



The Board of Directors Report
On Corporate Affairs
For the year of report ended December 31, 2007

Payton Industries Ltd. and its consolidated companies

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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 theyear ended December 31, 2007.

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, the Subsidiary, prepares its statements on a USD (“United Stats 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 – without relating to an actual change in those items. In 2007, there was a decline of 9% in the USD exchange rate compared to the NIS.

Due to the above-mentioned decline in the exchange rate, a decrease was presented in all the assets and liabilities items of Payton Planar while in the balance sheet of Payton Industries they are presented as translated into NIS.

b. Significant changes in balance sheet items as at December 31, 2007 compared to December 31, 2006

- ◆ Increase of NIS 14,590 thousands in marketable securities and short term deposits – due to an increase in the investment of Payton Planar in short term USD deposits and in foreign USD marketable securities .
- ◆ Decrease of NIS 7,784 thousands in trade accounts receivables – due to the decline in sales.
- ◆ Increase of NIS 2,714 thousands in fixed assets, the most of which stems from the investment in a building in Florida, U.S.A. – As

detailed in Chapter 3.i. to the Description of the Corporate Businesses Report.

- ◆ Decrease of NIS 746 thousands in trade accounts payable – mainly due to a decrease in trade payables linked to the USD (see Clause a. General, above).
- ◆ Decrease of NIS 197 thousands in accounts payable, which stemmed from a decrease in the balance of liabilities to employees and institutions with respect to a payroll of approximately NIS 1.5 million, the most of which was setoff due to an increase in liabilities to institutions (Income Tax) with respect to a liability to pay tax on the income of Payton Planar.

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 / 07	1-12 / 06	1-12 / 07	1-12 / 06	1-12 / 07	1-12 / 06
\$ linked		Euro linked		Other linkage	
About 89%	About 89%	About 10%	About 9%	About 1%	About 2%

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

Euro	\$	Other
3%	94%	3%

3. The following are data which relate to assets and liabilities according to linkage bases as at December 31, 2007 and as reflected in Note 16 to the financial statements with respect to the linkage terms of financial balances:

- a. Total assets, net, linked to the US dollar, aggregate NIS 67,842 thousands.
- b. Total assets, net, linked to the Euro, aggregated NIS 4,266 thousands and comprise mainly debt of trade receivables and cash balance.
- c. Total liabilities in NIS (unlinked), net, aggregated NIS 10,655 thousands and comprise, inter alia, liabilities to trade accounts payable, to employees and institutions for payroll and long term liabilities for severance pay.
- d. Total liabilities, net, linked to other currencies, aggregate NIS 100 thousands.

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:*
Lichtenstein Michael, V.P. 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, 2007, the Group was mainly exposed to a *NIS*-USD revaluation with respect to a balance of NIS 67,842 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 the USD, the revaluation in the NIS-USD representative rate causes a relative increase in labor costs.

The Group's management believes that hedging is inherently part of the Company's operational policy , and therefore it did not use derivatives as a tool for hedging.

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

2.4.1 The Group usually does not use financial derivatives for hedging purpose from considerations of cost versus utility.

2.4.2 The major part of the hedging of currency risks is embedded in the way the Group manages its current operations. The Groups manages its businesses on a USD basis and prices both its sales and its purchases according thereto.

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 16 to the financial statements.

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

During the period of report, the Company did not use financial derivatives.

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% 4.231 NIS / \$	+5% 4.038 NIS / \$		-5% 3.654 NIS / \$	-10% 3.461 NIS / \$
Exposure in linkage balance	6,784	3,392	-	(3,392)	(6,784)

Sensitivity to changes in the USD interest rate

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	Increase of 10% in interest rate 4.86%	Increase of 5% in interest rate 4.64%		Decrease of 5% in interest rate 4.2%	Decrease of 10% in interest rate 3.98%
Bank deposits in USD*	180	90	41,055	(90)	(180)

* Including deposits for a period shorter than 3 months (presented in cash and cash equivalents).

Sensitivity to changes in the NIS interest rate

As at December 31, 2007, the Group has a balance of bank deposits in NIS in the amount of NIS 251 thousands. Therefore, the effect of the changes in the NIS interest rate is negligible.

Sensitivity to changes in marketable securities (in USD)*:

In NIS thousands

	Income (loss) from changes		Fair value	Income (loss) from changes	
	Increase of 10% in interest rate 6.71%	Increase of 5% in interest rate 6.41%		Decrease of 5% in interest rate 5.8%	Decrease of 10% in interest rate 5.49%
Marketable securities in USD*	(85)	(43)	13,953	43	85

* 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 derived from changes in the interest of the USD market, and the effect of the changes in the Stock Exchange trade on their rates is estimated as minimal.

3. Adoption of International Financial Reporting Standards (IFRS)

In July 2006, the Israel Accounting Standards Board published Accounting Standard No. 29 "Adoption of International Financial Reporting Standards ("IFRS") (hereinafter – "Accounting Standard 29"). The Standard prescribes that companies which are subject to the Securities Law, 5728 – 1968 and are obligated to report in accordance with its regulations, the preparation of the financial statements will be based on the International Financial Reporting Standards (IFRS) as from the periods of report commencing on January 1, 2008.

The Standard prescribes that the Company should include the balance sheet data as at December 31, 2007 and the statement of income data for the year ended on that date in the notes to the annual financial statements as at December 31, 2007, after the IFRS rules of recognition, measurement and presentation were applied thereon.

It should be mentioned that the statements of Payton Planar, the Subsidiary, which is traded in the EuroNext Stock Exchange in Belgium are currently based on the IFRS. Yet due to the consolidation of its statements and their joint presentation with the consolidated data of Payton Industries, the effects of the application of IFRS become null and void and its results are presented in conformity with accounting standards generally accepted in Israel.

The Company's Management appointed Michal Lichtenstein, C.P.A., V.P. Finance, as the person in charge of the adoption process of the IFRS.

According to the Company's Management, the process will be carried out as follows:

Actions taken up to the date of the publication of the annual financial statements as at December 31, 2006:

- Review of all IFRS
- Mapping of all IFRS relevant to the Company for which a thorough examination of their effects on the financial statements is required
- Quality examination of the major effects which are expected to arise to the Company from the adoption of the IFRS

Actions taken up to the date of the publication of the annual financial statements as at December 31, 2007:

- Completion – from the aspects of quality and quantity - of the additional effects expected from the adoption of the IFRS
- Preparation of balance sheet as at December 31, 2007, in accordance with the IFRS

- Preparation of Income Statement for the year ended December 31, 2007, in accordance with the IFRS

For the effects expected on the Company's financial statements as a result of the transition to IFRS, including changes which may occur in the Company's accounting policy as a result of this transition, see Note 24 to the annual financial statements as at December 31, 2007.

4. 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

	<u>Annual 2007</u>	<u>Annual 2006</u>	<u>Quarter of 10-12 / 07</u>	<u>Quarter of 7-9 / 07</u>	<u>Quarter of 4-6 / 07</u>	<u>Quarter of 1-3 / 07</u>
Sales Revenues	88,720	109,891	21,825	21,012	24,116	21,767
Cost of sales	46,094	55,553	11,193	11,846	11,893	11,162
Gross profit	<u>42,626</u>	<u>54,338</u>	<u>10,632</u>	<u>9,166</u>	<u>12,223</u>	<u>10,605</u>
Development costs	2,493	2,339	621	624	580	668
Selling & marketing expenses	6,546	7,189	1,726	1,399	1,653	1,768
General & Administrative expenses	9,612	11,119	2,290	2,382	2,374	2,566
Operating Income	<u>23,975</u>	<u>33,691</u>	<u>5,995</u>	<u>4,761</u>	<u>7,616</u>	<u>5,603</u>
Financing income, net	1,745	919	262	403	680	400
Other income (expenses), net	1	(88)	4	-	(3)	-
Profit before income taxes	<u>25,721</u>	<u>34,522</u>	<u>6,261</u>	<u>5,164</u>	<u>8,293</u>	<u>6,003</u>
Income Taxes	(4,012)	(2,546)	(621)	(664)	(1,740)	(987)
Profit after income taxes	<u>21,709</u>	<u>31,976</u>	<u>5,640</u>	<u>4,500</u>	<u>6,553</u>	<u>5,016</u>
Minority share in profits of consolidated companies, net	<u>(6,701)</u>	<u>(10,258)</u>	<u>(1,715)</u>	<u>(1,432)</u>	<u>(1,941)</u>	<u>(1,613)</u>
Net profit for the year / period	<u><u>15,008</u></u>	<u><u>21,718</u></u>	<u><u>3,925</u></u>	<u><u>3,068</u></u>	<u><u>4,612</u></u>	<u><u>3,403</u></u>

1. General - the results of operations 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 as follows: As from January 1, 2004, Accounting Standard No. 13 – "The Effects of the Changes in the Foreign Currency Exchange Rates" was applied, according to which the quarterly results are translated every quarter into the average exchange rate of the USD.

As mentioned above, from December 31, 2006 to December 31, 2007, there was a decline of 9% in the USD-NIS exchange rate. This fact caused a decrease in the presentation of the operational results of Payton Planar, while being translated into NIS in the consolidated statements of Payton Industries.

2. **Sales** – in 2007, the Group's sales aggregated NIS 88,720 thousands compared to sales in the amount of NIS 109,891 thousands in the equivalent period last year, a decrease of approximately 19%. The aforementioned decline in sales, both in Payton Planar and in Payton Technologies, is explained mainly by:

- Due to the decline of the USD exchange rate, the operational results of Payton Planar were presented at a lower exchange rate (the average exchange rate according to which the 2006 sales of Payton Planar were translated was 4.42 compared to the average exchange rate of 4.10 according to which the 2007 sales of Payton Planar were translated) – see explanation in Clause 1 – "General" above. The total effect of this factor is estimated at approximately NIS 6 million.
- The production process of two projects of two substantial customers of Payton Planar (one of which was a Principal customer) ended as the product reached the end of its life cycle. The total effect of this factor is estimated at approximately NIS 10 million.
- As mentioned above, Payton Technologies prices its sales on a USD basis and translates it into NIS while issuing the sales invoice. Therefore, the decline in the USD exchange rate caused a decline in its sales.

3. Sales are composed as follows:

	2007	Δ%	2006	Δ%	2005
Sales of Payton Planar (and its consolidated company)	77,798	(18%)	95,369	64%	58,317
Sales of the rest of the Group	10,922	(25%)	14,522	11%	13,131
Total	88,720	(19%)	109,891	54%	71,448

4. **Gross profit** – the Group's gross profit aggregated NIS 42,626 thousands in 2007 (a rate of 48%) compared to a gross profit of NIS 54,338 thousands in 2006 (a rate of 49%). The Group managed to maintain a high percentage of gross profitability in spite of the decline in sales – due to maintaining a high level of effectiveness in production and by means of using a subcontractor in China.

5. **General & Administrative expenses** – aggregated NIS 9,612 thousands in 2007 compared to NIS 11,119 thousands in the equivalent period last year. The aforementioned decrease in these expenses stemmed mainly from the decrease in the incentives of the management derives from the Group's profits and from a decrease in other general & administrative expenses, which in the previous year included a provision for doubtful debt.

- 6. Financing income, net** – aggregated NIS 1,745 thousands in 2007 compared to NIS 919 thousands in the equivalent period last year. The major part of the increase in this income stemmed from an interested received on deposits.
- 7. Taxes on income** – in 2007, tax expenses in the amount of NIS 4,012 thousands were recorded compared to tax expenses in the net amount of NIS 2,546 thousands which were recorded in 2006. The tax expenses of 2007 stemmed mainly from current tax expenses due to the profits of Payton Planar. Yet the tax expenses of 2006 were presented under the offset of income from taxes which stemmed mainly from the update of the deferred tax assets generated by accumulated losses which have not yet been utilized for tax purposes. See Note 20 to the financial statements.

c. Liquidity

1. Cash flow from operating activities –

The Group's cash flow provided by operating activities aggregated NIS 31,106 thousands in 2007 compared to its cash flow provided by operating activities in the amount of NIS 30,200 thousands in 2006. The increase in cash provided by operating activities stemmed mainly from changes in items of assets and liabilities, the major part of which was a decline in the balance of trade accounts receivable and of changes in other items, as can be seen in Appendix A to the statement of cash flows. The aforementioned increase was partly setoff due to a decline in the net profit for the year.

The following are financial ratios in the balance sheet:

	December 31, 2007	December 31, 2006
Current ratio	5.0	4.5
Quick ratio	4.5	3.9

2. Cash flow from investing activities –

In 2007, the Company has cash flow used for investing activities in the amount of NIS 22,215 thousands. During the aforementioned period, the cash was used mainly for investment in foreign Bonds and Marketable Securities, in bank deposits and in a building in Florida, U.S.A.

3. Cash flow from financing activities –

In 2007, the Company has cash flow used for financing activities in the amount of NIS 5,188 thousands, which was wholly used for the distribution of a dividend.

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. Baruch Bauberg, 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.

f. 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 (2006) included an examination of the payroll system in the companies of Payton Group.

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.

g. Disclosure with respect to the fee of the Auditor

The overall fee of the auditors is detailed below:

C.P.A.	Type of service	2007		2006	
		Fee in USD thousands	Hours	Fee in UDS thousands	Hours
KPMG Somekh Chaikin *	Auditing services and tax services	50	1,580	41	1,388
Ribotsky, Levine & Company CPAs (Florida)**	Auditing services and tax services	14	100	12	93

* 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.).

h. Effect of external factors

1. 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 acute depreciation in the USD-NIS exchange rate causes an increase in the relative weight of these expenses in NIS in the pricing. In addition, the high volatility of the USD rate causes instability while estimating the component of the expenses in NIS in the pricing.
2. The Group's production is supported by subcontractors in China. The depreciation of the USD-Chinese currency exchange rate causes an increase in the local payroll in China while it is priced in USD. This incline causes an increase in the component of the Group's cost of sales.

3. Subsequent to the balance sheet date and close to the date of signing these statements, the USD rate declined by approximately 8.4% from NIS 3.846 to NIS 3.523 per dollar. In the Company's opinion, this decline causes, at this stage, an accumulated loss of approximately NIS 5.5 million, for net balances, which are stated in USD or linked thereto, from the end of 2007 to close to the date of signing these statements. The calculation is based on the assumption that no significant change occurred in the balances of assets and liabilities, including balances of trade accounts payable and trade accounts receivable. The above data include initial estimates and partial data which the Company currently has, and it does not relate to the effect of the exchange rate on the Company's equity, including an adjustments fund which arises from the translation of the financial statements of investee companies in foreign currency. The Company's Auditor has not yet processed, finally examined and reviewed these data, and they are subject to additional changes in the USD exchange rate by the end of the quarter. Therefore, it may be probable that changes will occur in them compared to the provisions mentioned above.

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, 2007.

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 25, 2008

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

Michael Peretz
Director