

RADA ELECTRONIC INDUSTRIES LTD
Form 20-F/A
September 02, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549
FORM 20-F/A
Amendment No. 1

- REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12 (g) OF THE SECURITIES EXCHANGE ACT OF 1934
or
- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2004
or
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number: 0-15375

RADA ELECTRONIC INDUSTRIES LTD.
(Exact Name of Registrant as Specified in Its Charter and Translation of Registrant's Name Into English)

Israel
(Jurisdiction of Incorporation or Organization)

7 Giborei Israel Street, Netanya 42504, Israel
(Address of Principal Executive Offices)

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

None

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

Ordinary Shares, NIS 0.005 Par Value
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, par value NIS 0.005 per share..... 20,448,364

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No _____

Indicate by check mark which financial statement item the registrant has

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elected to follow:

Item 17 Item 18 X

This annual report on Form 20-F/A is incorporated by reference into the registrant's Registration Statements on Form F-3, Registration Nos. 333-12074, 333-115598 and 333-117954.

Explanatory Note

This Amendment No. 1 on Form 20-F/A hereby amends Items 4,15, 18 and 19 of RADA Electronic Industries Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2004, which was filed on March 31, 2005. This Amendment No. 1 is being filed for the purpose of providing additional details to our disclosures in the original report pursuant to comments received from the Staff of the U.S. Securities and Exchange Commission in connection with its review of our periodic filings.

This Amendment is not intended to revise other information presented in our Annual Report on Form 20-F for the fiscal year ended December 31, 2004 as originally filed and all such other information in the original filing, which remains unchanged.

This Amendment does not reflect events occurring after the filing of the original Form 20-F and does not modify or update the disclosure therein in any way other than as required to reflect the amendments discussed above. As a result, this Amendment continues to speak as of March 31, 2005.

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PART I

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

RADA Electronic Industries Ltd. was incorporated under the laws of the State of Israel on December 8, 1970 for an indefinite term. We are a public limited liability company under the Israeli Companies Law 1999-5759, or the Israeli Companies Law, and operate under this law and associated legislation. Our registered offices and principal place of business are located at 7 Giborei Israel Street, Netanya 42504, Israel, and our telephone number is 972-9-892-1111. Our address on the internet is www.rada.com. The information on our website is not incorporated by reference into this annual report.

We develop, manufacture and sell automated test equipment, avionics products and ground debriefing systems and provide manufacturing services for military and commercial use, mainly in Israel, the U.S. and Europe. We refer to these activities as our core business. We also provide test and repair services using our CATS(R) testers and test program sets through our Chinese subsidiary.

In April 1985, we completed an initial public offering. We traded on the Nasdaq National Market under the symbol "RADIF" since our initial public offering in 1985 until June 10, 2002 when the listing of our ordinary shares was transferred to the Nasdaq SmallCap Market. On December 13, 2004, we changed our symbol to "RADI."

In February 2005, we purchased all the assets of Vectop Ltd., an Israeli company specializing in the design, development, marketing and sale of electro-optic equipment and debriefing systems. Such assets included the know-how, intellectual property and patents that were used by, or connected to Vectop's business.

B. BUSINESS OVERVIEW

Our Core Business

We provide integrated avionic solutions. Our aim is to provide not only a state of the art product but also a comprehensive end to end solution for one or more avionic systems. The first integrated system that we provided was for the A-4 avionics upgrade program of the Israeli Air Force, or IAF. This program is the first comprehensive and complete avionics system to be provided entirely by us. During 2004 we increased our involvement and development efforts in the area of unmanned aircraft vehicles.

Our solutions include the following:

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- o Advanced training solutions, based on our recently completed Net Centric Digital Recorder;
- o Integrated trainer aircraft avionics packages;
- o Flight data recorders and supporting ground analysis;

- o Integrated weapons management systems;
- o Video cameras for ground and airborne applications, based on the Vectop's Ltd. products;
- o Inertial and global positioning system based on navigation solutions; o Unmanned aerial vehicle avionics; and
- o Automatic testing solutions;

We also provide manufacturing services to original equipment manufacturers in Israel and in the United States, using the manufacturing capabilities of our Beit-She'an plant. We offer production of turnkey solutions, in "build to print" or "build to specification" modes. To date, we have provided our manufacturing services to, among others, Smiths, Israeli Aircraft Industries, or IAI, and RAFAEL Armament Development Authority Ltd., or RAFAEL. Our China based subsidiary provides test and repair services using our CATS(R) testers and test program sets.

Our core business activity is based in Israel. Our U.S.-based subsidiaries have been inactive since January 1, 2002.

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Advanced Training Solutions

General

Our training solutions are based on a complete and integrated system that incorporates an airborne component installed in the aircraft and a ground-based component, installed in the squadron facilities. Recent technological developments, undertaken primarily for the IAF, enable system adaptation to any kind of aircraft, regardless of its onboard avionics systems. Our recent solutions are based on our newly developed Net Centric Digital Recorder, that allows the integration of our airborne digital video recordings with numerous other digital data items and provides the essential building blocks for a squadron information management network, or SIMNET, as a ground component.

Autonomous Air Combat Evaluation System - ACE(TM)

ACE(TM) is an avionics system used for debriefing air combat missions and is based on data recordings from digital and analog communication channels in the aircraft. The system converts the data into digital form and inserts it on unused portions of the recording tape in the existing aircraft analog

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videocassette recorder, or VCR. The data is extracted from the videocassette and utilized by our ground debriefing station to generate 3-D graphic displays that portray all the aircraft maneuvers during operational and training missions, and fully synchronize between all the participating aircrafts. For each individual aircraft, the graphic display is fully synchronized with the heads-up display image captured on the VCR media. The IAF (F-16 A/B, A-4) and three other air forces (F-5, F-16 A/B) currently utilize the ACE(TM) system.

Debriefing of air combat maneuvers can also be implemented as an expansion application to our FACE(TM) system. The Royal Netherlands Air Force has upgraded its FACE(TM) systems with this capability to debrief its aircrews.

The latest enhancement of the ACE(TM) concept resulted in a contract with the Israeli Ministry of Defense and the IAF in the first quarter of 2003. Under the contract we will upgrade all of the existing IAF A-4 aircraft with our advanced ACE(TM) debriefing capabilities. The absence of advanced avionics systems and associated data onboard the A-4 aircraft required us to integrate a stand-alone Internal Navigation System, or INS, and a Global Positioning System, or GPS, on board the aircraft. We believe this enhanced solution will open the market segment of aircraft fleets not equipped with modern avionics platforms for the ACE(TM). We believe that this program uniquely positions us as the ultimate provider for debriefing solutions for all the advanced IAF trainers.

Squadron Information Management Network (SIMNET)

Since 1999 we have offered operational ground debriefing stations complementing our airborne systems. The operational ground debriefing station is a PC-based application operating in a Windows NT/2000(R) environment, supported by a proprietary plug-in board. The solution, designed by our employees (IAF F-16 and F-15 pilots in reserve service), provides a state-of-the-art debriefing environment, fully capitalizing on all available digital and video information in a highly synchronized presentation. Further capitalizing on current day technology, individual

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stations have a networking capability, providing data sharing, as well as cross-unit and inter-air force debriefing.

The IAF and two other air forces have purchased ground debriefing systems for their F-16 A/B, F-5 and A-4 fleets.

Net Centric Digital Recorder (NCDR) Based Training Systems

Recent developments in digital video recording systems and the significant reduction in size and cost of solid state memory hardware have turned solid state digital video recording systems into the de-facto standard solution for airborne applications. These systems have begun penetrating the aviation industry, in new aircraft such as the F-16I as well as in the retrofit market. Identifying this trend, we have ported our debriefing solutions to the digital domain, with the initial system developed for the new IAF F-16Is, delivered under the Peace Marble, or PM-V, Program and the new Net Centric Digital Recorder. We developed our Net Centric Digital Recorder with the view of capturing sales from the potential retrofit market for airborne video tape recorders. This new solution focuses on the throughput, data management and archiving requirements of the massive amounts of information generated by each aircraft, as well as on seamless data sharing within the squadron and the air

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force as a whole.

Based on the PM-V Program, we delivered two additional debriefing systems to Lockheed Martin Aerospace during the fourth quarter of 2002 for use in integration and flight-testing. We are in the midst of the development, integration and delivery of a complete digital debriefing system for the new F-16s purchased by the Chilean Air Force. As an extension of the development work completed as part of the PM-V Program, we are supplying the Chilean Air Force with a digital video recorder for each F-16 aircraft as well as an advanced digital video ground debriefing station. This station will be linked to the F-5 ground debriefing station we previously delivered to the Chilean Air Force, creating a common network debriefing solution for both front-line aircraft.

We have identified a growing need for digital video replacement of aging analogue airborne tape recorders (approximately 15,000 VTRs are installed onboard fighter aircraft today) and have initiated a world wide marketing effort to promote the replacement of these aging VTRs with our new NCDR. The NCDR, together with our ground debriefing system, enables advanced debriefing at an affordable price. During 2004, we completed the development of the NCDR and it is now being proposed to several customers. The NCDR will be marketed jointly by us and Smiths, utilizing Smiths' better access to some of the world markets, especially in the U.S.

Integrated Trainer Aircraft Avionics Package

Following our selection by the IAF to provide the ACE(TM) for their advanced trainer, the A-4 Skyhawk, we were awarded a follow on program aimed at total replacement of the aging avionics package of the A-4 aircraft with a new, upgraded package. The new avionics package replaces the current weapon delivery and navigation system of the aircraft with a new state of the art system that will significantly improve the A-4 capabilities, increase its' reliability and provide it with advanced training capabilities.

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The upgraded system includes INS, GPS, head up display, or HUD, camera, central weapon delivery and navigation processor based on enhanced flight monitoring unit, which is the core of the ACE(TM) system and a control and display unit.

The upgraded A-4 prototype began its planned flight testing phase on schedule and the serial production line is operating at full capacity. We plan to complete the upgrade of all the IAF A-4 fleet during 2005.

We believe that this program places us among the few companies that performed a complete aircraft avionics system upgrade. As a result of the A-4 system development, we have proposed similar, very cost effective, trainer aircraft avionics packages to other customers. The A-4 avionics package provides, at a very affordable price, a complete and modern avionics suite tailored for trainer aircraft. We have already launched marketing efforts to promote this package for different customers.

Flight Data Recorders and Supporting Ground Analysis

General

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Our fleet maintenance management solutions are based on our existing programs and products developed and supplied over the course of the past two years. These programs include airborne data collection and recording equipment (such as FACE(TM) or DAS) as well as ground support software packages (such as PERFORMS) that provide the infrastructure for efficient data logging and analysis to support fleet maintenance management.

Fatigue Analysis and Autonomous Air Combat Evaluation System - FACE(TM)

The FACE(TM) system is an avionics system designed to acquire, process and record data from various aircraft systems as well as from strain gauges (sensors) affixed to an aircraft structure. This data is used to streamline and manage the ongoing monitoring and maintenance of an aircraft and its systems. The FACE(TM) system communicates with a squadron's ground support logistic station, enabling downloading of data from an aircraft, analyzing the data, managing ongoing maintenance, creating and modifying the set-up configuration files and determining data for recording, as well as providing an interface to other applications.

The FACE(TM) system is capable of communicating in real time with a voice and data recorder, which is a crash survival unit known as a "black box" manufactured by Smiths, for the purpose of recording flight safety related data. We are currently upgrading the FACE(TM) systems supplied to the Royal Netherlands Air Force for its F-16 aircraft between the years 1996 and 1999 with this capability. During 2004 we supplied FACE(TM) systems for the F-16 fleets of the Portuguese Air Force and the U.S. Navy, and we plan to supply FACE(TM) systems to the Jordanian Air Force for its F-16 fleet starting in 2005.

Data Acquisition System - DAS

The DAS is an advanced avionics data acquisition system designed to acquire, process and record data from various aircraft systems. We jointly developed and marketed the DAS with Smiths for the new IAF F-16I aircraft. DAS consists of two sub-systems, a data acquisition unit, or DAU, and an enhanced crash survival memory unit, or ECSMU. The DAU interfaces to numerous data systems and data channels in the aircraft and acquires, processes and records data,

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mostly for maintenance purposes. The ECSMU is a "black box" capable of recording digital data and digitized audio transferred through the DAU. DAS is a form fit replacement for the CSFDR system, which is currently installed on most F-16 aircraft worldwide. DAS has been offered as a substitute in various projects that require a flight data recorder with advanced capabilities and growth potential.

The DAS is designed to meet all commercial aviation requirements for "black box" recorders, thus expanding its market potential. During 2004, we started supplying production DAS units to the IAF and entered into contracts to supply DAS units to the Polish Air Force and the Korean Air Force starting in 2005.

PERFORMS (Processing, Evaluating, and Reporting of Force Management Data Software)

Starting in mid-2001 we have been the primary sub-contractor to

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Lockheed Martin Aerospace in the development of a new aircraft data logging and analysis software package; accordingly, we provide design and development services for the new product, known as PERFORMS. PERFORMS is designed to replace the aging and hard to support data processing station, or DPS, that was developed to provide data logging and fatigue analysis for all F-16 aircraft users. PERFORMS is a Windows 2000R-based software package, utilizing a state of the art graphics user interface, and provides all the required infrastructure to perform any type of analysis on data acquired by all F-16 airborne flight data recorders.

The analysis includes fatigue monitoring, engine usage monitoring and other applications that may be added, as required by different users. The recorded data is downloaded to the station and stored in a commercial off the shelf database with an interface for "plug-in" applications, allowing those applications to access the data, manipulate and analyze it and provide a variety of maintenance management tools. The program is managed by Lockheed Martin Aerospace and is supplied to F-16 users in evolving software "builds" delivered every 12 months starting in April 2003. Under the agreement, we were granted a non-exclusive license to use the developed software in support of our FACE and DAS products to supply the application to our flight data recorder customers.

The first PERFORMS delivery in June 2003, exposed us to F-16 users at a higher level than we had ever previously experienced. This exposure led us to initiate business development activities with regard to PERFORMS add-on packages. Since 2004, we have presented this product to the F-16 user's community in seminars and conferences.

Updated and upgraded PERFORMS software packages were delivered during 2004 and are scheduled for delivery in 2005. Various air force customers already use the software, and we expect to receive requests to support the installation and operation of the software from these users.

Integrated Weapons Management Systems

In the early 1980s we started to develop, manufacture and sell an armament interface unit which controls the various weapon stations of an aircraft based on commands from the main on-board computer. The unit interfaces between the digital commands of the main controller and the analog weapons stations, performing a unique hybrid task. The armament interface unit was designed for IAI's worldwide upgrade programs. Later versions of the system are designed for

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installation in attack helicopters as well as in fighter aircraft. We are currently in the process of supplying a derivative of the system to IAI for a F-5 upgrade program in Spain and are proposing the system and its offshoots for multiple other applications in Israel and abroad. One of the major potential sales channels for the armament interface unit is IAI, through its upgrade programs and other ongoing projects.

We also provide complete armament testing solutions for aircraft using a variety of weapons management systems. The test unit verifies the serviceability of the armament management system during periodic maintenance or prior to installation of sophisticated weapons.

Video Cameras for Airborne and Ground Vehicles

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The recent acquisition of the Vectop Ltd.'s assets in February 2005 provides us with a new product line. Airborne cameras are integral part of any training and debriefing system airborne onboard military platforms. Our customers include major Israeli integrators (such as IAF, IAI and Elbit) as well as foreign customers. In 2005, our products in this line include:

Eye Witness

An airborne HUD camera, sold to many customers in different configurations represents a significant part of the future revenues related to the assets purchased from Vectop Ltd.

Night Witness

A night vision camera installed on any night vision goggles enables the recording of the pilot's view through the night vision goggles. Its unique capability has been integrated in several fighter aircraft and helicopter programs.

Armor Sentry

A video camera developed for ground armored vehicles and tanks. This system is being delivered to the Israeli ground forces for installation in the new "Merkava" battle tank and is generating interest in foreign markets.

Sniper Witness

The Sniper Witness enables sniper training facilities to better analyze the activities of the trainees as well as accurately debrief the operation resulting in better training. The system is based on a miniature video camera attached to the sniper sight and portable video recorder. The system is used by the Israeli armed forces training facility and is currently being demonstrated to other armed forces around the world.

Inertial and GPS based Navigation Solutions

During 2003, we developed low cost navigation systems based on a ring laser gyro, or RLG, and GPS. Our RLG based system is now qualified and operational as part of the IAF A-4 upgrade program. This development provided us with the know-how to further develop navigation solutions based on other sensors.

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During 2005, we plan to integrate two different sensors into our navigation system, which is based on attitude sensors and fiber optic gyros. Navigation systems based on these sensors are significantly more cost effective and provide good performance at a low price.

We are offering our customers the existing RLG Navigation System, or RNS, as part of our avionics packages and as a stand alone system and we plan to propose the new navigation systems by the end of 2005.

Unmanned Aerial Vehicles (UAV) Avionics

We identified the UAV avionics market as a fast growing area that will

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gradually replace the manned military airborne avionics market. This market has many common aspects with the manned avionics product lines; however, it requires slightly different technology and understanding of the various requirements.

Typically, a UAV avionics package needs to be smaller, lighter, more reliable and inexpensive than its comparable manned aircraft suite. The major advantage of UAV avionics systems is the envisioned large number of UAVs.

We initiated efforts to penetrate this market during 2001. Since then we have entered into a contract with IAI, to develop and provide them with an Input Output Controller, or IOC, a unit that is part of our data acquisition systems product line, for IAI's next generation UAV. We are continuing our efforts to widen our participation in this important program as well as in other programs.

During 2004, we developed and delivered a miniature avionics module to IAI. This unit is aimed at the miniature UAV market and provides complete avionics capabilities in a single, miniaturized unit. This product can be proposed to other customers and we have initiated marketing activities for that purpose.

Automatic Testing Solutions

General

Our business expansion into the automatic test equipment, or ATE, market is based on our existing products as well as the added value we deliver with the dedicated expertise and the wide-range experience we have acquired in this area. We rely on the preference indicated by OEMs to outsource the acquisition of ATE and have positioned our company as a strategic supplier/partner to provide ATEs and test solutions. We offer our ATEs with our own Advanced Test Environment, including all the required development tools. After a long period of inactivity in this market, we see some growing interest, especially from small maintenance houses rather than airlines, especially in the U.S.

CATS(R) - Commercial Aviation Test Stations

The Commercial Aviation Test Stations, or CATS(R), is a family of multi-purpose, computerized automatic test equipment that meets the specific needs of airlines and third party maintenance companies. The CATS(R) stations test and repair a variety of electronic units in existing commercial aircraft, incorporating tools for testing, troubleshooting, and performing

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diagnostic procedures. CATS(R) replaces or augments test stations from aircraft manufacturers or avionics OEM suppliers, while automating multiple manual test procedures.

Manufacturing Services

In 2000 we began providing manufacturing services to OEMs located in Israel and the United States, using the excess manufacturing capacity at our Beit-She'an plant. We offer manufacturing turnkey solutions, either in "build to print" or "build to specification" modes. To date, we have provided our manufacturing services to Smiths, IAI, RAFAEL, and other Israeli companies, both in the defense and commercial sectors.

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Test and Repair Stations

We operate a test and repair shop based on the use of our CATS(R) tester in Beijing, China through CACS, our 80% owned Chinese subsidiary. CACS was established as a joint venture company with Tianzu Forest Development Company, which owns the remaining 20% equity interest. Pursuant to the joint venture agreement, Tianzu Forest Development provided the facilities for CACS' operations while we provided CATS(R) testers and test program set services.

Sales and Marketing

Strategy

Our sales and marketing strategy is based on the following principles:

- o Maintaining our business focus on avionics for the military market and our family of testing solutions for the commercial and military markets.
- o Expanding our product line by adding new products and applications to our existing products by using our current development programs as the basis for new developments.
- o Expanding our customer base by including our products in solutions and integrated systems. This approach was successful both in Chile where, in 2002, we were awarded a contract to provide a complete debriefing solution for the F-16 aircraft purchased by the Chilean Air Force, and with the IAF, to whom we supply complete weapon delivery and navigation system for the A-4 aircraft.
- o Establishing marketing channels with system integrators and major aircraft manufacturers such as The Boeing Company, Lockheed Martin Aerospace, Smiths, IAI and RAFAEL.
- o Expanding large potential markets, especially in the military and the unmanned combat air vehicle areas, and developing new marketing channels aimed directly at these customers.

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As part of this strategy, we have entered into a number of strategic relationships and have focused our marketing and sales efforts to support these relationships.

Lockheed Martin Aerospace. Our sales of avionics products focus mainly on the F-16 aircraft manufactured by Lockheed Martin Aerospace, the most popular fighter aircraft in the Western world today. In February 1999, we signed a memorandum of understanding with Lockheed Martin pursuant to which we will provide certain avionics systems for the F-16 aircraft under the PM-V Program. In September 1999, the U.S. and the State of Israel signed a letter of acceptance pursuant to which the U.S. will provide the IAF with 50 F-16I aircraft and an option for an additional 52 aircraft, which was exercised in June 2001 for a total of 102 F-16I aircraft. In cooperation with Smiths, we are developing and supplying the data acquisition system that includes the advanced data acquisition unit and an enhanced crash survivable memory unit, which will be manufactured in our Beit-She'an facility. We are currently negotiating with

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Lockheed Martin with respect to the development of additional capabilities of this system for different applications.

In addition, in March 2001 we signed an agreement with the Aircraft Structural Integrity Program Group of Lockheed Martin pursuant to which we are assisting in the development of a fatigue analysis system based on a PC computer for analyzing structural fatigue of the F-16 aircraft. As the main subcontractor, our principal task is to develop the software for the fatigue analysis system. The fatigue analysis system will utilize data collected from the data acquisition unit and our FACE(TM) system, as well as other systems used by air forces operating F-16 aircraft. This five year development program will end in March 2006.

Smiths Aerospace Electronic Systems. In February 1999, we entered into an agreement with Smiths that outlines joint marketing activities for our FACE(TM) system and Smiths' voice and data recorder for F-16 A/B aircraft. Smiths is a worldwide leader in avionics systems for fighter and commercial aircraft. The two systems successfully passed flight tests conducted on the Royal Netherlands Air Force's F-16 aircraft by Lockheed Martin and the Royal Netherlands Air Force. The FACE(TM) system and the voice and data recorder complement each other and are intended to replace outdated data recording systems, mechanical strain recorders and flight load recorders. No sales under this agreement have been made to date.

In June 2000, we signed a memorandum of understanding with Smiths pursuant to which the parties agreed to establish a team for worldwide marketing, developing and manufacturing of the data acquisition system and its associated ground support that is intended to grow into an infrastructure for recording, processing and managing all data types available on board the aircraft. No sales of the systems have been made to date under this agreement. We cannot assure you that we will successfully negotiate a definitive agreement with a customer nor can we provide at present any forecast that the agreement with Smiths will result in future sales of avionics systems.

In October 2003, we signed a teaming agreement with Smiths. The teaming agreement establishes cooperation in connection with the products developed jointly by Smiths and us for the PM-V Program and its derivatives. In addition, the agreement details commitments made by Smiths to purchase production services from us in the coming years.

During 2004, we expanded our cooperation with Smiths to include our newly developed Net Centric Digital Recorder and have jointly offered this product to potential customers.

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Smiths was a principal customer in 2002 and 2003 and we expect that it will be one of our principal customers in 2005. In addition to the PM-V cooperation with Smiths, we are currently supplying the Royal Netherlands Air Force with an integration package for our FACE(TM) System and Smiths' black box for its F-16 MLU fleet. A similar package is also being supplied to the Portuguese Air Force.

Israel Aircraft Industries. IAI was our fourth largest customer in 2004, accounting for approximately 8% of our total annual revenues. We are actively supplying avionics and test equipment to four different divisions of IAI. We have identified the Israeli government-owned aerospace industries as a potential

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customers and cooperation entities. In particular the Lahav and Malat divisions of IAI, major aircraft integrators, require our services as avionics and test equipment providers. During 2004, in the IAF avionics upgrade program, where we are the prime contractor, we have cooperated with IAI, as our sub-contractor, to support various parts of this program.

RAFAEL Armament Development Authority Ltd. RAFAEL was one of our largest Israeli customers in 2004. Our sales to RAFAEL during 2004 were primarily for test equipment and build to print services. The addition of the Solid State Recording, or SSR, family of products to the products we supply to RAFAEL adds our own developed products to these sales. We expect that the SSR will result in significant sales to RAFAEL.

Marketing

Our chairman and president, Herzle Bodinger, our chief executive officer, Adar Azancot, and our vice president business development, Zvi Alon, lead our marketing efforts. We currently employ four other persons in marketing our core business products and plan to employ an additional person. Our engineering department supports our marketing staff with respect to product pricing and technical demonstrations. In addition, we have sales consultants, agents and representatives in Europe, South America, China and India who receive commissions for sales effected through them.

The Israeli Ministry of Defense has historically supported and continues to support our marketing efforts through its Export and Defense Assistance division, or SIBAT, through various projects for the Israeli Defense Forces and its related divisions. The Israeli Ministry of Industry and Commerce supports our marketing efforts via its Industrial Cooperation Authority through the exploitation of "offset commitments" by Lockheed Martin Aerospace and The Boeing Company to the State of Israel. Such future assistance is not guaranteed.

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Principal Customers

Generally, we complete a few transactions each year, each in an amount comprising approximately 10% of our revenues for such year. As a result, each year a significant portion of our revenues is derived from a small number of customers. The following table sets forth our principal customers for the years 2003 and 2004:

| | 2003 | 2004 |
|----------------------------------|------|------|
| | ---- | ---- |
| Smiths Electronic Systems..... | 22% | 5% |
| The Boeing Company..... | 14% | 10% |
| Israeli Ministry of Defense..... | 11% | 19% |
| Israel Aviation Industries..... | 12% | 6% |
| Portuguese Air Force..... | 19% | 17% |
| U.S. Navy..... | - | 11% |

Although we are striving to increase the number of our customers, we anticipate that a significant portion of our future revenues will continue to be derived from sales to a small number of customers.

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Like many companies deriving a substantial portion of their revenues from government contracts, we are subject to business risks, including changes in governmental appropriations and changes in national defense policies and priorities. Although many of the programs in which we participate as a contractor or subcontractor may extend for several years, our business is dependent upon annual appropriations and funding of new and existing contracts. Most of the contracts are subject to termination for the convenience of the customer, pursuant to which the customer pays only for reimbursement of costs incurred and the applicable profit on work performed. We cannot assure you that the Israeli Government or any other government will continue to fund the purchase of our products over the long term.

Markets

We sell our products to various air forces and companies. Our main market is in Israel with 35% of our sales in 2004, 26% in 2003 and 14% in 2002. The second largest market is the U.S. with 33% of our sales in 2004, 42% in 2003 and 64% in 2002. Western Europe is our third largest market with 21% of our sales in 2004, 28% in 2003 and 15% in 2002. Sales to the rest of the world accounted for 10%, 4% and 7% of our sales in 2004, 2003 and 2002, respectively.

Competition

The markets for our products are highly competitive, and we may not be able to compete effectively in those markets. Our principal competitors in the avionics market are Harris, Rockwell Collins, Honeywell, Elbit Systems Ltd., IAI, R.S.L. Ltd., TEAK and Elisra Systems Ltd. We expect to continue to face competition from these and other competitors. Most of our competitors are larger, have greater resources including financial, technological, marketing and distribution capabilities, and enjoy greater market recognition than we do. These competitors may be able to achieve greater economies of scale and may be less vulnerable to price

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competition than us. We may not be able to offer our products as part of integrated systems to the same extent as our competitors or successfully develop or introduce new products that are more cost effective or offer better performance than those of our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

Export Policy

Exports of military related products are subject to the military export policy of the State of Israel. Current Israeli Government policy encourages export to approved customers of military products similar to those manufactured by us, provided that such export does not run counter to Israeli policy or national security considerations. We must obtain a permit to initiate a sales proposal and ultimately an export license for the transaction is required. We cannot assure you that we will obtain export permits or licenses in the future or that governmental policy with respect to military exports will not be altered. However, to date we have not encountered any significant difficulties in obtaining necessary permits or licenses for sale of our products.

Fixed Price Contracts

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Most of our contracts, especially with the Government of Israel, its agencies and other foreign governments, are generally fixed-price contracts. Under fixed-price contracts, the price is not subject to adjustment by reason of the costs incurred in the performance of the contracts, as long as the costs incurred and work performed fall within governmental guidelines. Under our fixed-price contracts, we assume the risk that increased or unexpected costs may reduce our profits or generate a loss. This risk can be particularly significant under a fixed-price contract for research and development involving a new technology.

Our books and records may be subject to audits by the Israeli Ministry of Defense and other governmental agencies including the U.S. Department of Defense. These audits may result in adjustments to contract costs and profits. To date, we have not incurred any liability as a result of such audits.

Proprietary Information

We were granted a patent for our ACE(TM) system in both Israel and the United States (No. 5467274.) Nevertheless, we generally do not consider patent protection significant to our current operations and rely upon a combination of security devices, copyrights, trademarks, trade secret laws and contractual restrictions to protect our rights in our products. Our policy is to require employees and consultants to execute confidentiality agreements upon the commencement of their relationships with us. These measures may not be adequate to protect our technology from third-party infringement, and our competitors might independently develop technologies that are substantially equivalent or superior to ours. Additionally, our products may be sold in foreign countries that provide less protection for intellectual property rights than that provided under U.S. or Israeli laws.

The Israeli Government usually retains certain rights to technologies and inventions resulting from our performance as a prime contractor or subcontractor under Israeli Government contracts and may generally disclose such information to third parties, including other defense contractors. When the Israeli Government funds research and development, it may acquire rights to proprietary data and title to inventions; we may retain a non-exclusive, royalty-free license for

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such inventions. However, if the Israeli Government purchases only the end product, we may retain the principal rights and the Government may use the data and take an irrevocable, non-exclusive, royalty-free license.

Manufacturing and Supply

Our main production facilities are located in Beit-She'an, Israel. The plant is equipped to handle most of our manufacturing processes and testing requirements. For several specific processes we utilize subcontractors. This approach is a key to our flexibility and versatility.

We stress quality control in our product realization process. Commencing with customer requirements and expectations via raw material inspection through completion, specifications are repeatedly checked. We maintain a quality assurance team that participates in every stage of the design and manufacture of our products. Our quality management standards are certified by the Standards Institute of Israel, or SII, pursuant to ISO 9001 for hardware design and

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production and ISO 9000.3 for software, both since 1995. SII performs quality system audits twice a year and various customers perform audits four to six times a year. In April 2001, SII certified our Environmental Management System pursuant to ISO 14001. Our Quality Management System was revised to comply with ISO 9001:2000. This process was concluded in June 2003.

According to the standard warranty incorporated in most of our sales contracts, we warrant that our products will be free from defects in design, materials or workmanship, and guarantee repair or replacement of defective parts for the twelve months following delivery of a product to the customer. We also provide maintenance services to customers who sign maintenance contracts.

Source and Availability of Raw Materials

We acquire most of the components for the manufacturing of our products from a limited number of suppliers and subcontractors, most of whom are located in Israel and the United States. Certain of these suppliers are currently the sole source of one or more components upon which we are dependent. Since many of our purchases require long lead-times, a delay in supply of an item can significantly delay the delivery of a product. To date, we have not experienced any particular difficulty in obtaining timely deliveries of necessary components. See Item 3D "Risk Factors." We depend on a limited number of suppliers of components for our products and if we are unable to obtain these components when needed, we would experience delays in manufacturing our products and our financial results could be adversely affected.

C. ORGANIZATIONAL STRUCTURE

We had one active subsidiary in 2004, Beijing Huarui Aircraft Components Maintenance and Services Co., an 80% owned subsidiary based in China that is engaged in aircraft repair services.

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D. PROPERTY, PLANTS AND EQUIPMENT

Facilities

We own a 30,000 square feet building in Beit-She'an, Israel. The building, which includes manufacturing facilities, warehouse space and a portion of our development facilities, is situated on land leased from the Israel Land Authority for a period of 49 years until 2034. The plant has sufficient capacity to meet our current requirements. If volume was to increase significantly, we would be able to increase the number of workers or shifts at the plant, or use more subcontractors.

Our executive offices and research and development facilities are located in a 12,500 square foot office facility in Netanya, Israel. The lease for this facility expires in January 2006 and we have an option to extend the lease until January 2008.

Our Chinese subsidiary, CACS, conducts its business in an approximately 16,000 square foot facility in Beijing that includes offices and test and repair facilities. The land for this facility was leased by Beijing Tianzu Forestry Company or Tianzu, the minority shareholder in CACS, from the Chinese government for 30 years. Under a joint venture agreement, and in consideration for its equity investment in CACS, Tianzu granted CACS usage rights in the land,

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constructed the buildings and granted CACS the ownership of these buildings. However, the transfer of the title to the land and the buildings has not been completed, which may prevent the disposition of these assets should CACS desire to do so. Although Tianzu is legally obligated to complete such transfer of title to the land and the buildings, we can not guarantee that such transfer will be completed, or that we will not be required to initiate litigation in order to enforce our rights to receive title to the land and buildings.

The aggregate annual rent for our offices in Israel and China was approximately \$152,000 in 2004.

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PART II

ITEM 15. CONTROLS AND PROCEDURES

Our management, including our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this annual report on Form 20-F. Based upon that evaluation, our chief executive officer and chief financial officer have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by our company in the reports that we file or submit under the U.S. Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There were no changes to our internal control over financial reporting that occurred during the period covered by this annual report on Form 20-F that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting

Although our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, all internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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PART III

ITEM 18. FINANCIAL STATEMENTS

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Consolidated Financial Statements

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ITEM 19. EXHIBITS

Index to Exhibits

| Exhibit | Description |
|---------|---|
| ----- | ----- |
| 3.1* | Memorandum of Association of the Registrant |
| 3.2* | Articles of Association of the Registrant |
| 4.1* | Specimen of Share Certificate |
| 8**** | List of Subsidiaries of the Registrant |
| 10.1* | 1994 Employee Stock Option Plan, as amended |
| 10.2* | 1996 Employee Stock Option Plan, as amended |
| 10.3* | 1999 Employee Stock Option Plan, as amended |
| 10.4*** | 2003 Employee Stock Option Plan, as amended |
| 10.5* | Form of warrants to directors |
| 10.6* | Loan Agreement dated June 3, 2001 between the Registrant and Mr. Howard Yeung |
| 10.7* | Deed of Termination of Joint Venture Agreement dated June 3, 2001, effective as of January 1, 2000 and Agreement for the acquisition of |

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Ltd. dated June 3, 2001

- 10.8*** Memorandum of Agreement dated June 23 2003 between the Registrant and Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M.
- 12.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
- 12.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
- 13.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 13.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 23.1 Consent of Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global, Independent Registered Public Accounting Firm (Israel) with respect to our Registration Statements on Form F-3 and S-8
- 23.2 Consent of Luboshitz Kasierer, an affiliate member of Ernst & Young International, Independent Auditors (Israel) with respect to our Registration Statements on Form F-3 and S-8

-
- * Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2000 and incorporated herein by reference.
- ** Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2001 and incorporated herein by reference.
- *** Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2002 and incorporated herein by reference.
- **** Filed as an exhibit to our Annual Report on Form 20-F for the year ended December 31, 2004 and incorporated herein by reference.

RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2004

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U.S. DOLLARS IN THOUSANDS

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ERNST & YOUNG

REPORT OF INDEPENDENT AUDITORS

To the Shareholders of

RADA ELECTRONIC INDUSTRIES LTD.

We have audited the accompanying consolidated balance sheets of Rada Electronic Industries Ltd. (the "Company") and its subsidiary as of December 31, 2004 and 2003 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

Tel-Aviv, Israel
March 1, 2005

/s/Kost Forer Gabbay and Kasierer
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

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ERNST & YOUNG

REPORT OF INDEPENDENT AUDITORS PUBLIC ACCOUNTING FIRM

To the Shareholders of

RADA ELECTRONIC INDUSTRIES LTD.

We have audited the accompanying consolidated statement of operations, changes in shareholders' equity and cash flows of Rada Electronic Industries Ltd. (the "Company") and its subsidiary for the year ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

/s/Luboshitz Kasierer
Luboshitz Kasierer
An affiliate member of Ernst & Young International

Tel-Aviv, Israel
June 23, 2003

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

| | | December 31, | |
|--|------|--------------|--------|
| | Note | 2004 | 2003 |
| ASSETS | | | |
| CURRENT ASSETS: | | | |
| Cash and cash equivalents | | \$ 3,464 | \$ 467 |
| Trade receivables (net of allowance for doubtful accounts of \$ 221 and \$ 214, at December 31, 2004 and 2003, respectively) | | 1,643 | 3,496 |
| Other receivables and prepaid expenses | | 208 | 250 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 3 | 1,385 | 176 |
| Inventories | 4 | 1,824 | 873 |
| | | 8,524 | 5,262 |
| Total current assets | | | |
| LONG-TERM RECEIVABLES AND DEPOSITS: | | | |
| Long-term receivables | 5 | 988 | 990 |
| Long-term restricted cash | | 1,002 | - |
| Leasing deposits | | 94 | 71 |
| Severance pay fund | | 1,638 | 1,511 |
| | | 3,722 | 2,572 |
| Total long-term receivables and deposits | | | |
| PROPERTY, PLANT AND EQUIPMENT, NET | | | |
| | 6 | 4,283 | 4,728 |
| OTHER ASSETS: | | | |
| Intangible assets, net | 7 | 1,709 | 1,987 |
| Deferred charges, net | | 59 | - |
| | | 1,768 | 1,987 |
| Total other assets | | | |

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| | | | |
|--|----|-----------|-----------|
| Total assets | | \$ 18,297 | \$ 14,549 |
| ----- | | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | |
| CURRENT LIABILITIES: | | | |
| Short-term bank credit and loans | 8 | \$ 14 | \$ 1,123 |
| Trade payables | | 1,080 | 640 |
| Other payables and accrued expenses | 9 | 3,612 | 3,317 |
| Deferred revenues | | 488 | 1,062 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 3 | 1,065 | 1,836 |
| | | ----- | ----- |
| Total current liabilities | | 6,259 | 7,978 |
| ----- | | ----- | ----- |
| LONG-TERM LIABILITIES: | | | |
| Convertible note | 11 | 2,346 | - |
| Long-term loans | 8 | - | 1,220 |
| Accrued severance pay | | 2,063 | 2,048 |
| | | ----- | ----- |
| Total long-term liabilities | | 4,409 | 3,268 |
| ----- | | ----- | ----- |
| COMMITMENTS AND CONTINGENT LIABILITIES | 10 | | |
| MINORITY INTERESTS | | 397 | 425 |
| | | ----- | ----- |
| SHAREHOLDERS' EQUITY: | 11 | | |
| Share capital- | | | |
| Ordinary shares of NIS 0.005 par value - Authorized: | | | |
| 45,000,000 shares at December 31, 2004 and 2003; Issued | | | |
| and outstanding: 20,448,364 and 18,510,716 shares at | | | |
| December 31, 2004 and 2003, respectively | | 110 | 108 |
| Additional paid-in capital | | 61,851 | 59,139 |
| Warrants | | 2,223 | 1,405 |
| Accumulated deficit | | (56,952) | (57,774) |
| | | ----- | ----- |
| Total shareholders' equity | | 7,232 | 2,878 |
| ----- | | ----- | ----- |
| Total liabilities and shareholders' equity | | \$ 18,297 | \$ 14,549 |
| ----- | | ===== | ===== |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands, except per share data

| | | | | |
|-----------|-------|-------------------------|-------|-------|
| | | Year ended December 31, | | |
| | Note | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- | ----- |
| Revenues: | 15 | | | |

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| | | | | |
|--|-----|-----------|----------|--------|
| Products | | \$ 11,123 | \$ 8,977 | \$ 6 |
| Services | | 3,037 | 3,338 | 3 |
| | | ----- | ----- | ----- |
| | | 14,160 | 12,315 | 10 |
| | | ----- | ----- | ----- |
| Cost of revenues: | | | | |
| Products | | 9,111 | 6,933 | 6 |
| Services | | 1,176 | 2,659 | 2 |
| | | ----- | ----- | ----- |
| | | 10,287 | 9,592 | 9 |
| | | ----- | ----- | ----- |
| Gross profit | | 3,873 | 2,723 | 1 |
| | | ----- | ----- | ----- |
| Operating expenses: | | | | |
| Research and development | | - | - | |
| Marketing and selling | | 738 | 781 | |
| General and administrative | | 2,116 | 1,917 | 2 |
| | | ----- | ----- | ----- |
| Total operating expenses | | 2,854 | 2,698 | 3 |
| | | ----- | ----- | ----- |
| Operating income (loss) | | 1,019 | 25 | (2) |
| Financial income (expenses), net | 13a | (248) | 708 | |
| Other income (expenses), net | 13b | 23 | (2) | |
| | | ----- | ----- | ----- |
| | | 794 | 731 | (2) |
| Minority interests in losses of subsidiary | | 28 | 27 | |
| | | ----- | ----- | ----- |
| Net income (loss) | 16 | \$ 822 | \$ 758 | \$ (2) |
| | | ===== | ===== | ===== |
| Net income (loss) per share: | | | | |
| Basic net income (loss) per share | | \$ 0.04 | \$ 0.04 | \$ (|
| | | ===== | ===== | ===== |
| Diluted net income (loss) per share | | \$ 0.03 | \$ 0.04 | \$ (|
| | | ===== | ===== | ===== |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

| | Number of Ordinary shares | Share capital | Additional paid-in capital | Warrants | Accumulated Deficit | Total shareho equit |
|----------------------------|---------------------------------|------------------|----------------------------------|----------|------------------------|---------------------------|
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Balance at January 1, 2002 | 13,816,839 | \$ 103 | \$56,646 | \$ - | \$ (56,049) | \$ |

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| | | | | | | |
|---|------------|--------|----------|---------|-------------|-------|
| Issuance of Ordinary shares and warrants, net *) | 1,938,775 | 2 | 792 | 41 | - | |
| Conversion of loan into Ordinary shares and warrants | 2,755,102 | 3 | 1,347 | 83 | - | 1, |
| Net loss | - | - | - | - | (2,483) | (2, |
| Balance at December 31, 2002 | 18,510,716 | 108 | 58,785 | 124 | (58,532) | |
| Adjustment of accrual for issuance expenses | - | - | 354 | - | - | |
| Fair value of warrants issued in connection with settlement of debt, net *) | - | - | - | 1,267 | - | 1, |
| Fair value of warrants issued to suppliers | - | - | - | 14 | - | |
| Net income | - | - | - | - | 758 | |
| Balance at December 31, 2003 | 18,510,716 | 108 | 59,139 | 1,405 | (57,774) | 2, |
| Issuance of Ordinary shares and warrants, net *) | 1,864,313 | 2 | 2,482 | 818 | - | 3, |
| Beneficial conversion feature on convertible note | - | - | 180 | - | - | |
| Exercise of options | 73,335 | **) | 50 | - | - | |
| Net income | - | - | - | - | 822 | |
| Balance at December 31, 2004 | 20,448,364 | \$ 110 | \$61,851 | \$2,223 | \$ (56,952) | \$ 7, |

*) Net of issuance expenses of approximately \$ 95, \$ 38 and \$ 115 for the years ended December 31, 2004, 2003 and 2002, respectively.

***) Less than \$ 1.

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

Year ended December 31,

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| | 2004 | 2003 | 2002 |
|---|----------|---------|-----------|
| Cash flows from operating activities: | | | |
| Net income (loss) | \$ 822 | \$ 758 | \$(2,483) |
| Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 1,066 | 2,072 | 2,388 |
| Loss (gain) on extinguishment of debt | - | (1,013) | 83 |
| Provision of long-term receivable | - | - | 290 |
| Stock compensation expense - fair value of warrants issued to suppliers | - | 14 | - |
| Minority interests in losses of subsidiary | (28) | (27) | (206) |
| Accrued interest and translation differences on long-term receivables | 2 | (97) | (40) |
| Amortization expenses on convertible note | 106 | - | - |
| Capital loss on property, plant and equipment | 16 | - | - |
| Decrease (increase) in trade receivables, net | 1,853 | (1,664) | (1,015) |
| Decrease (increase) in other receivables and prepaid expenses | 42 | (157) | (26) |
| Decrease (increase) in costs and estimated earnings in excess of billings, net | (1,980) | 1,085 | 460 |
| Decrease (increase) in inventories | (951) | 204 | 539 |
| Increase (decrease) in trade payables | 440 | 5 | (162) |
| Increase in other payables and accrued expenses | 295 | 722 | 63 |
| Decrease in deferred revenues | (574) | (709) | (592) |
| Accrued severance pay, net | (112) | (172) | 276 |
| Net cash provided by (used in) operating activities | 997 | 1,021 | (425) |
| Cash flows from investing activities: | | | |
| Investment in long-term restricted cash | (1,002) | - | - |
| Purchase of property, plant and equipment | (349) | (49) | (85) |
| Proceeds from sale of property and equipment | - | - | 94 |
| Repayment of loans granted to employees | - | - | 20 |
| Investments in leasing deposits | (23) | (1) | (70) |
| Net cash used in investing activities | (1,374) | (50) | (41) |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of shares, net | 2,484 | - | 835 |
| Proceeds from issuance of convertible note, net | 2,351 | - | - |
| Proceeds of short-term loans | - | 946 | 4,397 |
| Repayments of short-term loans | (1,359) | (4,096) | (888) |
| Decrease (increase) in short-term bank credits, net | (970) | 2,076 | (3,732) |
| Issuance of warrants | 818 | - | - |
| Exercise of options | 50 | - | - |
| Proceeds from issuance of loan to a related party | - | - | 550 |
| Repayment of loan to a related party | - | - | (200) |
| Net cash provided by (used in) financing activities | 3,374 | (1,074) | 962 |
| Increase (decrease) in cash and cash equivalents | 2,997 | (103) | 496 |
| Cash and cash equivalents at the beginning of the year | 467 | 570 | 74 |
| Cash and cash equivalents at the end of the year | \$ 3,464 | \$ 467 | \$ 570 |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

| | Year ended December 31, | | |
|---|-------------------------|----------|----------|
| | 2004 | 2003 | 2002 |
| Non-cash transactions: | | | |
| Conversion of shareholder's loan into Ordinary shares and warrants | \$ - | \$ - | \$ 1,305 |
| Fair value of warrants issued in connection with settlement of debt | \$ - | \$ 1,305 | \$ - |
| Adjustment of accrual for issuance expenses | \$ - | \$ 354 | \$ - |
| Supplemental disclosures of cash flow activities: | | | |
| Net cash paid during the year for: | | | |
| Income taxes | \$ 3 | \$ 5 | \$ - |
| Interest | \$ 290 | \$ 240 | \$ 30 |

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

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NOTE 1:- GENERAL

- a. RADA Electronic Industries Ltd., an Israeli corporation ("the Company"), is engaged in the development, manufacture and sale of Automated Test Equipment ("ATE") products, avionics equipment and aviation data acquisition and debriefing systems.
- b. As reflected in the consolidated financial statements, as of December 31, 2004, the Company had an accumulated deficit of \$ 56,952. During 2004, the Company concluded a private placement of 1,800,000 Ordinary shares and issued convertible notes to investors in the amount of approximately \$ 5,800 (see Note 11). Management believes that the abovementioned round of financing and anticipated cash flows from operations will enable the Company to finance its operations at least through December 31, 2005.
- c. The Company operates a test and repair shop using its ATE products in Beijing, China through its 80% owned Chinese subsidiary, Beijing Huari Aircraft Components Maintenance and Services Co. Ltd. ("CACS" or "subsidiary"). CACS was established with a third party, which owns the remaining 20% equity interest.
- d. As for major customers, see Note 15.
- e. In 2003, the Company changed the estimated useful life of the remaining intangible assets associated with its Aircraft Test Systems Programs Sets ("TPSs") from a range of eight to eighteen years to a range of five to ten years. The effect of the change in estimated useful life of these assets on the net income and net income per share for the years ended December 31, 2004 and 2003 resulted in a decrease of \$ 221 (or \$ 0.01 per share) and \$ 136 (or \$ 0.01 per share), respectively.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles. The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are as follows:

- a. Use of estimates:

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- b. Financial statements in U.S. dollars:

Most of the revenues of the Company and its subsidiary are generated in U.S. dollars ("dollar"). In addition, a substantial portion of the costs of the Company and its subsidiary is incurred in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of the Financial Accounting Standard Board No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statement of operations as financial income or expenses, as appropriate. The representative exchange rate at December 31, 2004 was U.S. \$ 1.00 = NIS 4.308 (December 31, 2003 - NIS 4.379).

c. Basis of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiary. Inter-company transactions and balances have been eliminated upon consolidation.

d. Cash equivalents and restricted cash:

All highly liquid investments that are readily convertible to cash and are not restricted as to withdrawal or use and the period to maturity of which did not exceed three months at time of deposit, are considered cash equivalents.

Restricted cash is invested in a long-term bank deposit, which is used as security for the Company's guarantees to customers. The deposit is in U.S. dollars and bears interest at an average rate of 2.3%

e. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from slow-moving items, excess inventories, and for market prices lower than cost. As for write-offs included in these financial statements, see Note 4.

Cost is determined as follows:

Raw materials and components - using the "first-in, first-out" cost method.

Work in progress and finished goods - represents the cost of manufacturing with the addition of allocable indirect manufacturing costs.

Amounts related to long-term contracts as determined by the percentage of completion method of accounting are recorded as "Costs and estimated earnings in excess of billings."

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

f. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets. Annual rates of depreciation are as follows:

| | % |
|--------------------------------|-------------|
| | ----- |
| Factory and other buildings | 2.5 - 4 |
| Machinery and equipment | 10 - 15, 33 |
| Office furniture and equipment | 6 - 15 |

Leasehold improvements are amortized over the shorter of the estimated useful life or the lease period.

Assets in respect of which investment grants have been received, are presented at cost less the related grant amount. Depreciation is based on net cost.

g. Intangible assets:

Capitalized software costs are amortized by the greater of the amount computed using the: (i) ratio of current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product. The Company assesses the recoverability of these intangible assets on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. As for impairment charges included in these financial statements, see Note 7.

h. Impairment of long-lived assets:

The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As for write-down charges included in these financial statements, see Note 6.

i. Research and development costs:

Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or

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Otherwise Marketed", ("SFAS No. 86") requires capitalization of certain software development, costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a working model.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Research and development costs incurred in the process of developing product masters, product enhancements and the Company's Test System Programs Sets ("TPS") software library, integrated with the Company's test station, are charged to expenses as incurred.

Costs incurred by the Company between completion of the working model and the point at which the product is ready for general release, have been capitalized.

j. Income taxes:

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

k. Severance pay:

The Company's liability for severance pay is calculated pursuant to Israeli severance pay law generally based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its Israeli employees is partly provided by monthly deposits for insurance policies and/or pension funds and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet. The deposited funds of the Company's employees include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance expenses recorded in the statement of operations is net of interest and other income accumulated in the deposits. Severance expenses for the years ended December 31, 2004, 2003 and 2002 amounted to \$ 76, \$ 132 and \$ 541, respectively.

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1. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating fair value and disclosures for financial instruments.

The carrying amount of cash and cash equivalents, trade receivables, short-term bank credit, long-term deposits and trade payables approximate their fair value due to the short-term maturity of these instruments.

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

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

m. Concentrations of credit risk:

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

The Company's cash and cash equivalents and long-term deposit are mainly held in U.S. dollars with major banks in Israel. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are derived from sales to large and solid organizations located mainly in the United States, Europe and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to these amounts that the Company has determined to be doubtful of collection. The allowance is computed for specific debts and the collectibility is determined based upon the Company's experience. The Company granted loans in prior years to its former CEO and a former officer amounting to approximately \$ 983 as of December 31, 2004 and 2003. These loans are unsecured and the Company is currently in litigation with these officers regarding such loans. If the Company's claims for recovery of the loans will be dismissed, the Company will incur a loss equal to the amount of the loans, net of the respective provision against these loans. See also Note 10a (1) for additional information about the various legal proceedings with the former CEO and officer.

The Company has no off-balance sheet credit risks.

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n. Warranty:

In connection with the sale of its products, the Company provides product warranties for periods between one to two years. Based on past experience and engineering estimates, the liability from these warranties is immaterial at balance sheet date.

o. Share based compensation:

The Company accounts for employee stock based compensation under the intrinsic value model in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44"). In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), the Company discloses pro forma data assuming the group had accounted for employee stock option grants using the fair value-based method defined in SFAS No. 123.

Pro forma information regarding the Company's net loss and net loss per share is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123. The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

| | Year ended December 31, | | |
|--|-------------------------|---------|---------|
| | 2004 | 2003 | 2002 |
| Net income (loss), as reported | \$ 822 | \$ 758 | \$ (2,) |
| Add: Stock-based employee compensation included in reported net income (loss) | - | - | |
| Deduct: Total stock-based employee compensation expense under fair value based methods | (73) | (58) | |
| Pro forma net income (loss) | \$ 749 | \$ 700 | \$ (2,) |
| Basic and diluted net income (loss) per share: | | | |
| Basic net income (loss) per share as reported | \$ 0.04 | \$ 0.04 | \$ (0) |
| Pro forma basic net income (loss) per share | \$ 0.04 | \$ 0.04 | \$ (0) |
| Basic net income (loss) per share as reported | \$ 0.03 | \$ 0.04 | \$ (0) |
| Pro forma basic net income (loss) per share | \$ 0.03 | \$ 0.04 | \$ (0) |

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The fair value for options granted in 2004, 2003 and 2002 was estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

| | Year ended December 31, | | |
|-------------------------|-------------------------|---------|---------|
| | 2004 | 2003 | 2002 |
| Expected life of option | 2 years | 2 years | 2 years |
| Dividend yield | 0% | 0% | 0% |
| Expected volatility | 68% | 31% | 24% |
| Risk-free interest rate | 2.6% | 1.0% | 2.0% |

The Company applies SFAS No. 123 and Emerging Issues Task Force No. 96-18 "Accounting for Equity Instruments That Are Issued to Other Than Employees for "Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18"), with respect to options and warrants issued to non-employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the options and warrants at the measurement date.

p. Revenue recognition:

The Company generates revenues mainly from the sale of products and from long-term fixed price contracts for ATE, avionics and ground debriefing systems. In addition, the Company leases ATE and provides manufacturing, development and product support services.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Product revenues:

The Company recognizes revenue from sales of products and aircraft spare parts in accordance with Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition". Product revenue is recognized when there is persuasive evidence of an arrangement, the fee is fixed or determinable, delivery of the product to the customer has occurred and the Company has determined that collection of the fee is probable. If the product requires specific customer acceptance, revenue is deferred until customer acceptance occurs or the acceptance provisions lapse, unless the Company can objectively and reliably demonstrate that the criteria specified in the acceptance provisions are satisfied.

Revenues from certain long-term fixed price contracts are recognized in accordance with Statement of Position No. 81-1, "Accounting for Performance of Construction - Type and Certain Production - Type Contracts" ("SOP 81-1"), using contract accounting on a percentage of completion method in accordance

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with the "Input Method". The percentage of completion is determined based on the ratio of actual costs incurred to total costs estimated to be incurred over the duration of the contract. With regard to contracts for which a loss is anticipated, a provision is made for the entire amount of the estimated loss at the time such loss becomes evident. As of December 31, 2004, the estimated losses identified are \$ 392. Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit or loss are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

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

According to SOP 81-1, costs that are incurred and are directly associated with a specific anticipated contract are being deferred, subject to evaluation of their probable recoverability, and recorded as unbilled contract costs.

Revenues from certain arrangements may include multiple elements within a single contract. The Company's accounting policy complies with the provisions of Emerging Issues Task Force Issue 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"), relating to the separation of multiple deliverables into individual accounting units with determinable fair value. The Company's arrangements are accounted for as one unit of accounting since there is no objective and reliable evidence of fair value of the undelivered elements in the contract. When the undelivered elements are not essential to the functionality of the delivered elements, revenues are recognized for the delivered element when the respective fee is payable and noncontingent and all other revenue recognition criteria are met.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Service revenues:

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Revenues from services are recognized as the services are performed.

Revenue under operating leases of equipment are recognized ratably over the lease period, in accordance with Statement of Financial Accounting Standard No. 13, "Accounting for Leases" ("SFAS No. 13").

Deferred revenues include unearned amounts received under services contracts, and amounts received from customers but not yet recognized as revenues.

q. Basic and diluted net income (loss) per share:

Basic net income (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net income (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year in accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share". Options and warrants to purchase 16,005,112, 14,862,237 and 13,718,037 Ordinary shares have been excluded from the computation of diluted net income (loss) per share for the years ended December 31, 2004, 2003 and 2002, respectively, because their effect is anti-dilutive for all periods presented.

r. Recently issued accounting pronouncements:

SFAS No. 123 (Revised 2004) Share-based Payment

On December 16, 2004, the FASB issued Statement No. 123 (revised 2004), Share-Based Payment ("Statement 123(R)"), which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation ("Statement 123"). Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statements 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while Statement 123(R) requires all share-based payments to employees to be recognized based on their fair values. Statement 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for the Company in the first interim period beginning after June 15, 2005 (July 1, 2005 for the Company). The Company does not expect this Statement to have a material effect on the Company's financial statements or its results of operations in future periods.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

FAS 151 Inventory Costs - an amendment of ARB 43, Chapter 4:

In November 2004, the FASB issued Statement of Financial Accounting Standard No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4". ("SFAS 151"). SFAS 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005 (January 1, 2006 for the Company). The provisions of this Statement shall be applied prospectively. The Company does not expect this Statement to have a material effect on its financial statements or its results of operations.

FAS 153 Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29:

In December 2004, the FASB issued Statement of Financial Accounting Standard No. 153, Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29 ("SFAS 153"). The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions ("APB 29"), is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. APB 29 includes certain exceptions to that principle. SFAS 153 amends APB 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have a commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary assets exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not expect that the adoption of SFAS 153 will have a material effect on its financial position or results of operations.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 3:- CONTRACTS IN PROGRESS

Amounts included in the financial statements, which relate to costs and estimated earnings in excess of billings on uncompleted contracts are classified as current assets. Billings in excess of costs and estimated earnings on uncompleted contracts are classified as current liabilities. Summarized below are the components of the amounts:

- a. Costs and estimated earnings in excess of billings on uncompleted contracts:

| | December 31, | |
|------|--------------|------|
| | ----- | |
| 2004 | 2004 | 2003 |

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| | | |
|---|----------|--------|
| Costs incurred on uncompleted contracts | \$ 5,774 | \$ 862 |
| Estimated earnings | 50 | 324 |
| | 5,824 | 1,186 |
| Less - billings and progress payments | 4,439 | 1,010 |
| | \$ 1,385 | \$ 176 |

b. Billings in excess of costs and estimated earnings on uncompleted contracts:

| | | |
|---|--------------|------------|
| | December 31, | |
| | 2004 | 2003 |
| Costs incurred on uncompleted contracts | \$ 4,336 | \$ 3,711 |
| Estimated earnings | 1,454 | 1,019 |
| | 5,790 | 4,730 |
| Less - billings and progress payments | 6,855 | 6,566 |
| | \$ (1,065) | \$ (1,836) |

NOTE 4:- INVENTORIES

| | | |
|------------------------------|--------------|--------|
| | December 31, | |
| | 2004 | 2003 |
| Raw materials and components | \$ 1,178 | \$ 668 |
| Work in progress | 447 | 112 |
| Finished goods | 199 | 93 |
| | \$ 1,824 | \$ 873 |

Write-down of inventories for the years ended December 31, 2004, 2003 and 2002 amounted to \$ 0, \$ 0 and \$ 623, respectively. The write-down in 2002 was due to excess and slow moving inventories and was included in cost of revenues.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 5:- LONG-TERM RECEIVABLES

| | | |
|---|--------------|--------|
| | December 31, | |
| | 2004 | 2003 |
| Loan to former chief executive officer *) | \$ 705 | \$ 705 |

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| | | |
|-----------------------------|--------|--------|
| Loan to a former officer *) | 278 | 278 |
| Loans to employees | 5 | 7 |
| | ----- | ----- |
| | \$ 988 | \$ 990 |
| | ===== | ===== |

*) See also Note 10a.

NOTE 6:- PROPERTY, PLANT AND EQUIPMENT, NET

| | December 31, | |
|--------------------------------|--------------|----------|
| | 2004 | 2003 |
| | ----- | ----- |
| Cost: | | |
| Factory building | \$ 1,940 | \$ 1,940 |
| Other building | 1,042 | 1,042 |
| Machinery and equipment | 13,321 | 13,044 |
| Office furniture and equipment | 512 | 459 |
| Leasehold improvements | 23 | 20 |
| | ----- | ----- |
| | 16,838 | 16,505 |
| | ----- | ----- |
| Accumulated depreciation: | | |
| Factory building | 1,203 | 1,132 |
| Other building | 219 | 175 |
| Machinery and equipment | 10,779 | 10,145 |
| Office furniture and equipment | 334 | 305 |
| Leasehold improvements | 20 | 20 |
| | ----- | ----- |
| | 12,555 | 11,777 |
| | ----- | ----- |
| Depreciated cost | \$ 4,283 | \$ 4,728 |
| | ===== | ===== |

The Company's factory building in Beit-She'an, Israel, is located on land leased from the Israel Lands Administration until the year 2034.

Depreciation expenses were \$ 778, \$ 932 and \$ 918 for the years ended December 31, 2004, 2003 and 2002, respectively. Write-down of property and equipment, which is not in use by the Company, was \$ 0, \$ 0 and \$ 490 for the years ended December 31, 2004, 2003 and 2002, respectively. The write-downs were included in cost of revenues.

As for charges, see Note 10e.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 7:- INTANGIBLE ASSETS, NET

| | December 31, | |
|--|--------------|-------|
| | 2004 | 2003 |
| | ----- | ----- |

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| | | |
|---------------------------------|--------------|--------------|
| Test Systems Programs Sets: | | |
| Cost | \$ 8,275 | \$ 8,275 |
| Less - accumulated amortization | 6,566 | 6,288 |
| | ----- | ----- |
| Amortized cost | \$ 1,709 | \$ 1,987 |
| | ===== | ===== |

Amortization expenses were \$ 278, \$ 382 and \$ 730 for the years ended December 31, 2004, 2003 and 2002, respectively. The expected amortization expenses in the next five years are approximately as follows:

| | |
|------|---------|
| 2005 | \$ 275 |
| 2006 | 275 |
| 2007 | 275 |
| 2008 | 177 |
| 2009 | 177 |
| | ----- |
| | \$1,179 |
| | ===== |

Impairment of intangible assets was \$ 0, \$ 758 and \$ 251 for the years ended December 31, 2004, 2003 and 2002, respectively included in cost of revenues. The impairment was recorded in prior years since the Company did not anticipate future revenues on specific Test Systems Program Sets ("TPSs"). The weighted average useful life of the intangible assets is six years.

NOTE 8:- SHORT-TERM BANK CREDIT AND LOANS

| | December 31, | |
|--|--------------|----------|
| | 2004 | 2003 |
| | ----- | ----- |
| Short-term: | | |
| Current maturities of long-term loan in U.S. dollars (1) | \$ - | \$ 180 |
| Short-term bank credit in NIS (2) | 14 | 943 |
| | ----- | ----- |
| | \$ 14 | \$ 1,123 |
| | ===== | ===== |
| Long-term: | | |
| Loans in U.S. dollars (1) | \$ - | \$ 1,220 |
| | ===== | ===== |

(1) The interest rate at December 31, 2003 is 4.25%-5.13%. The weighted average interest rate as of December 31, 2003 - 4.25 %.

(2) The interest rate at December 31, 2004 is 11.7% (December 31, 2003 - 8%).

During 2003, the Company restructured a portion of its debt with the banks (see Note 11c).

The total authorized credit line of the Company at December 31, 2004 is \$4,123.

As for collateral, see Note 10e.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9:- OTHER PAYABLES AND ACCRUED EXPENSES

| | December 31, | |
|---|--------------|----------|
| | 2004 | 2003 |
| Payroll and related accruals | \$ 969 | \$ 860 |
| Provision for legal proceedings | 567 | 748 |
| Accrued royalties | 679 | 644 |
| Accrued commissions | 480 | 491 |
| Contracts in progress - provision for estimated losses | 392 | - |
| Other | 525 | 574 |
| | \$ 3,612 | \$ 3,317 |

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES

- a. As of December 31, 2004, the Company was a party to various legal proceedings, including the following:

1. In June 1998, the Company's Board of Directors accepted the resignation of the Company's former CEO. In December 1998, the former CEO commenced legal proceedings against the Company in the Tel Aviv Labor Court, claiming approximately \$ 500 in respect of salary, severance pay, vacation pay and other fringe benefits. The former CEO also claimed that a personal loan that was provided to him by the Company had been forgiven and that the Company is to bear the tax in respect thereof. In May 2001, an additional claim of approximately \$ 230 was filed by the former CEO against the Company in the Tel-Aviv District Court for damages allegedly caused to him as a result of attachment imposed on certain of his assets by the Company that was subsequently cancelled by the Court. In addition, in 2001, the Company filed a claim against a former director. In the event the former CEO's claim in the Labor Court is accepted by the Court, damages in the amount of \$ 250 should be covered by the former director. The Company filed additional lawsuits against the former CEO and a former director in the amount of \$ 250 for funds that they allegedly transferred from the Company to a third party. In September 1999, the Company filed a lawsuit against the former CEO and the former director with the District Court of Tel Aviv in the amount of \$ 1,400 for damages caused to the Company in the purchase of a subsidiary and negligence of management. In August 2000, the Company filed an additional lawsuit against the former CEO in the amount of approximately \$ 460 regarding the repayment of the loan provided to him. Management believes, based on the advice of its legal counsel, that the Company has valid defenses against all claims made against it.

2. In 1999 and 2000, the former CEO and his son filed a number

of complaints against the Company's president and are seeking damages for alleged slander by the defendant in the amount of approximately \$ 750. The claim by the former CEO was withdrawn and replaced by a new claim filed in 2004, while his son's claim was dismissed and an appeal is pending in the Supreme Court. Management believes, based on the advice of its legal counsel, that the Company has strong defenses against the allegations and accordingly did not record any provision.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

3. In 2001, a former employee and officer of the Company filed a claim against the Company with the Tel Aviv Labor Court claiming approximately \$ 580 in respect of severance pay, vacation pay and other fringe benefits. This claim was filed as a counter-claim to a claim filed by the Company in 2000, in the amount of \$ 300 in respect of the repayment of a personal loan that was provided to the former employee. Management believes based on its legal counsel advice that the Company has a strong defense against the employee's counter-claim and accordingly did not record any provision.
 4. In 2001, a former director filed a claim against the Company, claiming that he is entitled to 600,000 options to purchase Ordinary shares of the Company. Management believes based on its legal counsel advice that the claim does not have any merit and accordingly did not recorded any provision.
 5. In 2002, a claim was filed by an individual against the Company, claiming that he served as a broker in an agreement signed between the Company and a customer and is entitled to commissions (or finder's fee) in the amount of \$ 250. Management believes based on its legal counsel advice that the Company has a strong defense against the allegations.
 6. The Company is involved from time to time in various legal claims in the ordinary course of business, including claims by agents and others for commissions, royalties and others. The Company has accrued an amount which it believes is sufficient to cover any damages, if any, that may result from these claims. The Company's management, based on the advice of its legal counsel, believes that such claims will not have a material adverse effect on the financial position or results of operations of the Company.
- b. The Company's research and development efforts have been partially financed through royalty-bearing programs sponsored by the Office of the Chief Scientist of the Ministry of Industry and Trade of Israel ("OCS"). In return for the OCS's participation, the Company is committed to pay royalties at a rate ranging from 3% to 5% of sales of the products supported by the OCS, up to

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100% of the amount of such participation received linked to the U.S. dollar. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales, no payment is required. The Company's total obligation for royalties, net of royalties paid or accrued totaled approximately \$ 641 as of December 31, 2004.

The total amount of royalties charged to operations in the years ended December 31, 2004, 2003 and 2002 was approximately \$ 60, \$ 73 and \$ 98, respectively.

- c. Research and development projects undertaken by the Company were partially financed by the Binational Industrial Research and Development Fund ("BIRD") Foundation. The Company is committed to pay royalties to the BIRD Foundation at a rate of 5% of sales proceeds generating from projects for which the BIRD Foundation provided funding up to 150% of the sum financed by the BIRD Foundation. The Company's total obligation for royalties, net of royalties paid or accrued, totaled approximately \$ 1,958 as of December 31, 2004. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales, no payment is required.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 10:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

The total amount of royalties charged to operations for the years ended December 31, 2004, 2003 and 2002 was approximately \$ 20, \$ 15 and \$ 13, respectively.

- d. The Netanya offices of the Company are rented under a non-cancelable operating lease expiring January 31, 2006 and there is an option to renew it again, until January 2008. In addition, certain of the Company's vehicles and computers are under operating leases. Annual minimum future rental commitments under these leases, at exchange rates in effect on December 31, 2004, are approximately as follows:

| | |
|------|----------|
| 2005 | \$ 468 |
| 2006 | 306 |
| 2007 | 235 |
| | ----- |
| | \$ 1,009 |
| | ===== |

Lease expenses for the years ended December 31, 2004, 2003 and 2002 were \$ 508, \$ 447 and \$ 277, respectively.

- e. Floating charges have been registered on all of the Company's assets and specific charges have been registered on certain assets in respect of the Company's liabilities to its banks and other creditors.
- f. The Company obtains mainly short-term bank guarantees to its

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customers in the ordinary course of business. These guarantees are provided to customers to secure advances received at commencement of a project or to secure performance of operational milestones. The total amount of bank guarantees provided to customers as of December 31, 2004 is approximately \$ 4,123.

NOTE 11:- SHAREHOLDERS' EQUITY

a. Share capital:

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

In July 2004, the Company issued 1,800,000 shares, an aggregate of \$3,000 principal amount of convertible notes, additional investment rights to purchase up to an aggregate of 1,100,000 Ordinary shares at an exercise price of \$ 2.10 per share, (with a term of two years commencing six months following the closing) and warrants to purchase up to an aggregate of 937,500 Ordinary shares at an exercise price of \$ 2.50 per share (for a term of five years commencing six months following the closing) .to investors in a private placement for a total consideration of \$ 5,880 (\$ 5,712 net of issuance expenses) (see also c. below). The consideration was allocated based on the relative fair values of the Ordinary shares, notes and warrants in accordance with APB No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants". The convertible notes bear interest at a rate of six-month LIBOR plus 2.5%. The principal is due in July 2007 and the interest is payable in quarterly installments until July 2007. The notes are convertible to Ordinary shares at a conversion price of \$ 2.10. In connection with the issuance of the notes, additional of investment rights and warrant, \$180 was recorded as a beneficial conversion feature in accordance with EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

Contingently Adjustable Conversion Ratios". The total amount of the deemed discount on the notes as a result of the warrants issuance and the beneficial conversion feature amounting to \$ 760, is amortized over the term of the notes using the interest method. At December 31, 2004, the unamortized balance on the deemed discount on the convertible notes was \$ 654. The fair value of the warrants (including additional investment rights) was based on a valuation prepared using the Black-Scholes pricing model assuming a risk free interest of 2.64% and 3.69%, respectively, a volatility factor of 0.67 and 0.68, respectively, dividend yield of 0% and contractual life of two years and five years, respectively. In addition, the valuation considered that the warrants were restricted for the first six months, the warrants were not traded on the market at any time, and the

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underlying asset had low marketability. The valuation result was judged to be reasonable by comparison to benchmarks in similar circumstances. The Company's management is responsible for the valuation.

Costs incurred with respect to the issuance of the convertible notes of \$69 have been recorded as deferred charges and are amortized as financial expenses over the term of the notes using the interest method.

In June 2002, the Company issued 1,938,775 Ordinary shares in a private placement to certain investors in consideration for an aggregate amount of \$ 950 (\$ 835, net of issuance expenses). The shares were issued at a 30% discount from the Ordinary share price on NASDAQ at the date of issuance, which was deemed to be the fair value of a "restricted" Ordinary share. See (c). below for warrants issued to investors.

In June 2002, the Company issued 2,755,102 Ordinary shares in a private placement to a shareholder in consideration for conversion of a loan that was given to the Company in the amount of \$ 1,350. The shares were issued at the same price as the shares issued in the 2002 private placement described above. See (c). below for warrants issued to a shareholder.

b. Stock option plans:

In 1996, 1999 and 2003, the Company's Board of Directors approved the adoption of Employee Stock Option Plans (the "Plans"), which authorized the grant of options to purchase up to an aggregate of 240,000, 1,040,000 and 2,000,000 Ordinary shares, respectively, to officers, directors, consultants and key employees of the Company and its subsidiary. Options granted under the Plans expire within a maximum of ten years from adoption of the plan. Options granted under the Company's Plans vest ratably over three years, one third on each anniversary of the grant.

The exercise price of an option granted to an employee may not be less than 60% of the fair market value of the Ordinary shares on the date of grant of the option. The exercise price of an option granted to a non-employee director or consultant may not be less than 80% of the fair market value of the Ordinary shares on the date of grant of the option. Any options that are cancelled or forfeited before expiration, become available for future grants. At December 31, 2004, 226,032 options were available for grant under the Plans described above.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

In 2003, the Company granted suppliers/consultants, options to purchase 100,000 Ordinary shares at an exercise price ranging from \$ 0.69 - \$ 2.00. At the grant date, the fair value of the options was determined using the Black and Scholes pricing model

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assuming a risk free rate of 1%, a volatility factor ranging from 30% to 70%, dividend yield of 0% and a contractual life of two to five years. In relation to the options, the Company recorded \$ 14 as operating expenses.

Transactions related to the above Plans (including warrants to directors) during the years ended December 31, 2004, 2003 and 2002 were as follows:

| | Year ended December 31, | | | | | |
|--|-------------------------|---------------------------------|-------------------|---------------------------------|-------------------|---------------------------------|
| | 2004 | | 2003 | | 2002 | |
| | Amount of options | Weighted average exercise price | Amount of options | Weighted average exercise price | Amount of options | Weighted average exercise price |
| Options outstanding at beginning of year | 2,223,200 | \$ 1.60 | 526,000 | \$ 4.89 | 1,638,000 | \$ |
| Granted | 100,000 | \$ 1.29 | 1,852,000 | \$ 1.07 | - | \$ |
| Exercised | (73,335) | \$ 0.69 | - | \$ - | - | \$ |
| Expired | (36,400) | \$ 4.58 | - | \$ - | - | \$ |
| Forfeited or cancelled | (182,032) | \$ 1.89 | (154,800) | \$ 6.34 | (1,112,000) | \$ |
| Options outstanding at end of year | 2,031,433 | \$ 1.56 | 2,223,200 | \$ 1.60 | 526,000 | \$ |
| Exercisable options at end of year | 1,425,434 | \$ 1.71 | 1,045,200 | \$ 2.23 | 411,600 | \$ |

No options were granted in 2002. No compensation expense was recorded for the years ended December 31, 2004, 2003 and 2002.

The options outstanding as of December 31, 2004 have been separated into ranges of exercise price, as follows:

| Range of exercise price | Options outstanding | | | Options exercisable | | |
|-------------------------|----------------------|---|---------------------------------|----------------------|---------------------------------|--|
| | At December 31, 2004 | Weighted average remaining contractual life (years) | Weighted average exercise price | At December 31, 2004 | Weighted average exercise price | |
| \$ 0.69 - 1.00 | 685,500 | 9.00 | \$ 0.70 | 522,501 | \$ | |
| \$ 1.29 - 2.00 | 1,082,333 | 8.95 | \$ 1.37 | 639,333 | \$ | |
| \$ 3.09 - 4.13 | 135,600 | 5.46 | \$ 3.52 | 135,600 | \$ | |
| \$ 4.88 - 6.75 | 128,000 | 5.49 | \$ 5.63 | 128,000 | \$ | |

| | | | |
|-----------------------------|------------------|-----------------------------|-------------|
| ----- 2,031,433 ===== | \$ 1.56 ===== | ----- 1,425,434 ===== | \$ ===== |
|-----------------------------|------------------|-----------------------------|-------------|

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

c. Warrants:

As of December 31, 2004, warrants to purchase 19,486,840 Ordinary shares were outstanding.

In July 2004, in connection with the issuance of Ordinary shares and convertible notes described in a. above, the Company granted the investors additional investment rights to purchase up to an aggregate of 1,100,000 Ordinary shares at an exercise price of \$ 2.10 per share, (with a term of two years commencing six months following the closing) and warrants to purchase up to an aggregate of 937,500 Ordinary shares at an exercise price of \$ 2.50 per share (for a term of five years commencing six months following the closing).

In September 2003, the Company signed an agreement with Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M. (the "Banks") to restructure a portion of the debt owed to the Banks. The carrying value of the restructured debt was \$ 3,451. As part of the restructuring, the Company issued 3,781,995 warrants to the Banks, paid cash of \$ 1,100 and the Banks forgave the remaining debt. The warrants issued to the Banks have an exercise price equal to par value of the shares and a term of 2.5 years. The warrants have a lock-up period of 21 months. The Banks have a put option to sell the warrants to the Company's major shareholder for a consideration of \$ 1,251. The put option is exercisable by the Banks only once during the period of 45 days commencing after the end of the period of 18 months from the date of the agreement. In addition, the Banks granted the Company's major shareholder a call option that requires the Banks to sell the warrants to the shareholder at the exercise price of the put option with an additional payment equal up to 25% of the increase in the market share price from the date of the agreement up to a maximum of \$ 0.14 per warrant. The call option may be exercised by the shareholder during the period of 18 months from the date of the agreement and during a period of 45 days commencing after the termination of the put option. In addition, as part of the restructuring, the Company issued to the Banks 1,100,000 warrants having an exercise price of \$ 2.00 per share, and a term of five years.

The transaction was recorded in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings". The above warrants (3,781,995 warrants and 1,100,000 warrants) that were issued to the Banks were recorded at fair value (\$ 1,267, net of issuance expenses). The fair value

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of the warrants was based on a valuation prepared at the consummation date of the transaction. The valuation took into consideration the long lock-up period and a marketability discount. The valuation result was judged to be reasonable by comparison to benchmarks in similar circumstances. The Company's management is responsible for the valuation.

The difference between the consideration paid to the Banks (cash and warrants) and the carrying amount of the debt of \$ 1,013, was recognized as a gain on restructuring of debt, net of issuance expenses, presented in financial income (expenses), net, in the statement of operations.

In June 2002, in connection with the private placement described in a. above, the investors were issued warrants to purchase 4,302,041 of the Company's Ordinary shares. Such warrants are valid for five years and are exercisable during the first 36 months after issuance at an exercise price of \$ 2 per share, and thereafter, during the following 24-month period, at an exercise price which will be equal to the higher of: (i) \$ 2 per share or (ii) 50% of the average closing price during the ten trading days prior to the exercise date. The proceeds allocated to the warrants, based on the relative fair value of the warrants and shares issued amounted to \$ 41.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)

In June 2002, in connection with the conversion of a loan that was given to the Company by a shareholder in the amount of \$ 1,350 as described in a. above, the Company issued the shareholder warrants to purchase 8,265,306 Ordinary shares. Such warrants have the same terms as the warrants described above. The proceeds allocated to the warrants, based on the relative fair value of warrants and shares issued amounted to \$ 78. The benefit arising on conversion of the loan amounting to \$ 83, was recorded as interest expense.

The fair value of the warrants described above was estimated using Black-Scholes option-pricing model with the following weighted-average assumptions: risk-free interest rate of 2%, dividend yield of 0%, expected volatility of 24%, and expected life of warrant of five years.

NOTE 12:- TAXES ON INCOME

- a. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes are measured and adjusted in accordance with the change in the CPI. As explained in Note 2b, the consolidated financial statements are presented in U.S. dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate cause a difference between taxable

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income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on this difference between the financial reporting basis and the tax bases of assets and liabilities.

- b. Tax benefits under the Law for the Encouragement of Industry (Taxes), 1969:

The Company is an "Industrial Company" under the Law for the Encouragement of Industry. The principal benefit from the above law is the deduction of expenses in connection with a public offering.

- c. The Company in Israel is subject to tax at the rate of 35% of taxable income for 2004, 34% for 2005, 32% for 2006 and 30% for 2007 onwards. As of December 31, 2004, the net operating loss carryforward for tax purposes relating to the Company in Israel amounted to approximately \$ 44,400. Carryforward losses in Israel may be carried forward indefinitely and may be offset against future taxable income.

As of December 31, 2004, carryforward losses relating to non-Israeli companies (U.S. and China), amounted to approximately \$9,750.

As the Company believes that the tax assets in respect of these carryforward losses amounting to approximately \$19,000 are not more likely than not to be realized, the Company has recorded a valuation allowance in respect of the entire amount of the deferred tax asset relating to the carryforward losses.

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 12:- TAXES ON INCOME (Cont.)

- d. Income (loss) before income taxes:

| | Year ended December 31, | | |
|----------|-------------------------|--------|------------|
| | 2004 | 2003 | 2002 |
| Domestic | \$ 937 | \$ 867 | \$ (2,175) |
| Foreign | (115) | (109) | (308) |
| | \$ 822 | \$ 758 | \$ (2,483) |

- e. The main reconciling items between the statutory tax rate of the Company and the effective tax rate is the valuation allowance recorded in respect of the tax assets relating to net operating loss carryforwards and other temporary differences due to the uncertainty of the realization of such tax assets.

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NOTE 13:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Financial income (expenses), net:

| | Year ended December 31, | | |
|--|-------------------------|----------|--------|
| | 2004 | 2003 | 2002 |
| Income: | | | |
| Gain on restructuring of debt, net (see Note 11c) | \$ - | \$ 1,013 | \$ - |
| Foreign currency exchange differences | 234 | - | 1 |
| Interest on cash equivalents | 4 | 9 | |
| | ----- | ----- | ----- |
| | 238 | 1,022 | 1 |
| | ----- | ----- | ----- |
| Expenses: | | | |
| Interest on convertible note | 64 | - | |
| Amortization of beneficial conversion feature on convertible note | 115 | - | |
| Foreign currency exchange differences | 79 | 22 | |
| Interest on short-term loans and other credit balances | 82 | 230 | 2 |
| Bank commissions | 116 | 59 | |
| Interest to related parties | - | - | |
| Loss on extinguishment of debt | - | - | |
| Others | 30 | 3 | |
| | ----- | ----- | ----- |
| | 486 | 314 | 5 |
| | ----- | ----- | ----- |
| | \$ (248) | \$ 708 | \$ (3) |
| | ===== | ===== | ===== |

b. Other income (expenses), net:

| | | | |
|--------------------|-------|--------|--------|
| Impairment of loan | \$ - | \$ - | \$ (2) |
| Others, net | 23 | (2) | |
| | ----- | ----- | ----- |
| | \$ 23 | \$ (2) | \$ (2) |
| | ===== | ===== | ===== |

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 14:- RELATED PARTY TRANSACTIONS

There are no related party balances as of December 31, 2004 and 2003. Related party transactions reflected in the statement of operations for the years ended December 31, 2004, 2003 and 2002 are as follows:

Year ended December 31,

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| | 2004 | 2003 | 2002 |
|--------------------------------|-------|-------|--------|
| | ----- | ----- | ----- |
| Related party (*): | | | |
| Revenues | \$ - | \$ - | \$ 394 |
| | ===== | ===== | ===== |
| Shareholder: | | | |
| Interest expense | \$ - | \$ - | \$ 89 |
| | ===== | ===== | ===== |
| Loss on extinguishment of loan | \$ - | \$ - | \$ 83 |
| | ===== | ===== | ===== |

(*) A company controlled by a Company shareholder. See also Note 11c.

NOTE 15:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

- a. In accordance with Statement of Financial Accounting Standards No. 131 "Disclosures About Segments of an Enterprise and Related Information", the Company is organized and operates as one business segment, which develops, manufactures and sells ATE products, avionics equipment and aviation data acquisition and debriefing systems.

- b. Revenues by geographic areas:

Revenues are attributed to geographic area based on the location of the end customers as follows:

| | Year ended December 31, | | |
|---------------|-------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| North America | \$ 4,715 | \$ 5,115 | \$ 6,671 |
| Europe | 3,022 | 3,436 | 1,599 |
| Israel | 4,998 | 3,224 | 1,442 |
| Others | 1,425 | 540 | 687 |
| | ----- | ----- | ----- |
| Total | \$ 14,160 | \$ 12,315 | \$ 10,399 |
| | ===== | ===== | ===== |

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 15:- MAJOR CUSTOMERS AND GEOGRAPHIC INFORMATION

- c. Major customers:

Revenues from single customers that exceed 10% of the total revenues in the reported years as a percentage of total revenues, are as follows:

| | Year ended December 31, | | |
|--|-------------------------|-------|-------|
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |

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| | | % | |
|------------|----|----|----|
| Customer A | 19 | 11 | *) |
| Customer B | *) | 12 | *) |
| Customer C | *) | 22 | 34 |
| Customer D | 10 | 14 | 19 |
| Customer E | 11 | - | - |
| Customer F | 17 | 19 | *) |

*) Less than 10%.

d. Long lived assets by geographic areas:

| | December 31, | | |
|--------|----------------|----------------|----------------|
| | 2004 | 2003 | 2002 |
| Israel | \$4,718 | \$5,179 | \$6,977 |
| China | 1,333 | 1,536 | 1,761 |
| | <u>\$6,051</u> | <u>\$6,715</u> | <u>\$8,738</u> |

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RADA ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 16:- NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted net earnings (loss) per share:

| | Year ended December 31, | | |
|---|-------------------------|--------|------|
| | 2004 | 2003 | 2002 |
| Numerator: | | | |
| Net income (loss) | \$ 822 | \$ 758 | \$ |
| Denominator: | | | |
| Weighted average number of shares of Ordinary stock outstanding during the year used to compute basic net income (loss) per share (in thousands) | 19,374 | 18,511 | |
| Incremental shares attributable to exercise of outstanding options and warrants (assuming proceeds would be used to purchase Treasury stock) (in thousands) | 4,310 | 1,193 | |

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| | | | |
|--|---------|---------|-------|
| Weighted average number of shares of Ordinary stock outstanding during the year used to compute diluted net income (loss) per share (in thousands) | 23,684 | 19,704 | |
| | ===== | ===== | ===== |
| Basic net income (loss) per share | \$ 0.04 | \$ 0.04 | \$ |
| | ===== | ===== | ===== |
| Diluted net income (loss) per share | \$ 0.03 | \$ 0.04 | \$ |
| | ===== | ===== | ===== |

NOTE 17:- SUBSEQUENT EVENT

On February 2005, the Company's Board of Directors approved the purchase of all the assets that are used by, or related to the operation of Vectop Limited ("Vectop"), an Israeli company specializing in the design, development, marketing and sale of electro-optic equipment and debriefing systems business. Vectop's assets also include know-how, patents and intellectual property to produce off-the-shelf products such as cameras and video recorders, which are currently operational onboard aircraft and tanks in Israel and other countries. The Company purchased Vectops assets for \$ 280 in cash and future consideration based on revenues derived from Vectop projects. In addition, the Company is assuming \$ 800 of Vectop's bank debt, payable commencing in 2006 over a two-year period, as well as other operational liabilities.

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S I G N A T U R E S

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

RADA ELECTRONIC INDUSTRIES LTD.

By: /s/Herzle Bodinger

Name: Herzle Bodinger
Title: President

Dated: September 1, 2005

