dollars or linked thereto, which is also valid to most of the components of the Group's expenses. However, as most of the Group's payroll expenses and part of the other manufacturing costs are in NIS, the depreciation in the USD-NIS exchange rate causes an increase in the relative weight of these expenses in NIS. In addition, the high volatility of the USD rate causes instability while estimating the component of the expenses in NIS in the pricing.

To the best of the knowledge of the Group's Board of Directors, excluding the provisions mentioned above, no significant changes occurred under the effect of external factors and the ability to quantify them over and above the provisions detailed in the Statement of the Board of Directors for the year ended December 31, 2009.

**The Company's Board of Directors thanks the Group's employees and managers for the efforts invested in the promotion of the affairs of the Group.**

**Rishon LeZion, March 24, 2010**

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*David Yativ*  
*Chairman of the*  
*Board of Directors and*  
*the Company's CEO*

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*Michael Peretz*  
*Director*

**Consolidated Statements of Financial Position as at December 31**

	<b>Note</b>	<b>2009</b> <b>\$ thousands</b>	<b>2008</b> <b>\$ thousands</b>
<b>Current assets</b>			
Cash and cash equivalents	5	<b>31,883</b>	32,307
Marketable securities held for trading	6	<b>6,352</b>	4,770
Short-term deposits	8	<b>17,110</b>	17,109
Trade accounts receivable	9	<b>12,406</b>	17,674
Other accounts receivable	9	<b>661</b>	445
Current tax assets		<b>27</b>	103
Inventory	10	<b>9,611</b>	9,616
<b>Total current assets</b>		<b>78,050</b>	82,024
<b>Non-current assets</b>			
Long-term deposits	8	<b>7,601</b>	-
Marketable securities available for sale	7	<b>10,621</b>	10,115
Long-term investment	11	<b>1,312</b>	1,322
Property, plant and equipment, net	12	<b>7,336</b>	7,022
Deferred taxes	29	<b>898</b>	973
<b>Total non-current assets</b>		<b>27,768</b>	19,432
<b>Total assets</b>		<b>105,818</b>	101,456

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

**Consolidated Statements of Financial Position as at December 31 (cont'd)**

	Note	2009 \$ thousands	2008 \$ thousands
<b>Liabilities and equity</b>			
<b>Current liabilities</b>			
Trade payables	13	5,102	6,725
Other payables	14	3,078	2,712
Dividend declared	21,16	7,279	-
Current tax liabilities		4,370	6,178
Employee benefits	15	2,025	1,874
<b>Total current liabilities</b>		<b>21,854</b>	17,489
<b>Non-current liabilities</b>			
Long-term employee benefits	15	2,117	1,538
<b>Total non-current liabilities</b>		<b>2,117</b>	1,538
<b>Total liabilities</b>		<b>23,971</b>	19,027
<b>Equity</b>			
	16		
Share capital		12,403	12,403
Share premium		18,793	18,793
Foreign activity translation fund		(5,365)	(4,806)
Capital fund for available-for-sale assets		(352)	(758)
Accumulated earnings		30,342	30,703
<b>Total equity attributed to the parent company owner</b>		<b>55,821</b>	56,335
<b>Minority rights</b>		<b>26,026</b>	26,094
<b>Total equity</b>		<b>81,847</b>	82,429
<b>Total liabilities and equity</b>		<b>105,818</b>	101,456

David Yativ  
Chief Executive Officer and  
Chairman of the Board of Directors

Michael Peretz  
Director

Michal Lichtenstein  
V.P. Finance & CFO

March 24, 2010

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

**Consolidated Statements of Comprehensive Income for the year ended December 31**

	Note	2009 \$ thousands	2008 \$ thousands	2007 \$ thousands
Revenues from sales	22	<b>64,067</b>	63,963	88,720
Cost of sales	23	<b>(40,593)</b>	(40,239)	(45,865)
<b>Gross profit</b>		<b>23,474</b>	23,724	42,855
Development costs	24	<b>(2,595)</b>	(2,536)	(2,389)
Selling and marketing expenses	25	<b>(4,797)</b>	(5,217)	(6,541)
General and administrative expenses	26	<b>(9,544)</b>	(8,617)	(9,754)
Other income	27	<b>8</b>	23	1
<b>Operating income</b>		<b>6,546</b>	7,377	24,172
Finance income	28	<b>2,532</b>	1,635	2,461
Finance expenses	28	<b>(105)</b>	(867)	(716)
<b>Finance income, net</b>		<b>2,427</b>	768	1,745
<b>Profit before income taxes</b>		<b>8,973</b>	8,145	25,917
Income taxes	29	<b>(2,024)</b>	(1,956)	(4,093)
<b>Net profit for the year</b>		<b>6,949</b>	6,189	21,824
<b>Components of other comprehensive income</b>				
Foreign currency translation differences for foreign activity		<b>(839)</b>	(539)	(6,609)
Change, net in fair value of available-for-sale assets		<b>611</b>	(1,146)	-
<b>Total comprehensive income for the year</b>		<b>6,721</b>	4,504	15,215
<b>Net profit for the year attributed to:</b>				
Company's shareholders		<b>4,774</b>	4,362	15,039
Minority rights		<b>2,175</b>	1,827	6,785
<b>Net profit for the year</b>		<b>6,949</b>	6,189	21,824
<b>Total comprehensive income attributed to:</b>				
Company's shareholders		<b>4,621</b>	3,246	10,668
Minority rights		<b>2,100</b>	1,258	4,547
<b>Total comprehensive income for the year</b>		<b>6,721</b>	4,504	15,215
<b>Basic and diluted earnings per ordinary share (in NIS)</b>	30	<b>0.70</b>	0.64	2.21

The presentation of the statement of comprehensive income was changed as a result of the initial implementation of revised IAS 1 in these financial statements. See also Note 2E regarding changes in accounting policies.

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

**Consolidated Statement of Changes in Equity**

	Company's shareholders							
	Share capital	Share premium	Foreign activity translation fund	Capital fund for available-for-sale assets	Accumulated earnings	Total	Minority rights	Total Equity
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
<b>Balance at January 1, 2007</b>	12,403	18,793	(77)	-	18,490	49,609	20,289	69,898
Comprehensive income for the year	-	-	(4,371)	-	15,039	10,668	4,547	15,215
Dividend payable	-	-	-	-	(5,188)	(5,188)	-	(5,188)
<b>Balance at December 31, 2007</b>	12,403	18,793	(4,448)	-	28,341	55,089	24,836	79,925
Comprehensive income for the year	-	-	(358)	(758)	4,362	3,246	1,258	4,504
Dividend payable	-	-	-	-	(2,000)	(2,000)	-	(2,000)
<b>Balance at December 31, 2008</b>	12,403	18,793	(4,806)	(758)	30,703	56,335	26,094	82,429
Comprehensive income for the year	-	-	(559)	406	4,774	4,621	2,100	6,721
Acquisition of minority rights	-	-	-	-	-	-	(24)	(24)
Dividend declared by the Company	-	-	-	-	(5,135)	(5,135)	-	(5,135)
Dividend declared by an investee company	-	-	-	-	-	-	(2,144)	(2,144)
<b>Balance at December 31, 2009</b>	<b>12,403</b>	<b>18,793</b>	<b>(5,365)</b>	<b>(352)</b>	<b>30,342</b>	<b>55,821</b>	<b>26,026</b>	<b>81,847</b>

The presentation of the statement of changes in equity was changed as a result of the initial implementation of revised IAS 1 in these financial statements. See also Note 2E regarding changes in accounting policies.

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

**Consolidated Statements of Cash Flows for the year ended December 31**

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	<u>\$ thousands</u>	<u>\$ thousands</u>	<u>\$ thousands</u>
<b>Operating activities</b>			
Net profit for the year	<b>6,949</b>	6,189	21,824
Adjustments to reconcile net profit to net cash generated from operating activities:			
Depreciation	<b>1,235</b>	1,023	1,071
Income taxes	<b>2,024</b>	1,956	4,093
Loss (profit) from the realization of non-current assets	<b>2</b>	(23)	(1)
Income from the acquisition of minority rights	<b>(10)</b>	-	-
Finance income, net	<b>(1,635)</b>	(1,340)	(1,459)
	<b>8,565</b>	7,805	25,528
Decrease in trade receivables	<b>5,157</b>	865	6,354
(Increase) decrease in other account receivables	<b>(223)</b>	317	(355)
(Increase) decrease in inventory	<b>(77)</b>	(422)	75
(Decrease) increase in trade payables	<b>(1,476)</b>	9	(62)
Increase (decrease) in other account payables	<b>324</b>	65	(1,683)
Increase (decrease) in employee benefits	<b>746</b>	(1,795)	(844)
Interest received in cash	<b>1,211</b>	1,579	2,220
	<b>14,227</b>	8,423	31,233
Income tax payable	<b>(3,759)</b>	(694)	(364)
<b>Cash flows generated from operating activities</b>	<b>10,468</b>	7,729	30,869
<b>Investing activities</b>			
Acquisition of non-current assets	<b>(1,698)</b>	(2,298)	(4,375)
Acquisition of minority share	<b>(14)</b>	-	-
Investment in marketable securities available for sale	<b>-</b>	(3,622)	(12,623)
Investment in marketable securities held for trading	<b>(2,958)</b>	(2,704)	(6,681)
Proceeds from sale of marketable securities available for sale	<b>-</b>	3,765	-
Proceeds from sale of marketable securities held for trading	<b>1,714</b>	-	5,278
Proceeds from (investment in) short-term deposits	<b>143</b>	(5,425)	(3,484)
Investment in long-term deposits	<b>(7,569)</b>	-	-
Proceeds from realization of non-current assets	<b>28</b>	302	36
<b>Cash flows used for investing activities</b>	<b>(10,354)</b>	(9,982)	(21,849)
<b>Financing activities</b>			
Dividend payable	<b>-</b>	(2,000)	(5,188)
<b>Cash flows used for financing activities</b>	<b>-</b>	(2,000)	(5,188)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>114</b>	(4,253)	3,832
<b>Cash and cash equivalents at beginning of the year</b>	<b>32,307</b>	36,558	36,037
<b>Effect of exchange rate fluctuations on cash held</b>	<b>(538)</b>	2	(3,311)
<b>Cash and cash equivalents at end of the year</b>	<b>31,883</b>	32,307	36,558

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