

**ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**  
**as of December 31, 2008**  
**(In U.S. dollars)**

**ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS  
as of December 31, 2008  
In U.S. dollars**

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

	<u>Page</u>
REPORTS OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM	2 - 3
CONSOLIDATED FINANCIAL STATEMENTS:	
Consolidated Balance Sheets	4 - 5
Consolidated Statements of Income	6
Statements of Changes in Shareholders' Equity	7 - 8
Consolidated Statements of Cash Flows	9 - 10
Notes to the Consolidated Financial Statements	11 – 65

# # # # # # #



■ **Kost Forer Gabbay & Kasierer**  
3 Aminadav St.  
Tel-Aviv 67067, Israel

■ Phone: 972-3-6232525  
Fax: 972-3-5622555

## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

### **To the Shareholders and Board of Directors of Elbit Systems Ltd.**

We have audited the accompanying consolidated balance sheets of Elbit Systems Ltd. ("Elbit Systems") and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in the shareholders' equity and cash flows for each of the three years in the period ended December 31, 2008. These consolidated financial statements are the responsibility of Elbit Systems' management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We did not audit the financial statements of certain majority-owned subsidiaries, which statements reflect total assets, before the effect of purchase price adjustments, constituting 13.97% and 14.78% as of December 31, 2007 and 2006, and total revenues constituting 18.42% and 13.47% for the years ended December 31, 2007 and 2006, respectively, of the related consolidated totals. Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for these subsidiaries, is based solely on the reports of the other auditors.

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 evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Elbit Systems and its subsidiaries as of December 31, 2008 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S generally accepted accounting principles.

As discussed in Note 16(E) to the consolidated financial statements, Elbit Systems adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109", effective January 1, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Elbit Systems' internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 10, 2009 expressed an unqualified opinion thereon.

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

Haifa, Israel  
March 10, 2009



Ernst & Young ®

■ **Kost Forer Gabbay & Kasierer**  
3 Aminadav St.  
Tel-Aviv 67067, Israel

■ Phone: 972-3-6232525  
Fax: 972-3-5622555

## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

### **To the Shareholders and Board of Directors of Elbit Systems Ltd.**

We have audited Elbit Systems Ltd.'s ("Elbit Systems") internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). Elbit Systems' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on Elbit Systems' internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. 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.

As indicated in the accompanying Management's Report on Internal Control Over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Innovative Concepts, Inc. ("ICI"), Bar-Kal Systems Engineering Ltd. ("Bar-Kal") and Electro Optic Research and Development Company Ltd. ("EORD"), which were acquired in 2008, are included in Elbit Systems 2008 consolidated financial statements and constituted \$19 million of total assets, as of December 31, 2008, and \$3 million of revenues, for the year then ended. Our audit of internal control over financial reporting of Elbit Systems also did not include an evaluation of the internal control over financial reporting of ICI, Bar-Kal and EORD.

In our opinion, Elbit Systems maintained in all material respects, effective internal control over financial reporting, as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Elbit Systems and its subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2008, and our report dated March 10, 2009 expressed an unqualified opinion thereon.

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

Haifa, Israel  
March 10, 2009

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS

U. S. dollars (In thousands)

	Note	December 31,	
		2008	2007
<b>CURRENT ASSETS:</b>			
Cash and cash equivalents		\$ 204,670	\$ 362,802
Short-term bank deposits		69,642	10,068
Available for sale marketable securities	(8B)	3,731	2,830
Trade receivables (net of allowance for doubtful accounts in the amount of \$5,471 and \$3,794 as of December 31, 2008 and 2007, respectively)	(3)	477,010	431,961
Other receivables and prepaid expenses	(4)	203,990	130,867
Inventories, net of customer advances	(5)	647,561	480,603
Total current assets		<u>1,606,604</u>	<u>1,419,131</u>
<b>LONG-TERM INVESTMENTS AND RECEIVABLES:</b>			
Investments in affiliated companies and a partnership	(6)	62,300	66,161
Compensation receivables in respect of fire damages, net	(7)	-	15,530
Long-term bank deposits and trade receivables	(8)	37,746	20,747
Available for sale marketable securities	(8)	2,999	20,885
Deferred income taxes, net	(16)	9,201	19,323
Severance pay fund	(2P)	236,928	238,083
		<u>349,174</u>	<u>380,729</u>
<b>PROPERTY, PLANT AND EQUIPMENT, NET</b>	(9)	<u>384,086</u>	<u>352,702</u>
<b>GOODWILL</b>	(10)	<u>323,772</u>	<u>335,266</u>
<b>IDENTIFIABLE INTANGIBLE ASSETS, NET</b>	(10)	<u>270,511</u>	<u>300,989</u>
		<u>\$ 2,934,147</u>	<u>\$ 2,788,817</u>

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS

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

	Note	December 31,	
		2008	2007
<b>CURRENT LIABILITIES:</b>			
Short-term bank credit and loans	(11)	\$ 6,331	\$ 10,418
Current maturities of long-term loans	(14)	9,082	18,659
Trade payables		340,315	272,627
Other payables and accrued expenses	(12)	471,678	429,746
Customer advances in excess of costs incurred on contracts in progress	(13)	489,192	510,562
Total current liabilities		<u>1,316,598</u>	<u>1,242,012</u>
<b>LONG-TERM LIABILITIES:</b>			
Long-term loans, net of current maturities	(14)	269,760	431,312
Customer advances in excess of costs incurred on contracts in progress	(13)	115,470	137,296
Deferred income taxes and tax liabilities, net	(16)	70,068	96,717
Pension and termination indemnities	(15, 2P)	332,236	293,848
Other long term liabilities		29,707	31,285
		<u>817,241</u>	<u>990,458</u>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>	(17)		
<b>MINORITY INTERESTS</b>		<u>76,475</u>	<u>20,085</u>
<b>SHAREHOLDERS' EQUITY:</b>	(18)		
Share capital:			
Ordinary shares of New Israeli Shekels (NIS) 1 par value;			
Authorized – 80,000,000 shares as of			
December 31, 2008 and 2007;			
Issued 42,488,373 and 42,468,673 shares as			
of December 31, 2008 and 2007, respectively;			
Outstanding 42,079,452 and 42,059,752 shares			
as of December 31, 2008 and 2007, respectively			
		11,892	11,886
Additional paid-in capital		300,227	294,862
Treasury shares - 408,921 shares as of			
December 31, 2008 and 2007		(4,321)	(4,321)
Accumulated other comprehensive loss		(13,573)	(24,367)
Retained earnings		429,608	258,202
		<u>723,833</u>	<u>536,262</u>
		<u>\$ 2,934,147</u>	<u>\$ 2,788,817</u>

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF INCOME

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

	Note	Year ended December 31,		
		2008	2007	2006
Revenues	(19)	\$ 2,638,271	\$ 1,981,761	\$ 1,523,243
Cost of revenues		1,870,830	1,454,913	1,149,768
Restructuring expenses	(1D)	-	10,482	-
Gross profit		<u>767,441</u>	<u>516,366</u>	<u>373,475</u>
Research and development expenses, net	(20)	184,984	126,995	92,232
Marketing and selling expenses		198,274	157,411	111,880
General and administrative expenses		134,182	107,447	77,505
Acquired in-process research and development ("IPR&D")		1,000	16,560	-
		<u>518,440</u>	<u>408,413</u>	<u>281,617</u>
Operating income		249,001	107,953	91,858
Financial expenses	(21)	(51,102)	(41,206)	(22,373)
Financial income and exchange rate differences	(21)	14,287	21,877	917
Other income, net	(22)	94,294	368	1,814
Income before taxes on income		<u>306,480</u>	<u>88,992</u>	<u>72,216</u>
Taxes on income	(16)	54,367	13,810	20,694
		<u>252,113</u>	<u>75,182</u>	<u>51,522</u>
Equity in net earnings of affiliated companies and partnership	(6B)	14,435	14,565	14,743
Minority interests in losses (earnings) of subsidiaries		(62,372)	(13,038)	5,977
Net income		<u>\$ 204,176</u>	<u>\$ 76,709</u>	<u>\$ 72,242</u>
Earnings per share	(18)			
Basic earnings per share		<u>\$ 4.85</u>	<u>\$ 1.82</u>	<u>\$ 1.75</u>
Diluted earnings per share		<u>\$ 4.78</u>	<u>\$ 1.81</u>	<u>\$ 1.72</u>
Weighted average number of shares used in computation of basic earnings per share		<u>42,075</u>	<u>42,041</u>	<u>41,340</u>
Weighted average number of shares used in computation of diluted earnings per share		<u>42,758</u>	<u>42,342</u>	<u>41,880</u>

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

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

	Number of outstanding shares	Share capital	Additional paid-in capital	Accumulated other comprehensive loss	Retained earnings	Treasury shares	Total shareholders' equity	Total comprehensive income
<b>Balance as of January 1, 2006</b>	40,966,624	\$ 11,636	\$ 278,679	\$ (1,340)	\$ 166,123	\$ (4,321)	\$ 450,777	
Exercise of options	1,050,050	240	8,008	-	-	-	8,248	
Tax benefit in respect of options exercised	-	-	2,144	-	-	-	2,144	
Stock based compensation	-	-	195	-	-	-	195	
Dividends paid	-	-	-	-	(24,616)	-	(24,616)	
Other comprehensive income (losses), net of tax:								
Unrealized loss on derivative instruments, net of \$2,711 tax income	-	-	-	(15,642)	-	-	(15,642)	\$ (15,642)
Foreign currency translation differences	-	-	-	2,034	-	-	2,034	2,034
Decrease in additional minimum pension liability per FAS 87, net of \$1,856 tax expense	-	-	-	2,603	-	-	2,603	2,603
Adjustment for adoption of FAS 158 for the pension plans, net of \$2,875 tax income	-	-	-	(4,341)	-	-	(4,341)	-
Adjustment for adoption of FAS 158 for the post medical plan	-	-	-	(252)	-	-	(252)	-
Unrealized gain on available for sale securities	-	-	-	192	-	-	192	192
Net income	-	-	-	-	72,242	-	72,242	72,242
Total comprehensive income								<u>\$ 61,429</u>
<b>Balance as of December 31, 2006</b>	<u>42,016,674</u>	<u>\$ 11,876</u>	<u>\$ 289,026</u>	<u>\$ (16,746)</u>	<u>\$ 213,749</u>	<u>\$ (4,321)</u>	<u>\$ 493,584</u>	
Cumulative impact of change in accounting for uncertainties in income taxes (FIN 48)	-	-	-	-	(4,846)	-	(4,846)	
Exercise of options	43,078	10	417	-	-	-	427	
Tax benefit in respect of options exercised	-	-	46	-	-	-	46	
Stock based compensation	-	-	4,778	-	-	-	4,778	
Gain resulting from affiliated company's IPO	-	-	595	-	-	-	595	
Dividends paid	-	-	-	-	(27,410)	-	(27,410)	
Other comprehensive income, net of tax:								
Unrealized loss on derivative instruments, net of \$127 tax income	-	-	-	(9,562)	-	-	(9,562)	\$ (9,562)
Foreign currency translation differences	-	-	-	605	-	-	605	605
Unrealized pension income, net of \$826 tax expense	-	-	-	2,037	-	-	2,037	2,037
Unrealized loss on available for sale securities	-	-	-	(701)	-	-	(701)	(701)
Net income	-	-	-	-	76,709	-	76,709	76,709
Total comprehensive income								<u>\$ 69,088</u>
<b>Balance as of December 31, 2007</b>	<u>42,059,752</u>	<u>\$ 11,886</u>	<u>\$ 294,862</u>	<u>\$ (24,367)</u>	<u>\$ 258,202</u>	<u>\$ (4,321)</u>	<u>\$ 536,262</u>	

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

**ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES**

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (CONT.)**

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

	Number of outstanding shares	Share capital	Additional paid-in capital	Accumulated other comprehensive loss	Retained earnings	Treasury shares	Total shareholders' equity	Total comprehensive income
<b>Balance as of January 1, 2008</b>	42,059,752	\$ 11,886	\$ 294,862	\$ (24,367)	\$ 258,202	\$ (4,321)	\$ 536,262	
Exercise of options	19,700	6	182	-	-	-	188	
Tax benefit in respect of options exercised	-	-	116	-	-	-	116	
Stock based compensation	-	-	5,067	-	-	-	5,067	
Dividends paid	-	-	-	-	(32,770)	-	(32,770)	
Other comprehensive income, net of tax:								
Unrealized loss on derivative instruments, net of \$2,397 tax expense	-	-	-	34,293	-	-	34,293	\$ 34,293
Foreign currency translation differences	-	-	-	(8,427)	-	-	(8,427)	(8,427)
Unrealized pension income, net of \$9,480 Tax income	-	-	-	(14,026)	-	-	(14,026)	(14,026)
Unrealized loss on available for sale Securities, net of \$113 tax expense	-	-	-	(1,046)	-	-	(1,046)	(1,046)
Net income	-	-	-	-	204,176	-	204,176	204,176
Total comprehensive income								<u>\$ 214,970</u>
<b>Balance as of December 31, 2008</b>	<u>42,079,452</u>	<u>\$ 11,892</u>	<u>\$ 300,227</u>	<u>\$ (13,573)</u>	<u>\$ 429,608</u>	<u>\$ (4,321)</u>	<u>\$ 723,833</u>	

**Accumulated other comprehensive loss (net of taxes)**

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Accumulated gains (losses) on derivative instruments	\$ 14,624	\$ (19,669)	\$ (10,107)
Accumulated foreign currency translation differences	(5,922)	2,505	1,900
Accumulated unrealized gain (loss) on available for sale securities	(1,555)	(509)	192
Unrealized pension losses	(20,720)	(6,694)	(8,731)
Accumulated other comprehensive loss	<u>\$ (13,573)</u>	<u>\$ (24,367)</u>	<u>\$ (16,746)</u>

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS

U. S. dollars (In thousands)

	Year ended December 31,		
	2008	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 204,176	\$ 76,709	\$ 72,242
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	129,437	99,414	58,500
Write-off impairment	10,514	-	-
Acquired IPR&D	1,000	16,560	-
Other-than-temporary impairment of available for sale marketable securities	17,885	10,027	-
Stock based compensation	5,067	4,778	195
Deferred income taxes and reserve	(8,488)	(30,955)	(4,659)
Severance, pension and termination indemnities, net	15,211	(3,171)	(5,197)
Gain on sale of property, plant and equipment	(1)	(1,120)	(2,351)
Gain on sale of investment	(100,031)	-	-
Minority interests in earnings (losses) of subsidiaries	62,372	13,038	(5,977)
Equity in net earnings of affiliated companies and partnership, net of dividend received (*)	(1,866)	(2,182)	(1,696)
Changes in operating assets and liabilities:			
Increase in short and long-term trade receivables, and prepaid expenses	(39,698)	(68,129)	(58,793)
Increase in inventories, net	(169,482)	(124,381)	(69,974)
Increase in trade payables, other payables and accrued expenses	120,734	151,283	75,869
Increase (decrease) in advances received from customers	(37,402)	120,814	142,844
Other	-	2	(35)
Net cash provided by operating activities	<u>209,428</u>	<u>262,687</u>	<u>200,968</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchase of property, plant and equipment	(129,241)	(106,269)	(64,809)
Acquisitions of subsidiaries (Schedule A)	(20,637)	(353,175)	-
Investments in affiliated companies and other companies	(4,001)	(916)	(31,930)
Proceeds from sale of property, plant and equipment	8,779	4,364	5,705
Proceeds from sale of investment	50,254	1,431	5,000
Investment in long-term bank deposits	(19,166)	(12,216)	(880)
Proceeds from sale of long-term bank deposits	939	8,839	780
Investment in short-term deposits	(62,518)	(4,116)	(862)
Proceeds from sale of short-term deposits	3,884	197,379	-
Net cash used in investing activities	<u>(171,707)</u>	<u>(264,679)</u>	<u>(86,996)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from exercise of options	188	427	8,248
Repayment of long-term bank loans	(333,590)	(150,310)	(188,723)
Issuance of long-term bank loans	183,211	464,878	85,053
Dividends paid	(32,770)	(27,410)	(24,322)
Tax benefit in respect of options exercised	116	46	2,144
Change in short-term bank credit and loans, net	(13,008)	(7,401)	(5,695)
Net cash provided by (used in) financing activities	<u>(195,853)</u>	<u>280,230</u>	<u>(123,295)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(158,132)	278,238	(9,323)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	362,802	84,564	93,887
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	<u>\$ 204,670</u>	<u>\$ 362,802</u>	<u>\$ 84,564</u>
(*) Dividend received	<u>\$ 12,569</u>	<u>\$ 12,383</u>	<u>\$ 13,047</u>

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS (CONT.)

U. S. dollars (In thousands)

	Year ended December 31,		
	2008	2007	2006
<b>SUPPLEMENTAL CASH FLOW ACTIVITIES:</b>			
Cash paid during the year for:			
Income taxes	\$ 30,827	\$ 23,282	\$ 15,955
Interest	\$ 21,356	\$ 20,949	\$ 14,311
<b>SCHEDULE A:</b>			
Acquisitions of subsidiaries (*)			
Estimated net fair value of assets acquired and liabilities assumed at the date of acquisition was as follows:			
Working capital, net (excluding cash and cash equivalents)	\$ 3,378	\$ 40,540	\$ -
Property, plant and equipment	463	25,175	-
Other long term assets	-	63,063	-
Goodwill and other intangible assets	12,886	530,536	-
IPR&D	1,000	16,560	-
Deferred income taxes	-	(71,919)	-
Long-term liabilities	(48)	(76,910)	-
Equity investment in Tadiran Communication Ltd. ("Tadiran")	-	(173,870)	-
Equity acquired in subsidiaries	2,958	-	-
	\$ 20,637	\$ 353,175	\$ -

(\*) In 2008, the shares of Bar-Kal Systems Engineering Ltd., the shares of Electro Optic Research and Development Company Ltd., 46% of the shares of A.E. Electronics S.A. (of which 54% of the shares were held by the Company prior to the acquisition), 40% of the shares of Xseed Technologies and Computing Ltd. (of which 60% of the shares were held by the Company prior to the acquisition), and the shares of Innovative Concepts, Inc. - (See Note 1(E))

(\*) In 2007, the shares of Tadiran – (See Note 1(C)) and FTL - (See Note 1(D)).

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

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U. S. dollars (In thousands)

### Note 1 - GENERAL

- A. Elbit Systems Ltd. (“Elbit Systems”) is an Israeli corporation, 45.9% owned by the Federmann Group. Elbit Systems’ shares are traded on the Nasdaq National Market in the United States (“Nasdaq”) and on the Tel Aviv Stock Exchange (“TASE”). Elbit Systems and its subsidiaries (collectively the “Company”) are engaged mainly in the field of defense electronics, homeland security and commercial aviation. Elbit Systems’ principal wholly-owned subsidiaries are the Elbit Systems of America, LLC (“ESA”) companies, Elbit Systems Electro-Optics Industries Elop Ltd. (“Elop”) and Elbit Systems Land and C<sup>4</sup>I – Tadiran Ltd. (“ESLC-T”) (see Note 1(C)). Elbit Systems also owns 70% of Elisra Electronic Systems Ltd. (“Elisra”).
- B. A majority of the Company’s revenues are derived from direct or indirect sales to governments or to governmental agencies. As a result, a substantial portion of the Company’s sales is subject to the special risks associated with sales to governments or to governmental agencies. These risks include, among others, the dependency on the resources allocated by governments to defense programs, changes in governmental priorities, changes in governmental registration and changes in governmental regulations and changes in governmental approvals regarding export licenses required for the Company’s products and for its suppliers. As for major customers, refer to Note 19(C).
- C. On April 26, 2007, the Company completed its Cash Tender Offer (the “Offer”) for the balance of the ordinary shares of Tadiran, which prior to the completion of the Offer was a publicly traded company in Israel, held 42% by the Company and accounted for using the equity method. The total purchase price of the Tadiran shares relating to the Offer was approximately \$383,000. The results of Tadiran have been consolidated in Elbit Systems’ financial statements commencing May 1, 2007.

Tadiran was a leading provider of defense communications systems. The Company is active in the command, control, communications, computers, intelligence, surveillance and reconnaissance (“C4ISR”) area, and is using integrated communication equipment in its systems. As a result of the acquisition, the Company recorded goodwill (non deductible for tax purposes) and believes there are synergies between its systems operations and Tadiran, by providing advanced integrated network and communication solutions to their customers.

The Purchase Price Allocation (“PPA”) period ended during 2008. Based on a PPA performed by an independent advisor, the purchase price was attributed to the fair value of assets acquired and liabilities assumed as follows:

	Acquired share of book value in Tadiran	Excess cost	Total	<u>Expected useful lives</u>
Working capital	\$ 67,600	(17,400)	\$ 50,200	
Long-term assets and investments	34,800	-	34,800	
Property, plant and equipment	9,300	1,100	10,400	20 years
Long-term liabilities	(53,000)	800	(52,200)	
Brand name	5,700	18,200	23,900	15 years
Customer relationships and backlog	-	96,800	96,800	2-10 years
Technology	2,700	40,800	43,500	10 years
IPR&D	-	16,600	16,600	Immediate write-off
Deferred taxes	-	(35,100)	(35,100)	
Goodwill	<u>32,800</u>	<u>161,300</u>	<u>194,100</u>	Indefinite – subject to annual impairment test
	<u>\$ 99,900</u>	<u>\$ 283,100</u>	<u>\$ 383,000</u>	

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

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

### Note 1 - GENERAL (Cont.)

Following the acquisition of the Tadiran shares in the second quarter of 2007, Elbit Systems identified and wrote-off duplicated inventories and equipment and accrued termination costs in a total amount of \$10,482, which was recorded as restructuring expenses in the cost of revenues.

The following unaudited proforma data is based on historical financial statements of Elbit Systems and Tadiran and is provided for comparative purposes only. The proforma information does not purport to be indicative of the results that actually would have occurred had the purchase of the shares been consummated prior to the beginning of the reported periods.

The proforma information reflects the results of the Company's operations assuming that Tadiran's results, instead of the 42% previously owned, were included in the Company's consolidated results for each of the reported periods and under the following assumptions:

- (1) Intangible assets (customer relationships, backlog, brand name and technology) arising from the acquisition of the Tadiran shares of approximately \$228,000, net of related deferred taxes of approximately \$57,000, are amortized over a period of 2-15 years.
- (2) Excess of cost over equity purchased allocated to real estate assets of approximately \$1,800, net of related deferred taxes of approximately \$450, is amortized over a period of 20 years.
- (3) The cost attributed to purchased IPR&D projects, in the amount of approximately \$16,560, was immediately charged to operations as a non-recurring item and is not included in the proforma consolidated results.
- (4) Intercompany balances and transactions, if any, have been eliminated.

	<b>Year ended December 31,</b>	
	<b><u>2007</u></b>	<b><u>2006</u></b>
	<b>Unaudited</b>	
Proforma sales	\$ 2,067,805	\$ 1,775,247
Proforma net income	\$ 97,575	\$ 85,890
Proforma earnings per share		
Basic	\$ 2.32	\$ 2.08
Diluted	\$ 2.30	\$ 2.05

In November 2007, the Company announced that Elbit Systems' Board of Directors approved a plan to merge Tadiran into Elbit Systems and for Tadiran's Israeli operations to be combined with Elbit Systems Land and C4I Division under a new wholly-owned subsidiary ESLC-T. The merger and the split were completed during the second half of 2008.

- D. On July 27, 2007, the Company acquired the entire share capital of the U.K. company Ferranti Technologies (Group) Limited ("FTL") for £15 million (approximately \$31,000). FTL is a design and manufacturing company providing engineering, manufacturing and logistic support to the aerospace and defense industries. The Company's management believes that FTL will enable the Company to offer its products and solutions to FTL customers in the U.K.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

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

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

- E. During 2008, the Company completed the following acquisitions:
- (1) On June 23, 2008, the Company's subsidiary Elop acquired all of the shares of Bar-Kal Systems Engineering Ltd. ("Bar-Kal"), for a purchase price of \$1,600. Bar-Kal is an Israeli company, engaged in research, development and marketing of technologies related to systems engineering of hyper spectral remote sensing for defense and government-related customers in Israel and abroad.
  - (2) On June 30, 2008, the Company acquired all of the shares of Electro Optic Research and Development Company Ltd. ("EORD") from their former shareholders, Technion Research & Development Foundation Ltd. and Bynet Electronics Ltd., for a purchase price of \$1,300. EORD is an Israeli company, engaged in research and development of acoustic and seismic sensors and systems for military and security applications.
  - (3) On July 1, 2008, the Company acquired 46% of the shares of A.E. Electronics S.A. (of which 54% of the shares were held by the Company prior to the acquisition) for \$2,100.
  - (4) On November 11, 2008, the Company's U.S. subsidiary ESA, acquired all of the shares of Innovative Concepts, Inc. ("ICI") from Herley Industries, Inc. in a \$15 million all cash transaction. ICI, located in McLean, Virginia, is a wireless communications technology firm specializing in design, production and support of real-time embedded systems and high-speed processing solutions for defense and homeland security applications. ICI became part of Elbit Systems of America's C4I Solutions business. This acquisition is part of ESA's strategy to provide advanced C4I systems solutions to the United States Department of Defense and Department of Homeland Security. The results of ICI were consolidated in the Company's financial statements commencing the date of acquisition.
  - (5) On November 12, 2008, the Company acquired approximately 19.5% of the shares of Azimuth Technologies Ltd. ("Azimuth") for a purchase price of \$3,400. Azimuth is an Israeli company whose shares are traded on the Tel Aviv Stock Exchange ("TASE") and is engaged in the development and sale of products for target acquisition, navigation and orientation for the defense market. The investment in Azimuth is accounted for as a long-term available-for-sale investment.
  - (6) On December 3, 2008 the Company acquired 40% of the shares of Xseed Technologies and Computing Ltd. (of which 60% of the shares were held by the Company prior to the acquisition) for \$850, and an additional amount of \$750 was paid to the seller for a non competition agreement.
- F. On December 22, 2008, the Company's 41.3%-owned subsidiary (on a fully diluted basis), MediGuide Inc. ("Mediguide"), signed a definitive agreement with St. Jude Medical to acquire all of the outstanding shares of MediGuide for \$283 million in cash and the assumption of net liabilities totaling approximately \$17 million. Under the transaction, St. Jude Medical paid \$138 million of the purchase price in December 2008, with the balance due in two subsequent payments of \$111 million in November 2009 and up to \$34 million in April 2010.

As a result of the above, the Company included in its 2008 results a gain before tax of \$100,031. The gain was included in Other Income, net. This gain does not include contingent proceeds of up to \$13,000 that may be received in 2010, upon achievement of certain events and fulfillment of several conditions.

In 2008, the Company received the first payment for the shares, which amounted to \$50,254, and the balance is expected in 2009 and 2010.

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

### Note 2 - SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ("U.S. GAAP").

#### A. USE OF ESTIMATES

The preparation of financial statements in conformity with general acceptable accounting principles requires management to make estimation and assumption that affect the amounts reported in the financial statements and accompanying notes. The most significant assumptions are employed in estimates used in determining values of intangible assets, sales and return accruals, legal contingencies, tax assets and tax liabilities, stock-based compensation costs, retirement and post-retirement benefits (including the actuarial assumptions), financial instruments with no observable market quotes, as well as in estimates used in applying the revenue recognition policy. Actual results may differ from estimated results.

#### B. FINANCIAL STATEMENTS IN U.S. DOLLARS

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

Transactions and balances of the Company and certain subsidiaries, which are denominated in other currencies, have been remeasured into U.S. dollars in accordance with principles set forth in SFAS No. 52 "Foreign Currency Translation". All exchange gains and losses from the remeasurement mentioned above are reflected in the statement of income in Financial expenses, net.

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

#### C. PRINCIPLES OF CONSOLIDATION

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

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

#### D. CASH AND CASH EQUIVALENTS

Cash equivalents, are short-term highly liquid investments that are readily convertible to cash with maturities of three months or less, when purchased.

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

#### E. SHORT-TERM BANK DEPOSITS

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

#### F. AVAILABLE FOR SALE MARKETABLE SECURITIES

The Company accounts for marketable securities in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 115, “Accounting for Certain Investments in Debt and Equity Securities”. The Company determined the appropriate classification of all marketable securities as “available-for-sale” at the time of purchase or at the time marketable securities were first consolidated as a result of an acquisition. At December 31, 2008 and 2007, all of the Company’s investments in marketable securities were reported at fair value. Fair value is determined based on observable market value quotes or in case market value is not available using valuation models including assessments of counterparty credit worthiness, credit default risk, underlying security type of collaterals risk premium and overall capital market liquidity conditions. Declines in fair value that are considered other-than-temporary are charged to earnings and those that are considered temporary are reported, net of tax, as a component of accumulated other comprehensive income (“OCI”) in shareholders’ equity. The Company uses the average cost method of determining the cost basis in computing realized gains and losses on the sale of its available-for-sale securities. Realized gains and losses are included in Financial expense, net (see Notes 8(B) and 21). During 2008 and 2007, other-than-temporary impairment loss on available for sale marketable securities amounted to \$18,714 and \$10,027, respectively.

#### G. 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 or technological obsolescence for which recoverability is not probable.

Cost is determined as follows:

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

Advances from customers are allocated to the applicable contract inventories and are presented as net amounts. Advances in excess of related inventories are classified as liabilities.

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

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

#### H. INVESTMENT IN AFFILIATED COMPANIES AND A PARTNERSHIP

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

Investments in preferred shares, which are not in substance common stock, are recorded on a cost basis according to EITF 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock."

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

Investments in non-marketable equity securities of entities in which the Company does not have control or the ability to exercise significant influence over their operation and financial policies, are recorded at cost (generally when the Company holds less than 20% of the voting rights).

Management evaluates investments in affiliates and other companies for evidence of other-than-temporary declines in value. When relevant factors indicate a decline in value that is other-than-temporary the Company recognizes an impairment loss for the decline in value. A judgmental aspect of accounting for investments involves determining whether an other-than-temporary decline in value of the investment has been sustained. Such evaluation is dependent on the specific facts and circumstances. Accordingly, management evaluates financial information (e.g. budgets, business plans, financial statements, etc.) in determining whether an other-than-temporary decline in value exists. Factors indicative of an other-than-temporary decline include recurring operating losses, credit defaults and subsequent rounds of financings at an amount below the cost basis of the investment. This list is not all inclusive and management weighs all quantitative and qualitative factors in determining if an other-than-temporary decline in value of an investment has occurred. During 2008, an impairment loss of \$10,514 related to the investment in Sandel Avionics Inc. ("Sandel") was recognized (see Note 6(C)). During 2007 and 2006, no impairment loss was recorded.

#### I. LONG-TERM RECEIVABLES

Long-term trade and other receivables, from extended payment agreements, are recorded at their estimated present values (determined based on the market interest rates at the date of initial recognition).

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

#### J. LONG-TERM BANK DEPOSITS

Long-term bank deposits are deposits with maturities of more than one year. These deposits are presented at cost. Accumulated interest is recorded as current assets, the deposits and accumulated interest approximate fair value.

#### K. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost, net of accumulated depreciation and investment grants. For equipment produced for the Company's own use, cost includes materials, labor and overhead (including interest costs, when applicable) but not in excess of the fair value of the equipment.

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

	%	
Buildings and leasehold improvements	2-33	
Instruments, machinery and equipment	3-33	
Office furniture and other	4-33	
Motor vehicles	15-33	(Mainly 15%)

Prepayments for operating lease and leasehold improvements are amortized generally over the term of the lease or the useful life of the assets, which ever is shorter.

#### L. INVESTMENT GRANTS

As a governmental incentive for industrial companies in Israel, the "Investment Center", which is a branch of the Israel Ministry of Industry and Trade, permits industrial companies to submit a request to qualify as an "Approved Enterprise". An Approved Enterprise is entitled to certain benefits in respect of capital investments. The benefits may be in the form of reduced tax rates and of capital grants received as a percentage of the investments of the Approved Enterprise. The amount of a capital grant is determined as a percentage of the Approved Enterprise investment in property, plant and equipment. These capital grants are non-royalty bearing and are not conditioned on the results of operations. As the capital grants are a direct participation in the cost of the acquisition of property, plant and equipment, they are offset against the cost of property, plant and equipment.

#### M. IDENTIFIABLE INTANGIBLE ASSETS

Identifiable intangible assets consist of purchased technology, customer relations and trademarks. These intangible assets are stated at cost net of accumulated amortization and are amortized over their useful life using the straight-line method, or the accelerated method, which ever better reflect their expected utilization pattern.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### N. IMPAIRMENT OF LONG-LIVED ASSETS

The Company's long-lived assets and identifiable intangible assets are reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If an asset is determined to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. For each of three years in the period ended December 31, 2008, no impairment has been identified.

##### O. GOODWILL

Goodwill represents the excess of the cost of acquired businesses over the net fair values of the assets acquired and liabilities assumed. Goodwill is no longer amortized, but is instead tested for impairment at least annually (or more frequently if impairment indicators arise).

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

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

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

The Company identified several reporting units based on the guidance of SFAS 142, "Goodwill and Other Intangible Assets".

For each of the three years in the period ended December 31, 2008, no impairment losses have been identified.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### P. SEVERANCE PAY

Elbit Systems and its Israeli subsidiaries' obligation for severance pay is calculated pursuant to Israel's Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date and is presented on an undiscounted basis. Employees are entitled to one month's salary for each year of employment or a portion thereof. The obligation is provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet. The deposited funds may be withdrawn only upon the fulfillment of the obligation, pursuant to the Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes profits (or losses) accumulated to balance sheet date.

Elbit Systems and its Israeli subsidiaries have entered into an agreement with some of its employees implementing Section 14 of the Severance Pay Law and the General Approval of the Labor Minister dated June 30, 1998, issued in accordance to the said Section 14, mandating that upon termination of such employees' employment, the company shall release to them all the amounts accrued in their insurance policies. The severance pay liabilities and deposits covered by these plans are not reflected in the balance sheet as the severance pay risks have been irrevocably transferred to the severance funds.

Severance pay expenses for the years ended December 31, 2008, 2007 and 2006 amounted to approximately \$51,567, \$26,294 and \$19,161, respectively.

##### Q. PENSION AND POSTRETIREMENT BENEFITS

The Company presents its obligations for pension and postretirement benefits in accordance with SFAS No.158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans", an amendment of FASB Statements No. 87, 88, 106 and 132(R); FAS 87, "Employers' Accounting for Pension" ("SFAS 158"); and SFAS No. 106, "Employers' Accounting for Postretirement Benefit Other Than Pension". FAS 158, which was adopted in the year ending December 31, 2006, requires a Company to recognize on a plan-by-plan basis, the funded status of its pension and postretirement benefit plans, with a corresponding adjustment to accumulate other comprehensive loss, net of tax, in shareholder's equity, of any unrecognized gains and losses (see Note 15).

##### R. REVENUE RECOGNITION

The Company generates revenues principally from long-term contracts involving the design, development, manufacture and integration of defense systems and products. In addition, to a minor extent, the Company provides support and services for such systems and products.

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### R. REVENUE RECOGNITION (Cont.)

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

Sales and anticipated profit under long-term fixed-price production type contracts are recorded on a percentage-of-completion basis, using the units-of-delivery as the basis to measure progress toward completing the contract and recognizing revenues. In certain circumstances, which involve long-term fixed-price production type contracts for non-homogenous or small quantity of units, revenue is recognized based on the achievement of performance milestones, which provide a more reliable, and objective measure to the extent of progress toward completion.

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

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

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

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### R. REVENUE RECOGNITION (Cont.)

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, revenue is recognized when the Company expects to perform its contractual obligations, and its customers are expected to satisfy their obligations under the contract

Management reviews periodically the estimates of progress towards completion and project costs. These estimates are determined based on engineering estimates and past experience, by personnel having the appropriate authority and expertise to make reasonable estimates of the related costs. Such engineering estimates are reviewed periodically for each specific contract by professional personnel from various disciplines within the organization. These estimates take into consideration the probability of achievement of certain milestones, as well as other factors that might impact the contract's completion.

A number of internal and external factors affect our cost estimates, including labor rates, estimated future material prices, revised estimates of uncompleted work, efficiency variances, linkage to indices and exchange rates, customer specifications and testing requirement changes. If any of the above factors were to change, or if different assumptions were used in estimating progress cost and measuring progress towards completion, it is likely that materially different amounts would be reported in the Company's consolidated financial statements.

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

In cases where the contract involves the delivery of products and performance of services, or other obligation (e.g. buy-back obligations – see Note 17(B)), the Company follows the guidelines specified in EITF 00-21, "Revenue Arrangements with Multiple Deliverables" ("EITF-00-21") in order to allocate the contract elements between the products accounted for under SOP 81-1, SAB 104 and the services.

Service revenues include contracts primarily for the provision of supplies or services other than associated with design, development or production activities. It may be a stand-alone service contract or a service element, which was separated from the design, development or production contract according to the criteria established in EITF-00-21. Service contracts primarily include operation and maintenance contracts, outsourcing-type arrangement, return and repair contracts, training, installation service, etc. Revenue from services was less than 10% of consolidated revenues in each of the fiscal years 2008, 2007 and 2006.

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### S. WARRANTY

The Company estimates the costs that may be incurred under its basic warranty. Such costs are: (1) estimated as part of total contract's cost or (2) recorded as a liability at the time revenue for delivered products is recognized. The specific terms and conditions of those warranties vary depending upon the product sold and the country in which the Company does business. Factors that affect the Company's warranty cost include the number of delivered products, engineering estimates and anticipated rates of warranty claims. The Company periodically assesses the adequacy of its recorded warranty cost and adjusts the amount as necessary. Specific warranty reserves are recorded in the period defects or potential products failures are identified and recorded based on estimates made by management. The estimates are evaluated on a periodic basis.

Changes in the Company's provision for warranty, which is included in other payables and accrued expenses in the Balance Sheet, are as follows:

	<u>2008</u>	<u>2007</u>
Balance, at January 1	\$ 74,113	\$ 44,417
Warranties issued during the year	49,933	29,157
Warranties related to acquisitions	221	18,720
Warranties forfeited or exercised during the year	<u>(31,966)</u>	<u>(18,181)</u>
Balance, at December 31 <sup>(*)</sup>	<u>\$ 92,301</u>	<u>\$ 74,113</u>

(\*) The balance of provisions for long-term warranties is not material.

##### T. RESEARCH AND DEVELOPMENT COSTS

Research and development costs, net of participation grants, include costs incurred for independent research and development and bid and proposal efforts and are expensed as incurred unless the costs are related to certain contractual arrangements which are recorded as part of cost of sales, over the period that revenue is recognized, consistent with the Company's revenue recognition accounting policy. The Company does not have significant stand-alone research and development arrangements performed for others.

The Company has certain research and development contractual arrangements that meet the requirements for best efforts research and development accounting. Accordingly, the amounts funded by the customer are recognized as an offset to our research and development expenses rather than as contract revenues.

Elbit Systems and certain subsidiaries in Israel receive grants (mainly royalty-bearing) from the Israeli Chief Scientist's Office (OCS) and from other sources for the purpose of partially funding approved research and development projects. The grants are not to be repaid, but instead the subsidiaries are obliged to pay royalties as a percentage of future sales if and when sales from the funded projects will be generated. These grants are recognized as a deduction from research and development costs at the time the applicable entity is entitled to such grants on the basis of the research and development costs incurred. Since the payment of royalties is not probable when the grants are received, the Company records a liability in the amount of the estimated royalties for each individual contract, when the related revenues are recognized, as part of cost of revenues. For more information regarding OCS royalties' commitment, please see "Note 17(A).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### U. INCOME TAXES

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109"). This Statement prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to amounts that are more likely than not to be realized. As part of the determination of its tax liability, management exercises considerable judgment in evaluating tax positions taken by the Company in determining the income tax provision and establishes reserves for tax contingencies in accordance with FASB Interpretation No. 48, Accounting for uncertainty in income taxes, an interpretation of SFAS 109 ("FIN 48").

The Company records interest related to its unrecognized tax benefit or exposures in the financial statements as income tax expense. The Company's January 1, 2007 unrecognized tax benefit or exposures included \$2,450 of interest (\$1,404 and \$806 interest exposure related to 2006 and 2005, respectively).

##### V. CONCENTRATION OF CREDIT RISKS

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

The majority of the Company's cash and cash equivalents, deposits and foreign exchange forward contracts and options are invested in dollar instruments with major banks mainly in Israel and the United States. Management believes that the financial institutions that hold the Company investments have a high credit rating.

The Company entered into foreign exchange forward contracts and option strategies (together: "derivative instruments") intended to protect against the increase in value of forecasted non-dollar currency cash flows. These derivative instruments are designed to effectively hedge the Company's non-dollar currency exposure (see Note 2(W) below).

The Company's trade receivables are derived primarily from sales to large and stable customers and governments located mainly in Israel, the United States and Europe. The Company performs ongoing credit evaluations of its customers and has not experienced in recent years any unexpected material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

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

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### W. DERIVATIVE FINANCIAL INSTRUMENTS

The Company accounts for derivatives and hedging based on SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), as amended and related Interpretations. SFAS No. 133 requires the Company to recognize all derivatives on the balance sheet at fair value. If a derivative meets the definition of a hedge and is so designated, depending on the nature of the hedge, changes in the fair value of the derivative will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings (for Cash Flow hedge transactions) or recognized in other comprehensive income until the hedged item is recognized in earnings (for Fair Value hedge transactions). The ineffective portion (which was immaterial during 2008, 2007 and 2006) of a derivative's change in fair value is recognized in earnings. If a derivative does not meet the definition of a hedge the changes in the fair value are included in earnings. Cash flows related to such hedges are classified as operating activities.

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

The Company also enters into forward exchange contracts and options strategies in order to limit the exposure to exchange rate fluctuation associated with payroll expenses mainly incurred in NIS. The Company elected not to follow the designation and documentation processes required to qualify for the hedge accounting method under SFAS 133, and any gain or loss derived from such instruments is recognized immediately as financial expenses, net.

As of December 31, 2008, the Company had forward contracts with a notional amount of approximately \$229,411 to purchase and sell foreign currencies (\$133,258 in Euro, \$85,295 in Great Britain Pounds ("GBP") and \$10,858 in other currencies). These foreign exchange forward contracts have maturities between one and five years.

As of December 31, 2008, the Company had also forward contracts with a notional amount of approximately \$196,750 to purchase NIS and \$136,500 million in NIS – put and call options). These foreign exchanges forward put and call options having maturities of 12 months or less.

The fair value of the foreign exchange contracts and the options as of December 31, 2008 is an asset of approximately \$17,700.

##### X. STOCK-BASED COMPENSATION

The Company accounts for share-based arrangements under SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), which requires all equity-based payments, including grants of employee stock options, to be recognized in the income statement based on their fair values.

As required by SFAS 123(R), the fair value of options is estimated at grant date using a lattice-based option valuation model for options granted in 2008 and 2007 with the following weighted average assumptions:

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

#### X. STOCK-BASED COMPENSATION (Cont.)

	2008	2007	2006 <sup>(*)</sup>
Divided yield	1.84%	2.20%	-
Expected volatility	33.72%	28.50%	-
Risk-free interest rate	2.79%	4.70%	-
Expected life	4 years	4 years	-
Forfeiture rate	0.56%	0.56%	-
Suboptimal factor	1.75	2.67	-

(\*) No options were granted during 2006.

Because lattice-based option valuation models incorporate ranges of assumptions for inputs, those ranges are disclosed. Expected volatilities are based on implied volatilities from traded options on Elbit Systems' stock, historical volatility of the stock, and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model: separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The range, given above, results from certain groups of employees exhibiting different behavior. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

#### Y. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Effective January 1, 2008, we adopted SFAS 157 and effective October 10, 2008, we adopted FSP No. SFAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, except as it applies to the nonfinancial assets and nonfinancial liabilities subject to FSP 157-2. SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, SFAS 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

**Level 1** - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

**Level 2** - Include other inputs that are directly or indirectly observable in the marketplace.

**Level 3** - Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### Y. FAIR VALUE OF FINANCIAL INSTRUMENTS (Cont.)

In accordance with SFAS 157, the Company measures its marketable securities, auction rate securities (“ARS”) and foreign currency derivative contracts at fair value. Its cash equivalents and marketable securities are classified within Level 1 or Level 2. This is because its cash equivalents and marketable securities are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs. Its investments in ARS are classified within Level 3 and Level 2 because they are valued using valuation techniques (see Note 8(B)). Some of the inputs to these models are unobservable in the market and based on similar transactions and are significant. The Company’s foreign currency derivative contracts are classified within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments. Available for sale long-term marketable securities are classified as Level 1, since it is a traded equity securities.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

Description	Fair value measurement at reporting date using			
	December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Short term available for sale securities (*)	\$ 3,731	\$ 731	\$ -	\$ 3,000
Foreign currency derivative contracts	20,013	-	20,013	-
Long term available for sale securities	2,999	2,999	-	-
<b>Total assets</b>	<u>\$ 26,743</u>	<u>\$ 3,730</u>	<u>\$ 20,013</u>	<u>\$ 3,000</u>

(\*) Investment in short-term available-for-sale securities includes \$3,000 of ARS (see Note 8(B)).

The following table presents our assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as defined in SFAS 157 at December 31, 2008 (in thousands):

	<b>Level 3</b>
Balance, at December 31, 2007	\$ 20,885
Realized loss included in earning	(18,714)
Release from other comprehensive income	829
Balance, at December 31, 2008	<u>\$ 3,000</u>

For available-for-sale marketable securities not actively traded, fair values are estimated using values obtained from the Company’s asset managers. To estimate the value of these investments the asset managers employ various models that take into consideration such factors, among others, as the credit rating of the issuer, effective maturity of the security, yields on comparably rated publicly traded securities, availability of insurance and risk-free yield curves. The actual value at which such securities could actually be sold or settled with a willing buyer or seller may differ from such estimated fair values depending on a number of factors including, but not limited to, current and future economic conditions, the quantity sold or settled, the presence of an active market and the availability of a willing buyer or seller.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### Y. FAIR VALUE OF FINANCIAL INSTRUMENTS (Cont.)

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

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

It was not practicable to estimate the fair value of the Company's investments in shares of non-public companies that are accounted for under the cost method because of the lack of a quoted market price and the inability to obtain valuation of each company without incurring excessive costs. The carrying amounts of these companies as of December 31, 2008 and 2007 were \$3,745 and \$14,259, respectively, and represent the original cost of acquisition. As noted in Note 2(H) above, management continually monitors such investments for other-than-temporary decline in value, and in 2008 an amount of \$10,514 was recorded as an other-than-temporary impairment loss in the investment in Sandel (see Note 6(C)).

##### Z. BASIC AND DILUTED NET EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted earnings per share is computed based on the weighted average number of ordinary shares outstanding during each year, plus dilutive potential ordinary shares considered outstanding during the year. Outstanding stock options are excluded from the calculation of the diluted earnings per ordinary share when their effect is anti-dilutive.

##### AA. VARIABLE INTEREST ENTITIES

FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51" ("FIN 46") provides a framework for identifying Variable Interest Entities ("VIEs") and determining when a company should include the assets, liabilities, non-controlling interests and results of activities of a VIE in its consolidated financial statements.

The Company's assessment of whether an entity is a VIE and the determination of the primary beneficiary is judgmental in nature and involves the use of significant estimates and assumptions. Those include, among others, forecasted cash flows, their respective probabilities and the economic value of certain preference rights. In addition, such assessment also involves estimation of whether a group entity can finance its current activities, until it reaches profitability, without additional subordinated financial support.

UAV Tactical Systems Ltd. ("U-TacS"), in the U.K. is considered to be a variable interest entity. As Elbit Systems is the primary beneficiary and holds majority voting rights in U-TacS (51%), U-TacS is consolidated in the Company's financial statements.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### AB. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

- (1) In December 2007, the FASB issued SFAS 141(R), “Business Combinations” (“SFAS 141(R)”). This Statement replaces SFAS No. 141, “Business Combinations”, and requires an acquirer to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the statement. SFAS 141(R) also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141(R)). In addition, SFAS 141(R)’s requirement to measure the noncontrolling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the noncontrolling interest in addition to that attributable to the acquirer.

SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

- (2) In April 2008, the FASB issued FSP 142-3, “Determination of the Useful Life of Intangible Assets” (“FSP 142-3”). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, “Goodwill and Other Intangible Assets”. FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of FSP 142-3 will have a material impact on the Company’s consolidated financial position, results of operations and cash flows.
- (3) In December 2007, the FASB issued SFAS 160, “Noncontrolling Interests in Consolidated Financial Statements” (“SFAS 160”). SFAS 160 amends ARB 51, “Consolidated Financial Statements”, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest.

SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the noncontrolling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal years, beginning on or after December 15, 2008. The adoption of SFAS 160 is not expected to have a material effect on accounting for current subsidiaries.

# ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

#### AB. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS (Cont.)

- (4) EITF Issue No. 08-6, "Equity-Method Investment Accounting" ("EITF 08-6") concludes that the cost basis of a new equity-method investment would be determined using a cost-accumulation model, which would continue the practice of including transaction costs in the cost of investment and would exclude the value of contingent consideration. Equity-method investment should be subject to other-than-temporary impairment analysis. It also requires that a gain or loss be recognized on the portion of the investor's ownership sold. EITF 08-6 will be effective for the reporting period beginning after December 15, 2008. The Company does not expect a material impact on its consolidated financial statements from the adoption of EITF 08-6.
- (5) In December 2007, the FASB ratified a consensus opinion on EITF Issue 07-1, "Accounting for Collaborative Arrangements" ("EITF 07-1"). The guidance in EITF 07-1 defines collaborative arrangements and establishes presentation and disclosure requirements for transactions within a collaborative arrangement (both with third parties and between participants in the arrangement). The guidance in EITF 07-1 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2008. The guidance requires retrospective application to all collaborative arrangements existing as of the effective date, unless retrospective application is impracticable. The impracticability evaluation and exception should be performed on an arrangement-by-arrangement basis. The Company does not believe that the adoption of EITF 07-1 will have a significant effect on its financial statements.

#### AC. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

- (1) In March 2008, the FASB issued Statement 161 "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS 161") an amendment to FASB No. 133. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why and entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company does not expect the adoption of SFAS 161 to have a material impact on its financial position, results of operations or cash flows.
- (2) In October 29, 2008, the FASB issued FSP No.132 (R)-a, "Employers' Disclosures about Pensions and Other Postretirement Benefits", to require that an employer disclose the following information about the fair value of plan assets: 1) the level within the fair value hierarchy in which fair value measurements of plan assets fall; 2) information about the inputs and valuation techniques used to measure the fair value of plan assets; and 3) a reconciliation of beginning and ending balances for fair value measurements of plan assets using significant unobservable inputs. The FSP will be effective for fiscal years ending after December 15, 2009, with early application permitted. Application of the FSP would not be required for earlier periods that are presented for comparative purposes. The Company is currently evaluating the potential impact of adopting this FSP on its disclosures in the financial statements.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)

##### AC. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS (Cont.)

- (3) EITF Issue No. 08-7, "Defensive Intangible Assets" ("EITF 08-7"), requires an acquiring entity to account defensive intangible assets as a separate unit of accounting. Defensive intangible assets should not be included as part of the cost of the acquirer's existing intangible assets because the defensive intangible assets are separately identifiable. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141(R) and SFAS 157. EITF 08-7 will be effective for the reporting period beginning after December 15, 2008. The Company does not expect a material impact on its consolidated financial statements from adoption of EITF 08-7.

##### AD. RECLASSIFICATIONS

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 3 - TRADE RECEIVABLES, NET

	December 31,	
	2008	2007
Receivables (*)	\$ 405,796	\$ 333,999
Unbilled receivables	76,685	101,756
Less – allowance for doubtful accounts	(5,471)	(3,794)
	\$ 477,010	\$ 431,961
	\$ 9,608	\$ 9,914

(\*) Includes affiliated companies

Unbilled receivables on long-term contracts principally represent sales recorded under the percentage-of-completion method of accounting, when sales or revenues based on performance attainment, though appropriately recognized, cannot be billed yet under terms of contract as of the balance sheet date. Accounts receivable related to claims are items that we believe are earned, but are subject to uncertainty concerning their determination of ultimate realization. Such amounts were not material as of the balance sheet date. Accounts receivable, other than those detailed under Note 8(A) are expected to be billed and collected during 2009.

As for long-term trade receivables – see Note 8(A).

#### Note 4 - OTHER RECEIVABLES AND PREPAID EXPENSES

	December 31,	
	2008	2007
Deferred income taxes, net	\$ 24,936	\$ 18,606
Prepaid expenses	44,476	54,185
Government institutions	52,559	45,190
Receivables related to the sale of Mediguide shares (see Note 6(B))	49,777	-
Others	32,242	12,886
	\$ 203,990	\$ 130,867

#### Note 5 - INVENTORIES, NET OF CUSTOMER ADVANCES

	December 31,	
	2008	2007
Cost incurred on long-term contracts in progress	\$ 715,698	\$ 513,927
Raw materials	143,905	123,466
Advances to suppliers and subcontractors	41,211	61,158
	900,814	698,551
Less -		
Cost incurred on contracts in progress deducted from customer advances (see Note 13)(*)	106,263	69,199
Advances received from customers (*)	99,907	131,177
Provision for losses on long-term contracts	47,083	17,572
	\$ 647,561	\$ 480,603

(\*) The Company has transferred legal title of inventories to certain customers as collateral for advances received. Advances are allocated to the relevant inventories on a per-project basis. In cases where advances are in excess of the inventories, the net amount is presented in customer advances.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

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

##### A. Investments in affiliated companies:

	December 31,	
	2008	2007
Companies accounted for under the equity method	\$ 58,555	\$ 51,902
Companies accounted for on a cost basis	3,745	14,259
	\$ 62,300	\$ 66,161

##### B. Investments in companies accounted for under the equity method:

	December 31,	
	2008	2007
SCD (1)	\$ 41,456	\$ 36,594
VSI (2)	5,111	4,671
Opgal (3)	7,263	5,992
Chip PC (4)	665	1,853
Others	4,060	2,792
	\$ 58,555	\$ 51,902

- (1) Semi Conductor Devices (“SCD”) is an Israeli partnership, held 50% by the Company and 50% by Rafael Armaments Development Authority Ltd. (“Rafael”). SCD is engaged in the development and production of various thermal detectors and laser diodes. SCD is jointly controlled and therefore is not consolidated in the Company’s financial statements.
- (2) Vision Systems International LLC (“VSI”) based in San Jose, is a California limited liability company that is held 50% by ESA and 50% by a subsidiary of Rockwell Collins Inc. VSI operates in the area of helmet mounted display systems for fixed-wing military aircraft. VSI is jointly controlled and therefore is not consolidated in the Company’s financial statements.
- (3) Opgal Optronics Industries Ltd. (“Opgal”) is an Israeli company owned 50.1% by the Company and 49.9% by a subsidiary of Rafael. Opgal focuses mainly on commercial applications of thermal imaging and electro-optic technologies. The Company jointly controls Opgal with Rafael, and therefore Opgal is not consolidated in the Company’s financial statements.
- (4) Chip PC Ltd. (“Chip PC”) is an Israeli company, of which approximately 19% (16.3% on a fully diluted basis) is held by the Company. Chip PC develops and manufactures “Post PC” solutions, focused on enabling server-based-computing technologies to replace traditional PCs and deploy and control large numbers of workstations. In July 2007, Chip PC completed an initial public offering (“IPO”) on the Tel Aviv Stock Exchange (“TASE”). Following the offer, Chip PC became a publicly-traded company registered in Israel. As a result of the IPO, the Company recognized in 2007 an immaterial loss. The Company has significant influence in Chip PC due to its representatives in the Board of Directors and as such the investment is recorded according to the equity method of accounting. As of December 31, 2008, the Company identified impairment indicators in Chip PC and wrote-down the investment in Chip PC to its fair market value of \$665, recognizing an impairment loss of approximately \$800, included in equity in net earnings of affiliated companies.

## LBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### **Note 6 - INVESTMENTS IN AFFILIATED COMPANIES, PARTNERSHIP AND OTHER COMPANIES (Cont.)**

##### **B. Investments in companies accounted for under the equity method (Cont.)**

- (5) Mediguide Inc. (“Mediguide”) and its Israeli subsidiary, Mediguide Ltd., were established in 2000 as a spin-off from the Company. The share capital of Mediguide, consisted of Common shares and Preferred A, B, C and D shares. The Common shares and the Preferred shares, both had voting rights. The Company held all of the Common shares of Mediguide which constituted approximately 55% (41% on a fully diluted basis) of the voting rights of Mediguide. The preferred shareholders had certain participating rights and accordingly, based on the guidance in EITF 96-16, the Company did not consolidate Mediguide. The carrying value of the investment in Mediguide was zero. On December 22, 2008, a definitive agreement was signed with St. Jude Medical to sell all of Mediguide’s outstanding shares (see Note 22). As a consequence, the Company sold its entire interest in Mediguide in December 2008 (see Notes 1(F) and 22).
- (6) Starling Advanced Communications Ltd. (“Starling”) develops products in the area of internet communications through satellite transmissions and broad band information transfer for commercial aircraft. In May 2007, Starling completed an IPO on the TASE. Following the offering, Starling became a publicly-traded company registered in Israel, and the Company’s share ownership in Starling was diluted from approximately 21% to approximately 16% (or 10% on a fully diluted basis). In addition, the Company holds 52,358 options on debenture convertible shares issued by Starling. As a result of Starling’s IPO, the Company recorded in 2007 a gain in the amount of approximately \$595 as an increase to shareholders equity, since Starling is a development stage company.
- (7) Equity in net earnings (losses) of affiliated companies is as follows:

	Year ended December 31,		
	2008	2007	2006
Tadiran (*)	\$ -	\$ 716	\$ 3,988
SCD	8,682	7,922	5,466
VSI	4,338	4,590	5,354
Others	1,415	1,337	(65)
	\$ 14,435	\$ 14,565	\$ 14,743

- (\*) The Company’s share in Tadiran’s 2006 results included a loss of \$2,400 as a result of exercise of options in Tadiran. Until the date of the Company’s tender offer for Tadiran’s shares in 2007, Tadiran results were included under the equity method.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

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

##### B. Investments in companies accounted for under the equity method (Cont.)

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

Balance Sheet Information:

	December 31,	
	2008	2007
Current assets	\$ 165,455	\$ 188,923
Non-current assets	36,595	30,812
Total assets	\$ 202,050	\$ 219,735
Current liabilities	\$ 77,138	\$ 95,692
Non-current liabilities	27,152	23,787
Shareholders' equity	97,760	100,256
	\$ 202,050	\$ 219,735

Income Statement Information:

	Year ended December 31,		
	2008	2007	2006
Revenues	\$ 326,702	\$ 331,971	\$ 298,499
Gross profit	\$ 98,291	\$ 89,960	\$ 79,309
Net income	\$ 32,914	\$ 12,830	\$ 18,902

- (9) See Note 17(E) for guarantees.

##### C. Investments in companies accounted for on a cost basis

	December 31,	
	2008	2007
ISI (1)	\$ 1,830	\$ 1,830
Sandel (2)	1,900	12,414
Others	15	15
	\$ 3,745	\$ 14,259

- (1) ImageSat International N.V. ("ISI"), held 14% (10% on a fully diluted basis) by the Company, is engaged in the operation of satellite photography formations and commercial delivery of satellite photography for civil purposes. See also Note 17(C).
- (2) Sandel Avionics, Inc. ("Sandel") based in Vista, California, produces specialized integrated display systems and other products for the commercial aviation market. In 2006, ESA's subsidiary Kollsman, Inc. ("Kollsman") acquired Preferred B Shares of Sandel, which constitute a 20% interest in Sandel on a fully diluted and as converted basis. The investment in Sandel is accounted on a cost basis in accordance with EITF 02-14. During the fourth quarter of 2008, the fair value of Sandel decreased as a result of a decrease in Sandel's backlog and estimated future cash flows. Based on a valuation prepared by an independent appraiser (see also Note 2(Y)), the Company recognized an other-than-temporary impairment loss of approximately \$10,514 pre-tax of its investment in Sandel, which was classified in Other Income, net in the Consolidated Statement of Income.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 7 - COMPENSATION RECEIVABLES IN RESPECT OF FIRE DAMAGE, NET

	December 31,	
	2008	2007
Receivables from insurance company	\$ -	\$ 25,884
Net of contingent payment to Koor	\$ -	10,354
	\$ -	\$ 15,530

On March 17, 2001, a fire broke out in the manufacturing plants in two of Elisra's subsidiaries. The fire caused damages to equipment, building, inventory and work in progress. Through December 31, 2007, advances were received from the Phoenix Insurance Company ("Phoenix") in the aggregate amount of approximately \$10 million.

Upon the acquisition of Elisra in 2005, as part of the assets purchased in the business combination, Elbit Systems recorded, at that time, the receivables from Phoenix at their estimated value of approximately \$26 million considering the advances previously received from the insurance company in years prior to the acquisition.

On March 17, 2008, the District Court of Tel-Aviv approved a Settlement Agreement between the Elisra subsidiaries and Phoenix. Under the Settlement Agreement Phoenix paid Elisra approximately \$38 million in addition to approximately \$10 million in insurance proceeds already paid. In accordance with the terms of the agreement signed in 2005 between the Company and Koor in connection with the acquisition by the Company of Elisra's shares held by Koor Industries Ltd. ("Koor"), as part of the consideration for the purchase price of the Elisra shares, the Company agreed to pay Koor a portion of any insurance proceedings received as a result of the claim against Phoenix. Accordingly, as a result of the Settlement Agreement, the Company paid Koor a sum of approximately \$13 million. As a result of the settlement, the Company recorded in 2008 a gain of \$4.1 million pre-tax in Other Income and an amount of \$2.1 million in the minority interest in earnings of subsidiaries.

#### Note 8 - LONG-TERM DEPOSITS AND SECURITIES

##### A. Long-term bank deposits and trade receivables

	December 31,	
	2008	2007
Deposits with banks <sup>(1)</sup>	\$ 2,060	\$ 1,999
Long-term trade and other receivables <sup>(2)</sup>	7,609	8,754
Other deposits with banks <sup>(3)</sup>	28,077	9,994
	\$ 37,746	\$ 20,747

(1) The deposits are held as collateral for loans granted to the Company's employees and are linked to the Israeli CPI, bear annual interest of 4% and are presented net of current maturities of \$687 (2007 - \$665).

(2) Includes long-term trade receivables in the amount of \$6,390 and \$7,618 as of December 31, 2008 and 2007, respectively, of which \$393 and \$56 are unbilled long-term receivables as of December 31, 2008 and 2007, respectively.

(3) Restricted deposits in respect with bank guarantee issued.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 8 - LONG-TERM DEPOSITS AND SECURITIES (Cont.)

##### B. Marketable securities

	December 31,	
	2008	2007
Short-term available for sale marketable securities (*)	\$ 3,731	\$ 2,830
Long-term marketable securities (*)	-	20,885
Long-term available for sale securities	2,999	-
	\$ 6,730	\$ 23,715

(\*) Auction Rate Securities ("ARS") held as a result of the acquisition of Tadiran are private placement securities with long-term nominal maturities for which the interest rates are reset through a "dutch" auction each month. The monthly auctions historically have provided a liquid market for these securities. The Company's investments in ARS represent interests in collateralized debt obligations supported by pools of residential and commercial mortgages or credit cards, insurance securitizations and other structured credits, including corporate bonds. Some of the underlying collateral for the ARS held by the Company consists of sub-prime mortgages.

With the liquidity issues experienced in global credit and capital markets, the ARS have experienced multiple failed auctions as the amount of securities submitted for sale has exceeded the amount of purchase orders.

The fair value in 2007 was determined based on evaluation models applied by investment banks that have acted as the Company's broker in certain purchases of ARS positions, which estimated the value of the ARS according to the expected discounted cash flow ("DCF") for each of the ARS. The DCF calculation was based on the following parameters: the underlying securities, type of collateral, estimated duration, risk premium, insurance (if any), overall capital market liquidity conditions and comparable securities and market indexes. The principal assumptions of the model were: (1) the ARS will pay interest on time; and (2) the ARS will have an average term (estimated duration to reach full liquidity) of five years.

In addition, the Company consulted with individuals with applicable expertise within the investment banks, and following a review of the relevant above-mentioned parameters and assumptions, the Company concluded in 2007 that the value of each of the ARS derived from the investment banks' models can be used as an estimate of its fair value.

As a result of the failed auctions, in recent periods the Company's ARS are illiquid until there is a successful auction for them. Accordingly, the entire amount of such remaining ARS has been reclassified in 2007 from current to non-current assets on the Company's balance sheet.

During 2008, in recognition of management's intention to dispose of the ARS in the short-term, observable prices in non-active markets were obtained to establish the value. The ARS were classified as short-term marketable securities.

The estimated market value of the ARS holdings at December 31, 2008 and 2007 was approximately \$3.0 and \$20.9 million, respectively, which reflects an \$18.8 and \$10 million other-than-temporary impairment in their fair values at December 31, 2008 and 2007, respectively. See Note 2(Y).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 9 - PROPERTY, PLANT AND EQUIPMENT, NET

	December 31,	
	2008	2007
Cost <sup>(1)</sup> :		
Land, buildings and leasehold improvements <sup>(2)</sup>	\$ 244,655	\$ 217,303
Instruments, machinery and equipment <sup>(3)</sup>	483,169	449,345
Office furniture and other	60,371	54,392
Motor vehicles	69,981	58,808
	858,176	779,848
Accumulated depreciation	(474,090)	(427,146)
Depreciated cost	\$ 384,086	\$ 352,702

Depreciation expenses for the years ended December 31, 2008, 2007 and 2006 amounted to \$79,779, \$69,523 and \$50,323, respectively.

- (1) Net of investment grants received (mainly for instruments, machinery and equipment) in the amounts of \$30,683 and \$22,678 as of December 31, 2008 and 2007, respectively.
- (2) Set forth below is additional information regarding the real estate owned or leased by the Company:

	Israel <sup>(a)</sup>	U.S. <sup>(b)</sup>	Other Countries <sup>(c)</sup>
Owned	1,470,000 square feet	725,000 square feet	336,000 square feet
Leased	1,630,000 square feet	64,000 square feet	270,000 square feet

- (a) Includes offices, development and engineering facilities, manufacturing facilities, maintenance facilities, hangar facilities and a landing strip in various locations in Israel used by Elbit Systems' Israeli subsidiaries.
  - (b) Includes offices, development and engineering facilities, manufacturing facilities and maintenance facilities of Elbit Systems of America in Texas, New Hampshire, Florida, Alabama, Virginia, Georgia and Kansas.
  - (c) Includes offices, design and engineering facilities and manufacturing facilities, mainly in the U.K., Romania, Belgium, Germany and Brazil.
- (3) Includes equipment produced by the Company for its own use in the aggregate amount of \$138,672 and \$107,107 as of December 31, 2008 and 2007, respectively.

As for pledges of assets – see Notes 17(E) and 17(I).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 10 - GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS, NET

##### A. Composition:

Identifiable Intangible Assets	Weighted average useful lives	December 31,	
		2008	2007
Original cost:			
Technology <sup>(1)</sup>	12	\$ 171,800	\$ 165,297
Customer relations <sup>(2)</sup>	5	160,004	158,606
Trade marks and other <sup>(3)</sup>	15	43,758	42,592
		<u>375,562</u>	<u>366,495</u>
Accumulated amortization:			
Technology		66,534	53,065
Customer relations		33,862	11,738
Trade marks and other		4,655	703
		<u>105,051</u>	<u>65,506</u>
Amortized cost		<u>\$ 270,511</u>	<u>\$ 300,989</u>
Goodwill		<u>\$ 323,772</u>	<u>\$ 335,266</u>

(1) The technology acquired consists of the following major items as follows:

In 2000, Elbit Systems completed a merger with Elop. A portion of the purchase price was allocated to technology in the amount of approximately \$45,000.

In 2000, ESA's subsidiary EFW Inc. ("EFW") acquired from Honeywell Inc. ("Honeywell"), Honeywell's business relating to head-up displays and tracking systems for pilot helmets. An amount of \$9,300 was allocated to the acquired technology.

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

In 2002, Elbit Systems acquired the business of the Defense Systems Division of Elron Telesoft in consideration for \$5,700. An amount of \$5,100 was allocated to the technology.

In 2005, the Elbit Systems acquired 70% of Elisra's shares, in consideration for \$68,800. An amount of \$21,300 was allocated to the technology.

In 2005 through 2007, Elbit Systems acquired all of Tadiran's shares, as detailed in Note 1(C) above. An amount of \$70,300 was allocated to technology related to communication equipment and C<sup>4</sup>ISR.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 10 - INTANGIBLE ASSETS, NET (Cont.)

##### A. Composition (Cont.)

- (2) Includes mainly customer relations resulting from the acquisition of Tadiran (\$137,300) and FTL (\$9,000) in 2007.
- (3) Includes trade marks in the amount of \$8,000 acquired in the merger with Elop in 2000, and an amount of \$33,200 that was allocated to trade marks resulting mainly from the acquisition of Tadiran in 2005 - 2007.

**B.** Amortization expenses amounted to \$40,140, \$29,891 and \$8,176 for the years ended December 31, 2008, 2007 and 2006, respectively.

**C.** The estimated aggregate amortization expense for each of the five succeeding fiscal years :

2009	\$ 39,560
2010	36,538
2011	34,951
2012	33,078
2013	30,722

**D.** Changes in goodwill, during the years 2007 and 2008, are as follows:

	<b>2008</b>	<b>2007</b>
Balance, at January 1	\$ 335,266	\$ 58,402
Translation differences (*)	(3,432)	-
<u>Goodwill acquired during the year:</u>		
Tadiran (**)	(10,335)	264,809
FTL	-	12,055
ICI	2,273	-
Balance, at December 31	\$ 323,772	\$ 335,266

(\*) Translation differences resulting from goodwill allocated to reporting units, whose functional currency has been determined to be other than the U.S. dollar.

(\*\*) During 2008, the Company decreased certain tax liabilities previously recognized in connection with the purchase price allocation of Tadiran.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 11 - SHORT-TERM BANK CREDIT AND LOANS

	December 31,			
	2008	2007	2008	2007
Short-term bank loans:	<b>Interest Rate</b>			
In U.S. dollars	-	7.0-7.01%	\$ -	\$ 7,915
In Euro and GBP	5%	6.7-7.14%	5,982	757
			<u>5,982</u>	<u>8,672</u>
Short-term bank credit:				
In U.S. dollars	-	5.8%	-	1,727
In NIS unlinked and GBP	3.29-7.14%	-	349	19
			<u>349</u>	<u>1,746</u>
			<u>\$ 6,331</u>	<u>\$ 10,418</u>
Weighted average interest rate	4.91%	6.77%		

#### Note 12 - OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2008	2007
Payroll and related expenses	\$ 106,095	\$ 116,019
Provision for vacation pay	30,243	30,148
Provision for income taxes, net of prepayment	42,740	20,718
Tax obligation	18,939	9,865
Value added tax ("VAT") payable	5,486	7,128
Provisions for royalties	29,851	30,024
Provision for warranty	92,301	74,113
Liability in respect of hedge transactions	941	15,943
Provision for losses on long-term contracts	53,240	35,029
Others (*)	91,842	90,759
	<u>\$ 471,678</u>	<u>\$ 429,746</u>

(\*) Others, primarily includes provisions for estimated future costs in respect of (1) penalties and the probable loss from claims (legal or unasserted) in the ordinary course of business (e.g. damages caused by the items sold and claims as to the specific products ordered), and (2) unbilled services of service providers.

#### Note 13 - CUSTOMERS ADVANCES IN EXCESS OF COSTS INCURRED ON CONTRACTS IN PROGRESS

	December 31,	
	2008	2007
Advances received	\$ 810,832	\$ 848,234
Less -		
Advances presented under long-term liabilities	115,470	137,296
Advances deducted from inventories	99,907	131,177
	<u>595,455</u>	<u>579,761</u>
Less -		
Costs incurred on contracts in progress (see Note 5)	106,263	69,199
	<u>\$ 489,192</u>	<u>\$ 510,562</u>

As for guarantees and liens, see Notes 17(E), 17(F) and 17(I).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 14 - LONG-TERM LOANS

	Currency	Interest %	Years of maturity	December 31,	
				2008	2007
Long-term banks loans	U.S. dollars	Libor + 0.8-2.57%	mainly 2-3	\$ 251,056	\$ 412,040
	GBP	Libor + 0.875%	mainly 2-3	21,888	30,072
Other long-term loans	GBP	Libor + 1%		5,898	7,859
				278,842	449,971
Less-current maturities				9,082	18,659
				\$ 269,760	\$ 431,312

As of December 31, 2008 the Libor annual rate:

For long-term loans denominated in U.S. dollars was 2%.

For long-term loans denominated in GBP was 3.07%.

The maturities of these loans for periods after December 31, 2008 are as follows:

2009 – current maturities	\$ 9,082
2010	269,388
2011	-
2012	186
2013	186
	\$ 278,842

See Note 17(F) for covenants.

In order to secure liabilities to banks as well as guarantees to customers and performance guarantees, a subsidiary granted first priority liens and/or floating liens on all of its property and assets with no limitation as to amount, and specific liens on its short-term investments (see Notes 17(F) and 17(G)).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 15 - BENEFIT PLANS AND OBLIGATIONS FOR TERMINATIONAL INDEMNITY

The Company's subsidiaries ESA, Telefunken and a European subsidiary sponsored benefit plans for their employees in the U.S., Germany and Belgium, respectively, as follows:

##### Defined Benefit Retirement Plan based on Employer's Contributions

- a) ESA has three defined benefit pension plans (the "Plans") which cover the employees of EFW and Kollsman. Monthly benefits are based on years of benefit service and annual compensation. Annual contributions to the Plans are determined using the unit credit actuarial cost method and are equal to or exceed the minimum required by law. Pension fund assets of the Plans are invested primarily in stock, bonds and cash through a financial institution, as the investment manager of the Plans' assets. Pension expense is allocated between cost of sales and general and administrative expenses, depending on the responsibilities of the employee. The measurement date for the EFW and Kollsman benefit obligation is December 31. In November 2008, ESA ratified a new union agreement, which resulted in a higher multiplier for benefit payments. Additionally, in 2008, ESA revised its retirement and mortality estimates based on more recent experience factors, which resulted in 2008 as actuarial loss.
- b) Telefunken Radio Communication Systems GmbH & Co. ("Telefunken"), a wholly-owned German subsidiary, has mainly one defined benefit pension plan (the "P3-plan") which covers all employees. The P3-plan provides for yearly cash balance credits equal to a percentage of participant's compensation which accumulate together with the respective interest credits on the employee's cash balance accounts. In case of an insured event (retirement, death, disability) the benefits can be paid as a lump sum, in installments or as a life-long annuity. The P3-plan is an unfunded plan.

Under the P3-plan, employees are eligible to contribute salary deductions in order to increase their pension benefits. The plan provisions are similar to those for employer's contributions. No funding takes place for those benefits.

In addition, Telefunken sponsors an early retirement program – Altersteilzeit Plan (the "ATZ-plan") designed to create an incentive for employees within a certain age group, to transition from (full or part-time) employment into retirement before the legal retirement age. The ATZ-plan benefits are granted for a period between 24 and 60 months to all eligible employees, who signed an individual ATZ-plan contract. The employee is required to work regular work hours during a working phase (active period), which is followed by a non-working phase of the same length (inactive period). The total benefits are comprised of:

- 1) the ordinary 50% of salary for the ATZ-plan – paid during the active and inactive period,
- 2) an annual salary bonus ("Aufstockungsbetrag") and additional contributions into the German government pension scheme – paid during the active and inactive period, and
- 3) a compensation payment – paid at the end of the ATZ-plan period.

The German government provides a subsidy (reimbursement) to an employer for the bonuses paid to the employee and the additional contributions paid into the German government pension scheme. To receive this subsidy, an employer must meet certain criteria (typically, an employer must hire replacement employees from currently registered unemployed persons or former trainees).

Member contributions are not required. The ATZ-plan is an unfunded plan. The benefit obligation in ATZ-plan has changed significantly in 2008 because of the addition of 17 new plan participants. The plan was accounted for according to EITF 05-5.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT)

U. S. dollars (In thousands)

#### **Note 15 - BENEFIT PLANS AND ACCRUED TERMINATIONAL LIABILITY (Cont.)**

- c) A wholly-owned European subsidiary in Belgium has a defined benefit pension plan, which is divided into two categories:
- 1) Normal retirement benefit plan, with eligibility at age 65. The lump sum is based on employee contributions of 2% of the final pensionable salary up to certain breakpoint, plus 6% exceeding the breakpoint at a maximum of 5% of pensionable salary, and the employer contributions, with a maximum of 40 years. The vested benefit is equal to retirement benefit calculated with the pensionable salary and pensionable service observed at the date of leaving service.
  - 2) Pre retirement death benefit to employees.

The plan is funded and includes profit sharing.

The following table sets forth the Plans' funded status and amounts recognized in the consolidated financial statements for the years ended December 31, 2008 and 2007:

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
<u>Changes in benefit obligation:</u>		
Benefit obligation at beginning of year	\$ 75,557	\$ 56,779
Newly consolidated subsidiaries	-	12,905
Service cost, end of year	5,882	5,615
Interest cost	4,529	4,017
Amendments	(215)	-
Actuarial losses	5,998	(1,854)
Benefits paid	(1,894)	(1,905)
Benefit obligation at end of year	\$ 89,857	\$ 75,557
<u>Changes in Plan Assets:</u>		
Fair value of Plans assets at beginning of year	54,309	43,154
Newly consolidated subsidiaries	-	1,718
Actual return on Plan assets (net of expenses)	(12,670)	4,605
Employer contribution	4,444	6,384
Benefits paid	(1,568)	(1,552)
Fair value of Plans assets at end of year	\$ 44,515	\$ 54,309
<u>Accrued benefit cost, end of year:</u>		
Funded status	(45,342)	(21,248)
Unrecognized prior service cost	935	544
Unrecognized net actuarial loss	34,078	11,169
Accrued benefit cost, end of year	\$ (10,329)	\$ (9,535)
<u>Amount recognized in the statement of financial position:</u>		
Accrued benefit liability, current	(11,160)	(11,345)
Accrued benefit liability, non-current	(34,435)	(9,988)
Accumulated other comprehensive loss pre-tax	35,266	11,798
Net amount recognized	\$ (10,329)	\$ (9,535)
<u>Weighted average assumptions:</u>		
Discount rate as of December 31,	6.08%	6.09%
Expected long-term rate of return on Plan's assets	7.71%	7.62%
Rate of compensation increase	2.85%	2.83%

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 15 - BENEFIT PLANS AND ACCRUED TERMINATIONAL LIABILITY (Cont.)

	Year ended December 31,		
	2008	2007	2006
Components of the Plan's net periodic pension cost:			
Service cost	\$ 5,883	\$ 5,615	\$ 3,869
Interest cost	4,529	4,017	2,981
Expected return on Plans assets	(4,565)	(3,761)	(2,938)
Amortization of prior service cost	(110)	(99)	-
Amortization of transition amount	60	63	14
Recognized net actuarial loss	369	757	846
Total net periodic benefit cost	\$ 6,166	\$ 6,592	\$ 4,772

#### Asset Allocation by Category as of December 31:

	2008	2007
Asset Category		
Equity Securities	52.5%	53.0%
Debt Securities	45.0%	41.5%
Other	2.5%	5.5%
Total	100%	100%

The investment policy of ESA is directed toward a broad range of securities. The diversified portfolio seeks to maximize investment return while minimizing the risk levels associated with investing. The investment policy is structured to consider the retirement plan's obligations and the expected timing of benefit payments. The target asset allocation for the Plan years presented is as follows:

	2008	2007
Asset Category		
Equity Securities	60.0%	60.0%
Debt Securities	37.0%	37.0%
Other	3.0%	3.0%
Total	100%	100%

In developing the overall expected long-term rate of return on assets assumption, ESA used a building block approach in which rates of return in excess of inflation were considered separately for equity securities, debt securities, real estate and all other assets. The excess returns were weighted by the representative target allocation and added along with an approximate rate of inflation to develop the overall expected long-term rate of return. It is the policy of ESA to at least meet the ERISA minimum contribution requirements for a Plan year. The minimum contribution requirements for the 2008 Plan year and the quarterly contributions requirements for the 2008 Plan year have been satisfied as of December 31, 2008. However, ESA anticipates that it will make an additional discretionary contribution of approximately \$15,607 during 2009 in order to increase the Plan's funded current liability percentage. Benefit payments over the next five years are expected to be \$2,209 in 2009; \$2,560 in 2010; \$2,894 in 2011, \$3,405 in 2012 and \$3,899 in 2013.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 15 - BENEFIT PLANS AND ACCRUED TERMINATIONAL LIABILITY (Cont.)

##### Retiree Medical Plan

Effective January 1, 2003, ESA commenced offering retiree medical benefits to a limited number of retirees at EFW, in accordance with benefits agreed upon as part of union negotiations in 2002.

The measurement date for ESA benefit obligation is December 31, 2008. The following table sets forth the retiree medical plans' funded status and amounts recognized in the consolidated financial statements for the years ended December 31, 2008 and 2007.

	December 31 2008	December 31 2007
Change in Benefit Obligation:		
Benefit obligation at beginning of period	\$ 1,397	\$ 1,387
Service cost	87	67
Interest cost	80	75
Actuarial loss	1,111	9
Employee contribution	25	-
Benefits paid	(153)	(141)
Benefit obligation at end of period	<u>\$ 2,547</u>	<u>\$ 1,397</u>
Change in Plan Assets:		
Fair value of plan assets at beginning of period	\$ -	\$ -
Employer contribution	128	141
Employee contribution	25	-
Benefits paid	(153)	(141)
Fair value of plan assets at end of period	<u>\$ -</u>	<u>\$ -</u>
Accrued benefit cost, end of period:		
Funded status	\$ (2,547)	\$ (1,397)
Unrecognized net actuarial gain	776	(352)
Unrecognized prior service cost	373	523
Accrued benefit cost, end of period	<u>\$ (1,398)</u>	<u>\$ (1,226)</u>
Amounts recognized in the statement of financial position:		
Accrued benefit liability, current	\$ (140)	\$ (122)
Accrued benefit liability, non-current	(2,407)	(1,275)
Accumulated other comprehensive loss, pretax	1,149	171
Net amount recognized	<u>\$ (1,398)</u>	<u>\$ (1,226)</u>
Current	\$ 140	\$ 122
Non Current	\$ 1,258	\$ 1,104

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 15 - BENEFIT PLANS AND ACCRUED TERMINATIONAL LIABILITY (Cont.)

	Year ended December 31,	
	2008	2007
Components of net periodic pension cost (for period):		
Service cost	\$ 87	\$ 67
Interest cost	80	76
Amortization of prior service cost	150	150
Recognition of net actuarial gain	(17)	(20)
Total net periodic benefit cost	\$ 300	\$ 273
Assumptions as of end of period:		
Discount rate	6.34%	6.00%
Health care cost trend rate assumed for next year	8.00%	8.00%
Ultimate health care cost trend rate	5.00%	5.00%

The effect of a 1% change in the health care cost trend rate at December 31, 2008 is as follows:

	1% increase	1% decrease
Net periodic benefit cost	\$ 19	\$ (17)
Benefit obligation	\$ 199	\$ (179)

#### Defined Contribution Plan

The 401(k) savings plan (“401(k) plan”) is a defined contribution retirement plan that covers all eligible ESA employees, as defined in section 401(k) of the U.S. Internal Revenue Code. Employees may elect to contribute a percentage of their annual gross compensation to the 401(k) plan. ESA may make discretionary matching contributions as determined by ESA. Total expense under the 401(k) plan amounted to \$3,115, \$2,738 and \$2,503 for the years ended December 31, 2008, 2007 and 2006, respectively. Expense for the deferred 401(k) plan is allocated between cost of sales and general and administrative expenses depending on the responsibilities of the related employees.

#### Non-Qualified Defined Contribution Plan

In 2007, ESA implemented two new benefit plans for the executives of the organization. The non-qualified, defined contribution plan is structured under Section 409(A). The plan provides the employees at vice president level and above the opportunity to defer up to 100% of their salary and bonus or any amount below that to the 409(A) plan. ESA will provide a match of 50 cents on the dollar up to 10% of the employees’ total salary and incentive based compensation. The contribution can be made into the 401(k) plan, the 409(A) plan or both plans. The intent was to provide comparable defined contribution plan benefits for the senior management across three ESA locations. The 409(A) plan funds are contributed to several life insurance policies. Participant contributions transferred into the plan totaled \$519 in 2008 and \$485 in 2007, and the total ESA contribution to the plan was \$93 for 2008 and \$92 for 2007. The cash surrender value of these life insurance policies was \$1,393 and \$1,414 at December 31, 2008 and 2007, respectively. As of December 31, 2008, no executive had vested in the plan.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### **Note 15 - BENEFIT PLANS AND ACCRUED TERMINATIONAL LIABILITY (Cont.)**

The second plan implemented is a non-qualified, defined benefit plan for the top four executives of ESA. The plan provides a calculated, guaranteed payment in addition to their regular pension through the company upon retirement. The plan is funded with several life insurance policies. They are not segregated into a trust or otherwise effectively restricted. These policies are corporate owned assets that are subject to the claims of general creditors and cannot be considered as formal plan assets. The defined benefit plan put in place meets the ERISA definition of an unfunded deferred compensation plan maintained for the benefit of a select group of management or highly compensated employees. The plan assets currently are valued at \$446 and \$651 at December 31, 2008 and 2007, respectively. Related liability for the pension payments is \$599 and \$535 at December 31, 2008 and 2007, respectively. As of December 31, 2008, no executives had vested in the plan.

#### **Note 16 - TAXES ON INCOME**

##### **A. APPLICABLE TAX LAWS**

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

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

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

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

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

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

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 16 - TAXES ON INCOME (Cont.)

##### A. APPLICABLE TAX LAWS (Cont.)

Accordingly, certain income of the companies, derived from the "Approved Enterprise" expansion programs is tax exempt for two-years and subject to reduced tax rates of 25% for a five-year to eight-year period or tax exempt for a ten-year period commencing in the year in which the companies had taxable income (limited to twelve years from commencement of production or fourteen years from the date of approval, whichever is earlier). As of December 31, 2008, the tax benefits for these exiting expansion programs will expire within the period of 2009 to 2017.

The entitlement to the above benefits is subject to the companies fulfilling the conditions specified in the above referred law, regulations published there under and the letters of approval for the specific investments in "Approved Enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the companies may be required to refund the amount of the benefits, in whole or in part, including interest. (For liens – see Note 17(J)). As of December 31, 2008, the Company's management believes that the companies are meeting all conditions of the approvals.

As of December 31, 2008, retained earnings of Elbit Systems and its Israeli subsidiaries included approximately \$438,000 in tax-exempt profits earned by the companies' "Approved Enterprises". If the retained tax-exempt income is distributed, in manner other than liquidation, it would be taxed at the corporate tax rate applicable to such profits as if Elbit Systems had not elected the alternative tax benefits track (currently - 25%), and an income tax liability would be incurred of approximately \$109,000 as of December 31, 2008.

The companies' boards of directors have decided that their policy is not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the companies' "Approved Enterprises" and "Privileged Enterprise", as such retained earnings are essentially permanent in duration.

In Israel, income from sources other than the "Approved Enterprise" and "Privileged Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate (see also Note 16(I)).

Since the companies are operating under more than one approval, and since part of their taxable income is not entitled to tax benefits under the above mentioned law and is taxed at the regular tax rate of 27%, the effective tax rate is the result of a weighted combination of the various applicable rates and tax exemptions, and the computation is made for income derived from each approval on the basis of formulas specified in the law and in the approvals.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 16 - TAXES ON INCOME (Cont.)

##### B. NON – ISRAELI SUBSIDIARIES

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

##### C. INCOME BEFORE TAXES ON INCOME

	Year ended December 31,		
	2008	2007	2006
Income before taxes on income:			
Domestic	\$ 257,139	\$ 42,310	\$ 44,712
Foreign	49,341	46,682	27,504
	\$ 306,480	\$ 88,992	\$ 72,216

##### D. TAXES ON INCOME

	Year ended December 31,		
	2008	2007	2006
Taxes on income:			
Current taxes:			
Domestic	\$ 46,443	\$ 26,658	\$ 15,124
Foreign	14,245	22,551	8,302
	60,688	49,209	23,426
Adjustment for previous years:			
Domestic	2,025	(12,671)	1,928
Foreign	(146)	2,937	-
	1,879	(9,734)	1,928
Deferred income taxes:			
Domestic	(8,691)	(18,667)	(3,856)
Foreign	491	(6,998)	(804)
	(8,200)	(25,665)	(4,660)
	\$ 54,367	\$ 13,810	\$ 20,694

- E. Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainties in income taxes by establishing minimum standards for the recognition and measurement of tax positions taken or expected to be taken in a tax return. Under the requirements of FIN 48, the Company must review all of its tax positions and make a determination as to whether its position is more-likely-than-not to be sustained upon examination by regulatory authorities. If a tax position meets the more-likely-than-not standard, then the related tax benefit is measured based on a cumulative probability analysis of the amount that is more-likely-than-not to be realized upon ultimate settlement or disposition of the underlying issue. The impact on the Company's consolidated financial position and results of operations as a result of the adoption of the provisions of FIN 48 was \$4,846, which was recognized as an adjustment to opening retained earnings.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 16 - INCOME TAXES (Cont.)

E. (Cont.)

At December 31, 2008, the Company had a liability for unrecognized tax benefits of \$24,574 and an accrual of \$3,180 for the payment of related interest.

During 2008, Elbit Systems and its subsidiaries were subject to examination by various tax authorities in jurisdictions such as Israel, the United States and Europe.

During 2008 and 2007, the Company had settled certain income tax matters in Israel covering multiple years. As a result of the settlement of the tax matters, the Company recorded a reduction in "Provision for income taxes" of \$1,633 and \$16,081, respectively, related to settlement of tax matters of which \$1,326 and \$15,409 was recorded in the statements of income in "Provision for income taxes."

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2008	2007
Balance at the beginning of the year	\$ 25,443	\$ 18,704
Additions based on tax positions taken during a prior period	635	5,858
Reductions related to settlement of tax matters	(1,633)	(16,081)
Additions related to acquisitions	-	10,500
Additions related to interest and currency changes	654	2,116
Additions based on tax positions taken during the current period	2,655	4,346
Balance at the end of the year	<u>\$ 27,754</u>	<u>\$ 25,443</u>

The Company operates in multiple jurisdictions throughout the world, and its tax returns are periodically audited or subject to review by both domestic and foreign authorities. As a result of ongoing examinations, tax proceedings in certain countries, additions to unrecognized tax benefits for positions taken and interest and penalties, if any, arising in 2008, it is not possible to estimate the potential net increase or decrease to the Company's unrecognized tax benefits during the next twelve months. The following describes the open tax years, by major tax jurisdiction, as of December 31, 2008:

United States	2005 - present
Israel	2003 - present

#### F. DEFERRED INCOME TAXES

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 16 - INCOME TAXES (Cont.)

##### F. DEFERRED INCOME TAXES (Cont.)

	Total	Deferred <sup>(1)</sup> Tax asset (liability)	
		Current	Non-current
<u>As of December 31, 2008</u>			
Deferred tax assets:			
Reserves and allowances	\$ 28,179	\$ 13,396	\$ 14,783
Inventory	8,053	8,053	-
Investment in affiliates	5,285	5,285	-
Others	2,411	1,080	1,331
Net operating loss carry forwards	26,491	10,383	16,108
	70,419	38,197	32,222
Valuation allowance	(36,282)	(13,261)	(23,021)
Net deferred tax assets	34,137	24,936	9,201
Deferred tax liabilities:			
Intangible assets	(60,876)	-	(60,876)
Property, plant and equipment	(13,180)	-	(13,180)
Reserves and allowances	12,804	-	12,804
	(61,252)	-	(61,252)
Net deferred tax assets (liabilities)	(27,115)	24,936	(52,051)
<u>As of December 31, 2007</u>			
Deferred tax assets:			
Reserves and allowances	\$ 45,307	\$ 17,155	\$ 28,152
Inventory	4,333	3,367	966
Investment in affiliates	1,429	1,429	-
Other assets	4,702	788	3,914
Net operating loss carry forwards	36,793	4,786	32,007
	92,564	27,525	65,039
Valuation allowance	(54,635)	(8,919)	(45,716)
Net deferred tax assets	37,929	18,606	19,323
Deferred tax liabilities:			
Intangible assets	(72,265)	-	(72,265)
Property, plant and equipment	(7,675)	-	(7,675)
Reserves and allowances	(1,199)	-	(1,199)
	(81,139)	-	(81,139)
Net deferred tax assets (liabilities)	(43,210)	18,606	(61,816)

(1) The current tax asset is included in other receivables and prepaid expenses.

- G. As of December 31, 2008, Elbit Systems' Israeli subsidiaries have estimated total available carry forward tax losses of approximately \$103,900, and its non-Israeli subsidiaries have estimated available carry forward tax losses of approximately \$7,100. These losses of the Israeli subsidiaries can be offset against future taxable profits for an indefinite period. Deferred tax assets in respect of the above carry forward losses amount to approximately \$26,500 in respect of which a valuation allowance has been recorded in the amount of approximately \$25,200.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 16 - INCOME TAXES (Cont.)

- H. Reconciliation of the theoretical tax expense, assuming all income is taxed at the statutory rate applicable to income of the Company, and the actual tax expense as reported in the statements of operations, is as follows:

	Year ended December 31,		
	2008	2007	2006
Income before taxes as reported in the consolidated statements of income	\$ 306,480	\$ 88,992	\$ 72,216
Statutory tax rate	27%	29%	31%
Theoretical tax expense	<u>\$ 82,750</u>	<u>\$ 25,808</u>	<u>\$ 22,387</u>
Tax benefit arising from reduced rate as an “Approved and Privileged Enterprise” and other tax benefits (*)	(44,002)	(25,631)	(17,261)
Tax adjustment in respect of different tax rates for foreign subsidiaries	331	1,443	1,018
Operating carry forward losses for which valuation allowance was provided	1,215	4,272	6,542
Increase in taxes resulting from nondeductible expenses	6,775	8,534	1,926
Difference in basis of measurement for financial reporting and tax return purposes	6,117	8,879	4,548
Taxes in respect of prior years (**)	1,879	(9,734)	1,928
Other differences, net	(698)	239	(394)
Actual tax expenses	<u>\$ 54,367</u>	<u>\$ 13,810</u>	<u>\$ 20,694</u>
Effective tax rate	<u>17.7%</u>	<u>15.5%</u>	<u>28.7%</u>
(*) Net earnings per share – amounts of the benefit resulting from the Approved and Privileged Enterprise			
Basic	<u>1.05</u>	<u>0.61</u>	<u>0.42</u>
Diluted	<u>1.03</u>	<u>0.61</u>	<u>0.41</u>

(\*\*) Taxes in respect of prior years:

The Company prepares its tax provisions in accordance with the rules and estimates that are applicable at the end of each year.

In 2006, the Company recorded a tax provision in an amount of \$1.9 million as a result of the finalization by the Israeli Tax Authorities of the tax assessment for one of the Company’s subsidiaries, which increased the Company’s tax liability for prior years. This adjustment was a result of the Tax Authorities’ adoption of a change in its prior position with respect to its interpretation of the relevant rules.

The adjustment in the 2007 results for prior years included a reduction in tax liability of \$12.0 million attributable to the Israeli operations of the Company and certain subsidiaries and a \$2.3 million increase in tax liability attributable to the Company’s foreign subsidiaries. The adjustment in the Company’s foreign subsidiaries tax liability was a result of new information regarding deductible expenses received by the Company during the course of a tax audit in 2007, and as such, it was included in the 2007 provision.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 16 - INCOME TAXES (Cont.)

During 2007, the Israeli Tax Authorities conducted and finalized a tax audit for the years 2001 through 2005. The results of the final tax assessment by the Tax Authorities were in favor of the Company, thus resulting in the reduction to tax liability of \$12.0 million referred to above.

In 2008, the Company recorded a tax provision in an amount of \$1.9 million mainly as a result of the finalization by the Israeli Tax Authorities of the tax assessment for some of the Company's subsidiaries, which increased the Company's tax liability for prior years. This adjustment was a result of the Tax Authorities' adoption of a change in its prior position with respect to its interpretation of the relevant rules.

#### I. AMENDMENT TO THE INCOME TAX ORDINANCE

On July 25, 2005, the Knesset (Israeli Parliament) approved the Law for the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among other provisions, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2004 – 35%, in 2005 – 34%, in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

In February 2008, the Knesset passed an amendment to the Income Tax (Inflationary Adjustment) Law, 1985, which limits the scope of the law starting in 2008 and thereafter. Beginning in 2008, the results for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Consumer Price Index carried out in the period up to December 31, 2007. The amended law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting in 2008.

- J. Final tax assessments have been received by the Company up to and including the tax year ended December 31, 2005 and by certain subsidiaries, for the years between 2002 - 2006 (subsidiaries that were incorporated after 2000 have not received final assessments).

#### Note 17 - COMMITMENTS AND CONTINGENT LIABILITIES

##### A. ROYALTY COMMITMENTS

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

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

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 17 - COMMITMENTS AND CONTINGENT LIABILITIES

##### A. ROYALTY COMMITMENTS (Cont.)

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

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

Royalties' expenses amounted to \$3,292, \$1,573 and \$2,830 in 2008, 2007 and 2006, respectively.

##### B. COMMITMENTS IN RESPECT OF LONG-TERM PROJECTS

In connection with projects in certain countries, Elbit Systems and some of its subsidiaries have entered and may enter in the future into "buy-back" or "offset" agreements, required by a number of the Company's customers for these projects as a condition to the Company obtaining orders for its products and services. These agreements are customary in the Company's industry and are designed to facilitate economic flow back (buy-back) and/or technology transfer to businesses or government agencies in the applicable country.

These commitments may be satisfied by the Company's placement of direct work or vendor orders for supplies and/or services, transfer of technology, investments or other forms of assistance in the applicable country. The buy-back rules and regulations, as well as the underlying contracts, may differ from one country to another. The ability to fulfill the buy-back obligations may depend, among other things, on the availability of local suppliers with sufficient capability to meet our requirements and which are competitive in cost, quality and schedule. In certain cases, the Company's commitments may also be satisfied through transactions conducted by other parties.

The Company does not commit to buy-back agreements until orders for its products or services are definitive, but in some cases the orders for the Company's products or services may become effective only after the Company's corresponding buy-back commitments are in effect. Buy-back programs generally extend at least over the relevant commercial contract period and may provide for penalties in the event the Company fails to perform in accordance with buy-back requirements. In some cases the Company provides guarantees in connection with the performance of its buy-back obligations.

Should the Company be unable to meet such obligations it may be subject to contractual penalties, and its chances of receiving additional business from the applicable customers could be reduced or, in certain cases, eliminated.

At December 31, 2008, the Company had outstanding buy-back obligations totaling approximately \$911 million that extend through 2017.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 17 - COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

##### C. LEGAL CLAIMS

- (1) Elbit Systems and its subsidiaries are involved in legal claims arising in the ordinary course of business, including claims by employees, consultants and others. The Company's management, based on the opinion of its legal counsel, believes that the financial impact for the settlement of such claims in excess of the accruals recorded in the financial statements will not have a material adverse effect on the financial position or results of operations of the Company.
- (2) In September 2008, a settlement between Innovative Solutions and Support, Inc. ("IS&S") and ESA's subsidiary Kollsman became effective with respect to all claims by IS&S and Kollsman against each other in the United States District Court for the Western District of Tennessee, and a corresponding consent order was entered. Under the settlement agreement, all claims between IS&S and Kollsman were dismissed with prejudice, a final agreed injunction was entered and the matter was fully and finally mutually settled without any admission of guilt by either party. In addition, an agreed settlement payment of \$17 million was made by Kollsman to IS&S. The results of the settlements are included in the Company's Statement of Income in 2008.
- (3) In 2007, a claim was filed in the U.S. District Court for the Southern District of New York by certain minority shareholders and holders of expired warrants of ImageSat against ImageSat International N.V. ("ImageSat"), Israel Aerospace Industries, Ltd. ("IAI"), the Company and certain current and former officers and directors of ImageSat. ImageSat's largest shareholder is IAI, holding approximately 46% of ImageSat's issued share capital. Elop holds approximately 14% (7% on a fully diluted basis) of ImageSat's issued share capital and is entitled to nominate one director to ImageSat's board. The former and current directors of ImageSat named as defendants include, among others, Michael Federmann, Joseph Ackerman, Joseph Gaspar and the Estate of Jacob Toren (collectively the Individual Defendants), who were each nominated at various times by Elop to serve as a director of ImageSat. Currently, Michael Federmann, Joseph Ackerman and Joseph Gaspar serve as the Company's Board Chairman, Chief Executive Officer and Chief Financial Officer, respectively. In March 2008, the plaintiffs amended the complaint and named Elop as an additional defendant. The claim contained various allegations that the defendants allegedly breached their fiduciary and/or contractual obligations to the detriment of the plaintiffs. The claim alleged various causes of action and damages aggregating hundreds of millions of dollars, not all of which were alleged against the Company, Elop and/or each of the Individual Defendants. In July 2008, the court dismissed the claim on the grounds of forum non conveniens. Shortly thereafter, the plaintiffs appealed dismissal of the claim to the U.S. Federal Court of Appeals for the Second Circuit, which appeal is currently pending.

In August 2008 and in December of 2008, certain additional minority shareholders and debtholders of ImageSat filed claims, of a substantially similar nature, against the defendants in the U.S. District Court for the Southern District of New York. The Company believes that there is no merit or basis to the allegations made in the three existing legal proceedings against it, Elop or the current or former ImageSat directors who were nominated by Elop and the Company. IAI has agreed to indemnify the Company, Elop and the directors nominated by Elop to ImageSat's board, for any losses arising out of any of the foregoing claims or legal proceedings, net of insurance proceeds received from ImageSat's insurance policies and any indemnification proceeds received from ImageSat.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 17 - COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

##### C. LEGAL CLAIMS (Cont.)

- (4) In 2007, Elop initiated an arbitration claim against Rafael Armaments Development Authority Ltd. ("Rafael") in an amount equivalent to approximately \$53.4 million in damages, relating to a subcontract under which Rafael was a subcontractor to Elop. Rafael filed a counterclaim against Elop in an amount of approximately \$15 million. In March 2009, Elop and Rafael signed a settlement agreement, to which Rafael will pay certain amounts to Elop to recover certain agreed damages. The result of the settlement did not have a material effect on the Company's results of operations or financial position.
- (5) For information on Elisra's insurance claim for damage, as a result of a fire in 2001, see Note 7.

##### D. LEASE COMMITMENTS

The future minimum lease commitments of the Company under various non-cancelable operating lease agreements in respect of premises, motor vehicles and office equipment as of December 31, 2008 are as follows:

2009	\$ 32,225
2010	28,789
2011	21,248
2012	13,568
2013 and thereafter	7,503
	<u>\$ 103,333</u>

Rent expenses for the years ended December 31, 2008, 2007 and 2006 amounted to \$33,355, \$25,989 and \$13,786, respectively.

##### E. GUARANTEES

- (1) As of December 31, 2008, guarantees in the amount of approximately \$960,700 were issued by banks on behalf of Company's entities mainly in order to secure certain advances from customers and performance bonds.
- (2) Elbit Systems has provided, on a proportional basis to its ownership interest, guarantees for two of its investees in respect of credit lines granted to them by banks amounting to \$3,700 (2007 - \$5,600), of which \$3,700 (2007 - \$5,100) relates to a 50%-owned foreign investee. The guarantees will exist as long as the credit lines are in effect. Elbit Systems would be liable under the guarantee for any debt for which the investee would be in default under the terms of the credit line. The fair value of such guarantees as of December 31, 2008 is not material.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 17 - COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

##### F. COVENANTS

- (1) In connection with bank credits and loans, including performance guarantees issued by banks and bank guarantees in order to secure certain advances from customers, the Company and certain subsidiaries are obligated to meet certain financial covenants. Such covenants include requirements for shareholders' equity, current ratio, operating profit margin, tangible net worth, EBITDA, interest coverage ratio and total leverage. As of December 31, 2008, Elbit Systems and its subsidiaries, except Elisra, were in full compliance with all covenants.
- (2) Elisra's liabilities to banks, including performance guarantees issued by banks and bank guarantees in order to secure certain advances from customers, are secured, with first priority liens and/or floating liens on all of Elisra's property and assets with no limitations as to amount and by negative pledges. According to the agreement with the banks, Elisra committed to comply with certain financial covenants (to be measured based on Elisra's stand-alone financial statements), which include, among others, a minimum ratio of shareholders' equity to total assets (as defined in the agreement), a minimum current ratio, a minimum amount of shareholders' equity and a minimum amount of pre-tax income. In addition, certain restrictions have been imposed on Elisra regarding the provision of guarantees to third parties, creating new liens and on selling or transferring assets in material amounts. As a result of the non-compliance, Elisra's long-term loans as of December 31, 2008, in the amount of \$2,000 (December 31, 2007 - \$14,704), have been recorded as short-term.

##### G. CONTINGENT LIABILITIES AND GUARANTEES

As a result of cancellation of the export authorization in 2006 to a foreign country (hereinafter: "the Customer"), Elisra and one of its subsidiaries were forced to terminate four projects. Most of the activity in respect of the projects, the total volume of which amounts to approximately \$40 million, has already been executed and the deliveries have been made to the Customer. For those projects, Elisra and its subsidiary provided to the customer advance and performance guarantees, issued by banks and financial institutions, in the total amount of approximately \$7 million as of December 31, 2007.

On July 28, 2008, the subsidiary received an approval from the customer for the completion of the subsidiary's obligations in two of the abovementioned projects, the total volume of which amounts to approximately \$ 16.4 million. On September 22, 2008, the subsidiary received confirmation from a financial institution, stating that the advance and performance guarantees issued by said institution, in the amount of \$6.7 million, are null and void.

Therefore, as of December 31, 2008, there are two remaining projects, the total volume of which amounts to approximately \$23 million. Elisra provided the customer advance and performance guarantees related to the abovementioned projects in the amount of approximately \$5 million.

Elisra's management, based on the opinion of legal counsel, believes that termination of the projects under such circumstances constitutes a termination by mutual agreement due to force majeure, which provides a mechanism for mutual settlement between the parties.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 17 - COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

##### G. CONTINGENT LIABILITIES AND GUARANTEES (Cont.)

Elisra's management, based on the opinion of its legal counsel, believes that the financial impact of the termination of the two projects in excess of the accruals recorded in the financial statements will not have a material adverse effect on the financial position or results of operations of Elisra.

The customer financed the projects by means of bank loans. The banks received indemnity letters as security for repayment of the loans. Most of the indemnity was provided to the banks by International Foreign Trade Risks Insurance Company (hereinafter - "IFTRIC") and the rest was provided by Elisra and its subsidiary (as of December 31, 2008 and 2007 amounted to approximately \$46 and \$2,800, respectively).

In addition, Elisra provided indemnity letters to IFTRIC that can be exercised upon, inter alia, a commercial dispute, and is subject to IFTRIC fulfilling its commitments to the banks. In Elisra Management's opinion, based on legal advice, the likelihood that the indemnification provided to IFTRIC would be exercised is remote.

In the opinion of Elisra's and the Company's management, based on the above facts and circumstances, no provisions in respect of these indemnifications are required.

##### H. CONTRACTUAL OBLIGATIONS

Substantially all of the Company's purchase commitments relate to obligations under purchase orders and subcontracts entered into by the Company. These purchase orders and subcontracts are typically in standard formats proposed by the Company, with the subcontracts and purchase orders also reflecting provisions from the Company's applicable prime contract that apply to flow down to subcontractors and vendors. The terms typically included in these purchase orders and subcontracts are consistent with Uniform Commercial Code provisions in the United States for sales of goods, as well as with specific terms called for by its customers in international contracts. These terms include the Company's right to terminate the purchase order or subcontract in the event of the vendor's or subcontractor's default, as well as the Company's right to terminate the order or subcontract for the Company's convenience (or if the Company's prime contractor has so terminated the prime contract). Such purchase orders and subcontracts typically are not subject to variable price provisions. As of December 31, 2008 and 2007, the purchase commitments were \$948,000 and \$906,000 respectively.

- I. In order to secure bank loans and bank guarantees in the amount of \$960,700 as of December 31, 2008, certain Company entities recorded fixed liens on most of their machinery and equipment, mortgages on most of their real estate and floating charges on most of their assets.
- J. A lien on the Company's Approved Enterprises has been registered in favor of the State of Israel (see Note 16(A)(3) above).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

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

#### Note 18 - SHAREHOLDERS' EQUITY

##### A. SHARE CAPITAL

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

##### B. 2000 EMPLOYEE STOCK OPTION PLAN

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

##### C. 2007 STOCK OPTION PLAN

In January 2007, Elbit Systems' shareholders approved Elbit Systems' 2007 Option Plan (the "Plan"). The purpose of the Plan is to provide the benefits arising from ownership of share capital by Elbit Systems' and certain of its subsidiaries employees, who are expected to contribute to the Company's future growth and success. The options were allocated, subject to the required approvals, in two tracks as follows: (i) Regular Options - up to 1,250,000 options exercisable into 1,250,000 shares of Elbit Systems in consideration for the exercise price, all or any portion of which may be granted as Incentive Stock Options ("Regular Options") and (ii) Cashless Options - up to 1,250,000 options, which entitle the participant to exercise options for an amount reflecting only the benefit factor ("Cashless Options"). Each of the participants is granted an equal amount of Regular Options and Cashless Options. The exercise price for Israeli participants is the average closing price of Elbit Systems' share during 30 trading days preceding the options grant date. The exercise price of options granted to a non-Israeli participant residing in the United States is the fair market value of the share on the day the options were granted.

According to the Plan, the options granted on a certain date (the "Commencement Date") will become vested and exercisable in accordance with the following vesting schedule:

- (1) Fifty percent (50%) of the options will be vested and exercisable from the second anniversary of the Commencement Date;
- (2) An additional twenty-five percent (25%) of the options will be vested and exercisable from the third anniversary of the Commencement Date; and
- (3) The remaining twenty-five (25%) of the options will be vested and exercisable from the fourth anniversary of the Commencement Date.

The options expire no later than five years from the date of grant.

Elbit Systems granted options to Israeli participants in accordance with the provisions of Section 102 of the Israel Tax Ordinance related to the Capital Gains Tax Track.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

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

#### Note 18 - SHAREHOLDERS' EQUITY (Cont.)

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

	2008		2007		2006	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding – beginning of the year	2,386,826	\$ 32.51	167,460	\$ 16.45	1,602,752	\$ 12.83
Granted	135,800	56.15	2,381,300	33.27	-	-
Exercised	(22,675)	15.96	(53,624)	15.97	(1,366,809)	12.40
Forfeited	(45,100)	33.12	(108,310)	32.66	(68,483)	12.55
Outstanding – end of the year	2,454,851	\$ 33.96	2,386,826	\$ 32.51	167,460	\$ 16.45
Options exercisable at the end of the year	82,951	\$ 16.84	68,498	\$ 16.50	75,085	\$ 15.70

Aggregate intrinsic value of outstanding options as of December 31, 2008 and 2007 amounted to \$30,740 and \$64,564, respectively. The aggregate intrinsic value represents the total intrinsic value (the difference between Elbit Systems' closing stock price on the last trading day of the fourth quarter of fiscal 2008 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2008. This amount change based on the fair market value of the Company's stock. The total intrinsic value of options exercised for the year ended December 31, 2008 was \$692. As of December 31, 2008, there was \$11,195 of total unrecognized compensation cost related to share-based compensation arrangements granted under Elbit Systems' stock option plans. That cost is expected to be recognized over a weighted average period of three years.

As of December 31, 2008, 2,441,568 options were vested and expected to be vested at a weighted average exercise price of \$33.96. The weighted average remaining contractual life of exercisable options as of December 31, 2008 is approximately three year and their aggregate intrinsic value is approximately \$30,580.

E. The options outstanding as of December 31, 2008, have been separated into ranges of exercise prices, as follows:

Exercise price	Options outstanding			Options exercisable	
	Number of options	Weighted average remaining contractual li (years)	Weighted average exercise price per share	Number of options	Weighted average exercise price per share
\$14.76 - \$ 19.36	88,451	1.79	\$ 16.99	82,951	\$ 16.84
\$33.10 - \$ 57.47	2,366,400	3.16	\$ 34.59	-	-
	2,454,851	3.11	\$ 33.96	82,951	\$ 16.84

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

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

#### Note 18 - SHAREHOLDERS' EQUITY (Cont.)

Compensation expense amounting to \$5,067, \$4,778 and \$195 was recognized during the years ended December 31, 2008, 2007 and 2006, respectively. The expenses before tax were recorded as follows:

	Year ended December 31,		
	2008	2007	2006
Cost of revenues	\$ 2,349	\$ 2,146	\$ 75
R&D and marketing expenses	897	850	-
General and administration expenses	1,821	1,782	120
	\$ 5,067	\$ 4,778	\$ 195

- F. The weighted average exercise price and fair value of options granted during the years ended December 31, 2008, 2007 and 2006 were:

	Less than market price		
	Year ended December 31,		
	2008	2007	2006 <sup>(*)</sup>
Weighted average exercise price	\$ 56.15	\$ 33.28	\$ -
Weighted average fair value on grant date	\$ 13.87	\$ 8.44	\$ -

(\*) During 2006, no options were granted.

- G. COMPUTATION OF BASIC AND DILUTED NET EARNINGS PER SHARE:

	Year ended December 31, 2008			Year ended December 31, 2007			Year ended December 31, 2006		
	Net income to shareholders of ordinary shares	Weighted averaged number of shares (*)	Per share amount	Net income to shareholders of ordinary shares	Weighted averaged number of shares (*)	Per share amount	Net income to shareholders of ordinary shares	Weighted averaged number of shares (*)	Per share amount
Basic net earnings	\$ 204,176	42,075	\$ 4.85	\$ 76,709	42,041	\$ 1.82	\$ 72,242	41,340	\$ 1.75
Effect of dilutive securities:									
Employee stock options	-	683		-	301		-	540	
Diluted net earnings	\$ 204,176	42,758	\$ 4.78	\$ 76,709	42,342	\$ 1.81	\$ 72,242	41,880	\$ 1.72

(\*) In thousands

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

---

U. S. dollars (In thousands)

#### Note 18 - SHAREHOLDERS' EQUITY (Cont.)

- H. In December 2007, Elbit Systems U.S. Corp ("ESC"), a wholly-owned U.S. subsidiary of Elbit Systems, adopted a Stock Appreciation Rights Plan for Non-Employee Directors of Elbit Systems of America, LLC (the "SAR Plan"). ESC owns the shares of ESA. The purpose of the SAR Plan is to facilitate the retention of qualified and experienced persons to serve as "Non-Employee Directors" of ESA by providing them additional financial incentives. A "Non-Employee Director" is a director of ESA who is not an officer or employee of ESA, or any of its affiliated companies.

Under the Plan, the Board of ESC may grant Stock Appreciation Rights ("SARs") from time to time to Non-Employee Directors of ESA. A SAR is a right that, in accordance with the terms of the SAR Plan, entitles the holder to receive, on the exercise date of the SAR, cash in an amount equal to the excess of the "Fair Market Value" of the "Stock" corresponding to the SAR at the time of exercise of the SAR over the "Initial Value of the Stock". "Stock" means Elbit Systems Ordinary Shares. Each SAR corresponds to a share of Stock. "Fair Market Value" with respect to the Stock means the closing price of the Stock on the Nasdaq on the applicable date. "Initial Value" of a SAR means the Fair Market Value of one share of Stock on the grant date of the SAR.

A SAR may only be exercised after it becomes vested. 25% of any SAR's granted are exercisable on the first anniversary from the grant date and an additional 25% on each subsequent anniversary. The maximum term of a SAR is five years from the grant date. SAR's do not provide any rights as a shareholder in the Stock. On January 2, 2008, the Board of Directors of ESC issued a total of 21,000 SARs to Non-Employee Directors of ESA, at an Initial Value of \$61.42 per SAR.

#### I. TREASURY SHARES

Elbit Systems' shares held by Elbit Systems and its subsidiaries are presented at cost and deducted from shareholders' equity.

#### J. DIVIDEND POLICY

Dividends declared by Elbit Systems are paid subject to statutory limitations. Elbit Systems' Board of Directors has determined not to declare dividends out of tax exempt earnings.

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 19 - MAJOR CUSTOMER AND GEOGRAPHIC INFORMATION

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

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

	Year ended December 31,		
	2008	2007	2006
Europe	\$ 653,043	\$ 485,128	\$ 233,736
U.S.	907,098	702,721	609,492
Israel	474,405	408,920	407,113
Others (*)	603,725	384,992	272,902
	\$ 2,638,271	\$ 1,981,761	\$ 1,523,243

(\*) Mainly Asia and South America

B. Revenues are generated by the following product lines:

	Year ended December 31,		
	2008	2007	2006
Airborne systems	\$ 634,714	\$ 596,022	\$ 547,772
Land vehicles systems	699,485	380,958	317,731
(C <sup>4</sup> ISR) systems	844,456	581,983	313,493
Electro-optical systems	336,702	271,290	223,315
Others (*)	122,914	151,508	120,932
	\$ 2,638,271	\$ 1,981,761	\$ 1,523,243

(\*) Mainly non-defense engineering and production services.

C. Major customer data as a percentage of total revenues:

	Year ended December 31,		
	2008	2007	2006
Israeli Ministry Of Defense	19%	21%	24%
U.S. Government	5%	8%	15%

D. Long-lived assets by geographic areas:

	Year ended December 31,		
	2008	2007	2006
Israel	\$ 707,427	\$ 694,985	\$ 319,620
U.S.	195,752	191,822	86,373
Others	75,190	102,150	17,630
	\$ 978,369	\$ 988,957	\$ 423,623

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 20 - RESEARCH AND DEVELOPMENT EXPENSES, NET

	Year ended December 31,		
	2008	2007	2006
Total expenses	\$ 217,176	\$ 155,303	\$ 115,648
Less – grants and participations	(32,192)	(28,308)	(23,416)
	\$ 184,984	\$ 126,995	\$ 92,232

#### Note 21 - FINANCIAL EXPENSES, NET

	Year ended December 31,		
	2008	2007	2006
Expenses:			
Interest on long-term bank debt	\$ (17,898)	\$ (21,131)	\$ (10,975)
Interest on short-term bank credit and loans	(3,145)	(3,983)	(4,610)
Impairment of auction rate securities	(18,714)	(10,027)	-
Others	(11,345)	(6,065)	(6,788)
	(51,102)	(41,206)	(22,373)
Income:			
Interest on cash, cash equivalents and bank deposits	9,292	10,121	4,634
Gain on marketable securities	1,400	6,480	80
Others	4,410	2,797	951
	15,102	19,398	5,665
Gain (loss) from exchange rate differences	(815)	2,479	(4,748)
	\$ ( 36,815)	\$ (19,329)	\$ (21,456)

#### Note 22 - OTHER INCOME, NET

	Year ended December 31,		
	2008	2007	2006
Gain from sale of Mediguide shares <sup>(1)</sup>	\$ 100,031	\$ -	\$ -
Impairment of investment <sup>(2)</sup>	(10,514)	-	-
Gain in respect of fire damages in Elisra <sup>(3)</sup>	4,087	-	-
Others	690	368	1,814
	\$ 94,294	\$ 368	\$ 1,814

(1) On December 22, 2008, the Company sold all of its shares in Mediguide (see Note 1(F)).

(2) Impairment of investment in Sandel shares (see Note 6(C)).

(3) On March 17, 2008, the Company recorded a gain of \$4,087 as a result of the settlement agreement between Elisra and Phoenix (see Note 7).

## ELBIT SYSTEMS LTD. AND ITS SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (CONT.)

U. S. dollars (In thousands)

#### Note 23 - RELATED PARTIES TRANSACTIONS AND BALANCES

Transactions:	Year ended December 31,		
	2008	2007	2006
Income -			
Sales to affiliated companies (*)	\$ 20,561	\$ 60,870	\$ 71,808
Participation in expenses	\$ 3,372	\$ 8,941	\$ 3,497
Cost and expenses -			
Supplies from affiliated companies (**)	\$ 51,703	\$ 26,538	\$ 17,359
Participation in expenses	\$ -	\$ -	\$ -
 Balances:			
	December 31,		
	2008	2007	
Trade receivables and other receivables (*)	\$ 11,527	\$ 11,792	
Trade payables (**)	\$ 30,117	\$ 9,391	

The purchases from related parties are made at arm length. The sales to the Company's related parties in respect of U.S. government defense contracts are made on the basis of cost.

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

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

#### Note 24 - SUBSEQUENT EVENTS

On February 24, 2009, the Company, through ESLC-T, acquired all of the shares of Shiron Satellite Communications (1996) Ltd. ("Shiron"), a privately-owned Israeli company, for a purchase price of \$16 million. Shiron is engaged in the broadband communication market, and its solutions are suited for the growing interactive multimedia broadband satellite market. Shiron's InterSKY™ satellite communications system provides broadband satellite services to remote locations Shiron's technology, well proven in the commercial market, is anticipated to be synergetic to the communication technology developed and implemented in ESLC-T's military systems and products.

# # # # # # # #