Elbit Systems Ltd.
Management's Report
For the Year Ended December 31, 2006

This report should be read together with the audited consolidated financial statements and related notes of Elbit Systems Ltd. ("Elbit Systems" and together with its subsidiaries, the "Company" or the "Group") for the year ended December 31, 2006 and the Company's Form 20-F for the year ended December 31, 2005, filed by the Company with the U.S. Securities and Exchange Commission ("SEC") and with the Israeli Securities Authority.

Forward looking statements with respect to the Company's business, financial condition and results of operations in this document are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward looking statements, including, but not limited to, product demand, pricing, market acceptance, changing economic conditions, risks in product and technology development, the effect of the Company's accounting policies as well as certain other risk factors which are detailed from time to time in the Company's SEC filings.

A. Executive Overview

Business Description

The Group operates in the areas of aerospace, land and naval systems, command, control, communications, computers, intelligence, surveillance and reconnaissance ("C^4ISR"), advanced electro-optic and space technologies, EW suites, airborne warning systems, ELINT systems, data links and military communications systems and equipment. The Group also focuses on the upgrading of existing military platforms and developing new technologies for defense and homeland security applications.

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

The Group tailors and adapts its technologies, integration skills, market knowledge and battle-proven systems to each customer's individual requirements in both existing and new platforms. By upgrading existing platforms with advanced electronic and electro-optic technologies, the Group provides customers with cost-effective solutions, and its customers are able to improve their technological and operational capabilities within limited defense budgets.

The Group operates in a competitive environment for most of its projects, systems and products. Competition is based on product and program performance, price, reputation, reliability, maintenance costs and responsiveness to customer requirements. This includes the ability to respond to rapid changes in technology. In addition, its competitive position sometimes is affected by specific requirements in particular markets.

Financial Highlights

The Company's revenues increased by 42% and reached $1,523 million in 2006, as compared to $1,070 million in 2005.

Net earnings in 2006 were $72.2 million and the diluted earnings per share were $1.72, as compared to $32.5 million and $0.78, respectively in 2005.

The Company's backlog as of December 31, 2006 reached $3.79 billion, as compared to $3.35 billion as of December 31, 2005, an increase of 13.1%.

The Company's cash flow generated from operations in the year ended December 31, 2006 was $201 million, as compared to $187.6 million in the year ended December 31, 2005.

The Board of Directors declared a dividend of $0.16 per share for the last quarter of 2006, resulting in a cumulative dividend for 2006 of $ 0.61 per share.

B. Market Trends

Trends in the defense electronics and homeland security markets in which the Company operates have been impacted by the nature of recent conflicts and terrorism activities throughout the world. Lessons learned in Operation Iraqi Freedom, Afghanistan and various terrorist actions worldwide have increased the focus of defense forces on low intensity conflicts and homeland security.

In the defense electronics market, there is an increasing demand for products and systems in the areas of C^4ISR. Accordingly, while the Company continues to perform platform upgrades, more emphasis is being placed on C^4ISR, including information systems, intelligence gathering, situational awareness, precision guidance, all weather and day/night operations, border and perimeter security, UAV's, space and satellite based defense capabilities and homeland security systems.

The Company believes that its core technologies and abilities will enable it to take advantage of many of these emerging trends, as well as to continue to participate in the "Current Force" legacy operations of its customers.

In recent years consolidations in the defense industry have affected competition. This has decreased the number but increased the relative size and resources of the Company's competitors. The Company adapts to evolving market conditions by adjusting its business strategy to changing defense market conditions. It also anticipates continued competition in defense markets due to declining defense budgets in some countries.

The Company believes in its ability to compete on the basis of its systems development and technological expertise, combat-proven performance and policy of offering customers overall solutions to technological, operational and financial needs and in the same time enhancing the industrial capabilities at these countries.

C. Backlog of Orders

The Company's backlog of orders as of December 31, 2006 reached $3,786 million, of which 68% were for orders outside Israel. The Company's backlog as of December 31, 2005 was $3,347 million, of which 72% were for orders outside Israel.

Approximately 70% of the Company's backlog as of December 31, 2006 is scheduled to be performed during 2007 and 2008. The majority of the 30% balance is scheduled to be performed in 2009 and 2010.

D. Operating Subsidiaries and Affiliated Entities

- Elbit Systems Electro-Optics Industries Elop Ltd. ("Elop") - a wholly-owned subsidiary based in Israel, is engaged in the area of advanced electro-optical products and systems for military and civilian use. Elop's business areas include thermal imaging products, lasers, IMINT solutions, head-up displays, integrated sights for ground forces, space and airborne reconnaissance systems and electro-optical homeland security and defense security systems.

- Elbit Systems of America, LLC ("ESA") – is the headquarters for the U.S. operations of the Group and includes the following subsidiaries:

  - EFW Inc. ("EFW"), a wholly-owned subsidiary based in Fort Worth, Texas, provides combat-proven design, development, production and life-cycle support of mission critical systems for U.S. and allied military tactical platforms.

  - Kollsman, Inc. ("Kollsman"), a wholly-owned subsidiary located in Merrimack, New Hampshire, is a supplier of avionic equipment, electro-optic systems and subsystems, vision based solutions and surveillance systems to the commercial aviation, defense and homeland security markets.

  - International Enterprises, Inc. ("IEI"), a wholly-owned subsidiary based in Talladega, Alabama, provides depot level repair, manufacturing and logistics support for military electronic systems and components.

  - Vision Systems International LLC ("VSI"), a 50% joint venture with Rockwell Collins, located in San Jose, California, is a supplier of helmet mounted cueing systems for fixed-wing, tactical fighter aircraft.

- Cyclone Aviation Products Ltd. ("Cyclone") – a wholly-owned subsidiary based in Israel, is engaged in the production of structural components and parts for leading aerospace companies. Cyclone also performs maintenance, repair and customized upgrading of light airplanes and helicopters.

- Silver Arrow LP – a wholly-owned limited partnership based in Israel, is engaged in UAV systems development, production and support and produces a full range of UAV systems for tactical use.

- Ortek Ltd. ("Ortek") – a wholly-owned subsidiary based in Israel, is engaged in the development and production of optical security systems and products and performs a range of projects for homeland security and defense applications.

- European subsidiary – a wholly-owned subsidiary based in Belgium, is involved mainly in development, manufacturing and support of electro-optical products for defense and space markets.

- Elisra – in which Elbit Systems owns a 70% interest, is comprised of Elisra Electronic Systems Ltd. ("Elisra"), a privately held Israeli company, and Elisra's two wholly-owned Israeli subsidiaries – Tadiran Electronic Systems Ltd. and Tadiran Spectralink Ltd. Elisra specializes in the design, manufacture, integration and support of advanced defense solutions and its main business areas include EW suites, airborne warning systems, ELINT systems, artillery C4I systems and data links for UAVs and guided munitions.

- Kinetics Ltd. ("Kinetics") – a 51%-owned subsidiary based in Israel, is involved mainly in the development and production of systems and components for combat vehicles.

- Semi-Conductor Devices ("SCD") – an Israeli affiliated partnership held in equal part by each of the Company and Rafael Armaments Development Authority Ltd. ("Rafael"), is engaged in the development and production of infrared detectors and laser diodes.

- Opgal Optronic Industries Ltd. ("Opgal") – an Israeli affiliated company, owned 50.1% by the Company and 49.9% by Galram Technologies Ltd., a wholly-owned subsidiary of Rafael, is engaged mainly in the area of thermal imaging systems for commercial applications.

- Tadiran Communications Ltd. ("Tadiran") – a publicly-traded Israeli company in which Elbit Systems holds an approximately 43% interest, is engaged in the worldwide market for military communications systems and equipment and is also active in the civilian communications market.

The Company has holdings, directly and indirectly, in several relatively small companies in various countries. These companies are engaged mainly in the manufacturing, marketing and servicing of defense avionics and electronics as well as defense related software.

The Company also has holdings, directly and indirectly, in several non-defense technologies spin-off companies whose activities are usually based on technologies that were developed by the Group. The spin-off companies are involved primarily in the areas of medical equipment and space satellites.

The Company evaluates investments in affiliates, partnerships and other companies, and when relevant factors indicate other than temporary decline in the fair value of the investments below their carrying value, the Company adjusts the investment to the estimated fair value. The value of these companies is subject to ongoing changes resulting from their business conditions.

E. Recent Events

- On November 16, 2006, the Company reported that EFW, an Elbit Systems of America company, has been chosen to supply the Helmet Display and Tracking System (HDTS) for the US Army's new Armed Reconnaissance Helicopter designed and manufactured by Bell Helicopter. The HDTS will be based on EFW's ANVIS/HUD (Aviator's Night Vision Imaging System / Head Up Display) with a Tracking System for pilot targeting, cueing and crew coordination. The program has potential value of $51 million through 2012.

- On January 8, 2007, the Company reported that it has signed a contract to supply unmanned turrets and electro-optic systems for the Belgian Infantry Vehicle Program. The contract, valued at approximately $58 million, is pursuant to a co-operation between the Company and the Swiss company Mowag of the General Dynamics European Land Combat Systems Group.

- On January 30, 2007, the Company announced that it received notice on January 29, 2007 from the Bulgarian Ministry of Defense of the termination of the in the amount of €57 million for the modernization of Mi-24 and Mi-17 helicopters for the Bulgarian Air Force. The Company had previously announced the award of this contract on December 4, 2005. In the cancellation notice the Bulgarian MOD requested a return of a portion of the amounts paid to date to the Company under the contract. On March 5, 2007, the Company announced, that further to its January 30, 2007 announcement, it reached an agreement with the Bulgarian Government regarding the cancellation of the contract for the modernization of Bulgarian Air Force Mi-24 and Mi-17 helicopters. The agreement recognizes that the cancellation of the contract is by mutual consent and is not a result of breach of obligations by either party. Under the agreement the Company will return to the Bulgarian Ministry of Defense part of the advance payments received. The Company will also deliver the Ministry of Defense equipment and items already produced in the performance of the program in consideration of the balance of the payments to be retained by Elbit Systems. The Company believes that this matter will not have a material adverse affect on its results of operations**.**

- On February 20, 2007, the Company was awarded a contract to establish a training center for "Tzofit" (King Air B200 Beechcraft) for the Israeli Air Force ("IAF"). The Company will serve as the project's prime contractor, while Arkia and the Canadian Mechtronix will serve as sub-contractors. The training center will operate through a PFI (Private Financing Initiative) program, with the Company providing the IAF a turn-key solution including the establishment of the training center, its operation and the supply of simulators, training services and maintenance for a 10-year period. The Israeli Ministry of Defense will purchase flight training hours for the IAF from the Company. Potential revenues from the project are expected to exceed $15 million. The training center will be established on a civilian property outside military bases. Furthermore, for the first time in Israel, it will be possible to open such a training center for civilian pilots, providing them training in accordance with international aviation requirements while using local flight simulators and facilities.

- On February 26, 2007, the Company announced that its U.S. subsidiary, Kollsman, an ESA company, received two follow-on orders from the U.S. Marine Corps for its high-performance Laser Target Designator (LTD) systems that have proven successful in field test evaluations. The additional orders, under an indefinite delivery/indefinite quantity ("IDIQ") contract, consisting of approximately $16.9 million and $34 million respectively, represent an increase over the initial order of July 2006. Part of the work will be performed by Elop.

F. Critical Accounting Policies and Estimates

The Company's significant accounting policies are described in Note 2 to the audited consolidated financial statements for the year ended December 31, 2006.

The Company's results of operations and financial condition are based on the preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States ("U.S. GAAP"). The preparation of the consolidated financial statements requires management to select accounting policies for critical accounting areas as well as estimates and assumptions that affect the amounts reported in the consolidated financial statements. Significant changes in assumptions and/or conditions and changes in critical accounting policies could materially impact the Company's operating results and financial condition.

We believe our most critical accounting policies relate to:

- Revenue Recognition.
- Business Combinations and Purchase Price Allocation.
- Impairment of Goodwill and Other Long-Lived Assets.
- Other-Than-Temporary Decline in Value of Investments in Investee Companies.
- Useful Life of Long-Lived Assets.

(1) Revenue Recognition

The Company generates revenues, mainly from long-term contracts involving the design, development, manufacture and integration of defense systems and products and providing support and services for such systems and products.

Revenues from long-term contracts are recognized based on 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.

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 the 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 there is sufficient information to assess anticipated contract performance.

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

In cases where the contract involves the delivery of products and performance of services, the Group follows the guidelines specified in EITF 00-21, "Revenue Arrangements with Multiple Deliverables" in order to allocate the contract fees between the products accounted for under SOP 81-1 and the services.

In certain circumstances, sales under short-term fixed-price production type contracts are accounted for in accordance with SAB No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"), and recognized when 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.

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 the Group's 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.

(2) Business Combinations and Purchase Price Allocation

Business combinations are accounted for using the purchase method of accounting, under which the total purchase price is allocated to proportional interest in the acquired company's assets and liabilities based on their estimated fair values, and the remainder, if any, is attributed to goodwill.
The aggregate purchase price of any investment accounted for under either the consolidation or the equity method of accounting is being allocated to identifiable net assets, intangible assets other than goodwill, in-process research and development (IPR&D) activities, and to goodwill. The amount allocated to IPR&D is being charged immediately to the Group's results of operations in accordance with FASB Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method" (FIN 4). The amounts allocated to finite-lived intangible assets other than goodwill are amortized on a straight-line basis over their weighted average expected useful life.

Estimating the fair value of certain assets acquired and liabilities assumed is judgmental in nature and often involves the use of significant estimates and assumptions, mainly with respect to intangible assets. While there are a number of different methods for estimating the value of intangibles acquired, the primary method used is the discounted cash flow approach. Some of the more significant estimates and assumptions inherent in the discounted cash flow approach include projected future cash flows, including their timing, a discount rate reflecting the risk inherent in the future cash flows and a terminal growth rate. Another area which requires judgment which can impact the Group's results of operations is estimating the expected useful lives of the intangible assets.

To the extent intangible assets are ascribed with longer useful lives, there may be less amortization expenses recorded in any given period. As the Group companies operate in industries which are extremely competitive, the value of the intangible assets, including goodwill and their respective useful lives, are exposed to future adverse changes which can result in a charge to the Group's results of operations.

(3) Impairment of Goodwill and Other Long-Lived Assets

Consistent with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," goodwill is not amortized and is tested at least annually for impairment. According to SFAS 142, an impairment loss will be recognized when the carrying value of the goodwill is not recoverable and exceeds its fair value. The Company conducts a goodwill impairment review at least annually and on an interim basis whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important which could trigger an impairment review include significant underperformance relative to historical or expected future operating results and significant negative industry or economic trends. The Company tests for impairment at a level referred to as a reporting unit. Determining fair value of a reporting unit involves the use of significant estimates and assumptions. These estimates and assumptions could have an impact on whether or not an impairment charge is recognized. To determine fair value, the Company may use a number of valuation methods.

The methods commonly used to value a closely held company are the Income, Market and Cost approaches. The Company's reported units fair market value was estimated using two valuation methodologies: the Income Approach and the Market Approach. As mentioned above, these approaches use estimates and assumptions including projected future cash flows, discount rate and terminal growth rate. Using different assumptions could result in different results.

As of December 31, 2006, the Company's goodwill amounted to $58.4 million. The Company tested its goodwill as of December 31, 2006 and concluded that no impairment loss has been identified.

Consistent with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Company evaluates long-lived assets for impairment and assesses their recoverability whenever events or circumstances indicate that carrying amount of an asset may not be recoverable. The 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 considered 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. In the evaluation of fair value, the Company uses significant estimates and assumptions such as projected future cash flows which are subject to high degree of judgment. If the carrying value of the intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. In the valuation of fair value the Company uses judgment as to which is the most appropriate method to use for measuring fair value and as to what assumptions to use in implementing the methodology chosen. As the Group operates in industries

which are extremely competitive, changes in the assumptions and estimates may affect the carrying value of the intangible assets, and could result in an additional impairment charge to the Company results of operations. As of December 31, 2006, the Company's long-lived assets amounted to $364.7 million, including $70.6 million in intangible assets, and the Company concluded that there were no indicators for impairment.

Should future impairment tests made by the Company determine that impairment has occurred in the value of the Company's goodwill or long-lived assets, such impairment may have a material effect on the financial results of the Company in the period in which the impairment is determined. See also "Other Finance Expenses (Net)" below.

(4) Other-Than-Temporary Decline in Value of Investments in Investee Companies

At the end of each reported period the Company evaluates whether an other-than-temporary decline in the value of an investment in investee companies has been sustained. This evaluation is judgmental in nature. If it has been determined that an investment has sustained an other-than-temporary decline in its fair value relative to its carrying value, the investment is written down to its fair value by a charge to the Company's results of operations.

An evaluation of fair value is dependent upon specific facts and circumstances. Factors that are considered in this determination include financial information (including, among others, budgets, business plans and financial statements) and independent appraisals, if available. Factors indicative of an other-than-temporary decline include recurring operating losses, credit defaults, specific conditions affecting the investment, such as in the industry or in a geographic area, and subsequent rounds of financing at an amount below the cost basis of the investment. This list is not all inclusive, and the Company weighs all quantitative and qualitative factors in determining if an other-than-temporary decline in value of an investment has occurred. As the Group operates in industries which are extremely competitive, it is possible that estimates could change in the near term, and there can be no assurance that an additional write-down or write-off of the carrying value will not be required in the future.

(5) Useful Life of Long-Lived Assets

Intangible assets and property, plant and equipment are amortized over their estimated useful lives. Determining the useful life of such assets involves the use of estimates and judgments. In determining the useful life the Company takes into account various factors such as the expected use of the assets, effects of obsolescence, competition, demand, changes in business, acquisitions and other economic factors. If the Company's estimates changes and the useful lives of such assets increase or decrease, it will affect the Company' results of operations.

G. Sarbanes-Oxley Act

According to Section 404 of the U.S. Sarbanes-Oxley Act of 2002, the Company is required to include in its annual report for the fiscal year ending December 31, 2006 an assessment, as of the end of the fiscal year, of the effectiveness of its internal controls over financial reporting.

During 2006, the Company took steps to assure compliance of its documentation and internal controls over financial reporting with the guidelines stipulated in the Sarbanes-Oxley Act. The Company has completed the required activities for the 2006 year end financial statements.

H. New Accounting Standards

The significant accounting policies applied in the preparation of these statements are identical to those applied in preparation of the latest annual financial statements except as indicated below:

- In July 2006, the FASB issued 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 income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied. Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement.

  FIN 48 applies to all tax positions related to income taxes, including tax positions considered to be "routine" as well as those with a high degree of uncertainty.

  FIN 48 has expanded disclosure requirements, which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months. These disclosures are required at each annual reporting period and if a significant change occurs in an interim period.

  FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 will be reported as an adjustment to the opening balance of retained earnings. The Company is currently evaluating the effect of the adoption of FIN 48 on its financial statements.

- In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). This Statement provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except SFAS No. 123(R) and related interpretations. The Statement does not apply to accounting standards that require or permit measurement similar to fair value but are not intended to represent fair value. This pronouncement is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 157.

- In September 2006, the FASB issued FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No 87, 88, 106, and 132(R) ("SFAS 158"). Statement 158 requires plan sponsors of defined benefit pension and other postretirement benefit plans (collectively, "postretirement benefit plans") to recognize the funded status of their postretirement benefit plans in the statement of financial position, measure the fair value of plan assets and benefit obligations as of the date of the fiscal year-end statement of financial position, and provide additional disclosures. Effective December 31, 2006, the Company adopted the recognition and disclosure provisions of Statement 158. The effect of adopting Statement 158 on the Company's financial condition at December 31, 2006 has been included in the accompanying consolidated financial statements.

See the Company’s financial reports Note 15 for further discussion of the effect of adopting Statement 158 on the Company’s consolidated financial statements.

- In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). This Statement provides companies with an option to report selected financial assets and liabilities at fair value. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. The Statement’s objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. This Statement is effective as of the beginning of an entity’s first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 159.

I. Off Balance Sheet and Other Long-Term Arrangements and Commitments

- The Company and certain Israeli subsidiaries partially finance their research and development expenditures under programs sponsored by the Government of Israel Chief Scientist Office (“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, the Company and the subsidiaries agreed to pay 2% - 5% of total sales of products developed within the framework of these programs. The obligation to pay these royalties is contingent on actual sales of the products.

  The Company and some of its subsidiaries may also be obligated to pay certain amounts to the Israeli Ministry of Defense (“IMOD”) and others on certain sales including sales resulting from the development of some of the technologies developed with their participation.

- In connection with long-term projects in certain countries, the Company and certain subsidiaries undertook to use their respective best efforts to make or facilitate purchases or investments in those countries at specified percentages (typically up to 100%) of the amount of the specific contract. The companies’ obligation to make or facilitate third parties making such investments and purchases is subject to commercial conditions in the local market, typically without a specific financial penalty. The maximum aggregate undertaking as of December 31, 2006 amounted to $1,078 million to be performed over a period of up to 10 years. In the opinion of the Company’s management, the actual amount of the investments and purchases is anticipated to be less than that mentioned above, since certain investments and purchases can result in reducing the overall undertaking on more than a one-to-one basis.

- The future minimum lease commitments of the Group under various non-cancelable operating lease agreements in respect of premises, motor vehicles and office equipment are as of December 31, 2006 as follows: $14 million for 2007, $12 million for 2008, $9.5 million for 2009 and $28 million for 2010 and thereafter.

- 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, 2006, the Company and its subsidiaries, except Elisra, were in compliance with all covenants.

As at December 31, 2006, Elisra did not comply with its financial covenants. As a result, the banks requested to register a general floating lien on the assets of Elisra. In February 2007, Elisra's Board of Directors approved the banks' request.

- As of December 31, 2006, guarantees in the amount of approximately $766 million were issued by banks on behalf of Group companies in order to secure certain advances from customers and performance bonds.

- As of December 31, 2006 and 2005, the Group had purchase commitments that amounted to approximately $681 and $661 million, respectively. These purchase orders and subcontracts are typically in a standard format proposed by the Group, with the subcontracts and purchase orders also reflecting provisions from the Group applicable prime contract that are appropriate 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 the Group's customers in international contracts. These terms include our right to terminate the purchase order or subcontract in the event of the vendors' or subcontractors' default, as well as the Group's right to terminate the order or subcontract for the Group's convenience (or if the Group's prime contractor has so terminated the prime contract). Such purchase orders and subcontracts typically are not subject to variable price provisions.

- As a result of cancellation of the export authorization in 2006 to a foreign country ("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 amount of which was 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 advances and performance guarantees issued by banks and financial institutions in the total amount to approximately $10 million. Elisra's and the Company's management, based on the opinion of its legal advisors, believes that the financial impact of the four projects' termination 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. 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 ("IFTRIC") (since renamed "ASHRA") and the balance was provided by Elisra and its subsidiary. In addition, Elisra provided indemnity letters to IFTRIC that can be exercised upon the occurrence of specific unusual events and is subject to IFTRIC fulfilling its commitments to the banks. In the opinion of Elisra's and the Company's management, no provisions are required in respect of these indemnity letters.

J. Acquisitions and Divestitures During 2006

- On May 31, 2006, the Company's U.S. subsidiary, Kollsman acquired a 20% interest in Sandel Avionics, Inc. ("Sandel") in consideration for $12.5 million (represented by a $11.5 million cash payment and a $1 million holdback to be paid within 12 months). Sandel, based in Vista, California, produces specialized integrated display systems and other products for the commercial aviation market. The Company expects that some of Kollsman's new products will be integrated with Sandel's display electronics for the general aviation market.

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

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

	Book value in Sandel	Excess cost	Total	Expected useful lives of excess cost
Working capital	$ 700	$ -	$ 700	-
Fixed and others assets	700	-	700	-
Long-term liabilities	(2,100)	-	(2,100)	-
IPR&D	-	1,200	1,200	Immediate write-off
Technology and customer base	-	3,200	3,200	7 years
Goodwill	-	8,800	8,800	Indefinite – subject to annual impairment test
	$ (700)	$ 13,200	$ 12,500	

- On June 5, 2006, the Company acquired approximately 4.3% of Tadiran's outstanding shares in consideration for $18.3 million. Following the acquisition, the Company holds approximately 43% of Tadiran's shares.

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

	Book value in Tadiran	Excess cost	Total	Expected useful lives of excess cost
Working capital	$ 2,600	-	$ 2,600	-
Inventory	1,000	300	1,300	Up to a quarter
Long-term assets and investments	1,300	100	1,400	5 years
Long-term liabilities	(1,800)	-	(1,800)	-
Brand name	400	600	1,000	15 years
Customer base	-	5,300	5,300	2-12 years
Technology	200	2,300	2,500	10 years
IPR&D	-	1,000	1,000	Immediate write-off
Goodwill	2,500	2,500	5,000	Indefinite – subject to annual impairment test
	$ 6,200	$ 12,100	$ 18,300	

- In December 2006, the Company sold its holdings in Sultam Systems Ltd. ("Sultam") in consideration for $5 million, to be paid in 24 monthly installments. An amount of $2.3 million was recorded as long-term receivables. A gain of $1.5 million was recorded as other income.

K. Elisra Efficiency Plan

Elisra's 2006 financial results include a $26 million net loss (see below – "Summary of Financial Results – Elisra"). In February 2007, Elisra's Board of Directors approved the framework of an efficiency plan, including a reduction in the number of employees, with a potential efficiency plan cost of up to $16 million. The plan also includes co-location to one operating site as well as other cost cutting measures. The goal of the plan is to return Elisra to profitability. Elisra's Board of Directors determined that execution of the reduction in the number of employees is subject to preparation of a detailed list of the specific employees, the adequate availability of financing for the execution of the plan and the expected return on such expense in the future. As of the approval date of the Company's consolidated financial statements, Elisra's management had not yet completed the above mention procedures and therefore is unable to estimate the total extent and expected period of the efficiency plan.

L. 2007 Employee Stock Option Plan

On January 11, 2007, the Company's shareholders approved the Company's 2007 Option Plan (the "Plan"). The purpose of the Plan is to provide the benefits arising from ownership of share capital by the Company's and certain of its subsidiaries' employees, who are expected to contribute to the Group'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 Ordinary Shares of the Company 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 the Company's shares during 30 trading days proceeding 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 are 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 Company will grant options to Israeli participants in accordance with the provisions of Section 102 of the Israeli Tax Ordinance related to the Capital Gains Tax Track.

On January 11, 2007, the Company granted to its employees 2,354,300 option under the Plan. The exercise price for Israeli employees was $33.20 and for non-Israeli employees was $33.10.

The compensation cost related to the options granted in January 2007 is estimated at $20 million. That cost is expected to be recognized over a period of four years.

M. Summary of Financial Results

The following table sets forth the consolidated statements of operations of the Company and its subsidiaries for the three-month periods and years ended December 31, 2006 and December 31, 2005. The financial statements of the Company include consolidation of Elisra's financial results, commencing December 1, 2005, therefore Elisra's results are included in 2006 results and are not included in the 2005 results, prior to the day of the acquisition.

	For the year ended on December 31				For the three months ended on December 31			
	2006		2005		2006		2005	
	$	%	$	%	$	%	$	%
	(In thousands of U.S. dollars except per share data)							
Total revenues	**1,523,243**	100.0	**1,069,876**	100.0	**467,388**	100.0	**321,760**	100.0
Cost of revenues	**1,149,768**	75.5	**786,616**	73.5	**367,163**	78.5	**239,826**	74.5
Restructuring expenses (pre-contract and equipment write-off)	**-**	-	**3,488**	0.4	**-**	-	**3,488**	1.1
Gross profit	**373,475**	24.5	**279,772**	26.1	**100,225**	21.5	**78,446**	24.4
Research and development (R&D) expenses	**115,648**	7.6	**92,375**	8.6	**33,283**	7,1	**25,482**	7.9
Less - participation	**(23,416)**	(1.5)	**(20,472)**	(1.9)	**(5,414)**	(1.2)	**(7,022)**	(2.2)
R&D expenses, net	**92,232**	6.1	**71,903**	6.7	**27,869**	5.9	**18,460**	5.7
Marketing and selling expenses	**111,880**	7.3	**78,648**	7.4	**30,853**	6.6	**23,953**	7.4
General and administrative expenses	**77,505**	5.1	**54,417**	5.1	**20,051**	4.4	**16,155**	5.0
IPR&D write-off	**-**	-	**7,490**	0.7	**-**	-	**7,490**	2.3
	281,617	18.5	**212,458**	19.9	**78,773**	16.9	**66,058**	20.5
Operating income	**91,858**	6.0	**67,314**	6.3	**21,452**	4.5	**12,388**	3.9
Finance expenses, net	**(21,456)**	(1.4)	**(11,472)**	(1.1)	**(6,093)**	(1.3)	**(5,199)**	(1.6)
Other income (expenses), net	**1,814**	0,1	**(5,326)**	(0.5)	**1,423**	0.3	**(5,134)**	(1.6)
Income before taxes on income	**72,216**	4.7	**50,516**	4.7	**16,782**	3.5	**2,055**	0.7
Taxes on income	**20,694**	1.3	**16,335**	1.5	**4,049**	0.8	**4,046**	1.2
	51,522	3.4	**34,181**	3.2	**12,733**	2.7	**(1,991)**	(0.6)
Minority interest in loses (gains) of subsidiaries	**5,977**	0.4	**(58)**	(0.0)	**4,673**	1.0	**(710)**	(0.2)
Equity in net earnings (losses) of affiliated companies and partnership	**14,743**	1.0	**(1,636)**	(0.2)	**6,553**	1.4	**(2,974)**	(0.9)
Net earnings	**72,242**	4.7	**32,487**	3.0	**23,959**	5.1	**(5,675)**	(1.8)
Diluted earnings per share	**1.72**		**0.78**		**0.57**		**(0.14)**	

Elisra

The results of Elisra were included in the Company's consolidated financial reports commencing December 1, 2005. The effect on 2005 results was mainly a $7.5 million IPR&D write-off. Because of the acquisition date (November 30, 2005), the effects of Elisra's results on the Company consolidated results in 2005 were not material.

Accordingly, in light of the immaterial effect of Elisra on the Company's 2005 results, in order to facilitate comparison of the Company's 2006 results to those of 2005, the following information is provided on Elisra's 2006 results: revenues - $219 million, gross profit - $29 million and net loss – $26 million. The Company's net share in the loss (70%) was $18 million.

The results of Elisra reflect increased costs in the performance of several programs, mainly in the fourth quarter of 2006. Elisra's results reduced the Company's gross profit, operational profit and net profit percentages. (See above – "Elisra Efficiency Plan").

Revenues

The Company's sales are primarily to governmental entities and prime contractors under government defense programs. Accordingly, the level of the Company's revenues is subject to governmental budgetary constraints.

The Company's consolidated revenues increased by 42.4%, from $1,069.9 million in 2005 to $1,523.2 million in 2006.

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

	Year ended			
	December 31, 2006		December 31, 2005	
	$ millions	%	$ millions	%
Airborne systems	547.8	35.9	420.8	39.3
Land systems	317.7	20.9	117.4	11.0
C^4ISR systems	313.5	20.6	217.3	20.3
Electro-optics	223.3	14.7	242.3	22.7
Other (mainly non-defense engineering and production services)	120.9	7.9	72.1	6.7
Total	1,523.2	100.0	1,069.9	100.0

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

	Year ended			
	December 31, 2006		December 31, 2005	
	$ millions	%	$ millions	%
Israel	407.1	26.7	315.4	29.5
United States	609.5	40.0	397.5	37.2
Europe	233.7	15.3	104.2	9.7
Other countries	272.9	18.0	252.8	23.6
Total	1,523.2	100.0	1,069.9	100.0

The changes in revenues by areas of operation, other than the inclusion of Elisra, were in revenues from customers for land systems, which were increased mainly as a result of sales related to systems supplied to the U.S. Marine Corps.

The changes in revenues by geographic distribution, other than standard quarterly fluctuations, were in the revenues from customers in Europe and the U.S., which were increased mainly as a result of the Watchkeeper project in the United Kingdom and systems to the U.S. Marine Corps.

Gross Profit

The Company's gross profit represents the aggregate results of the Company's activities and projects and is based on the mix of programs in which the Company is engaged during the reported period.

Gross profit in 2006 was $373.5 million (with a gross profit margin of 24.5%), as compared to $279.8 million (gross profit margin of 26.1%) in 2005. The decrease in the gross profit margin was mainly as a result of the lower gross profit margin generated by Elisra.

Research and Development ("R&D")

The Company continually invests in R&D in order to maintain and further advance its technologies, in accordance with a long-term plan, based on its estimate of future market needs.

The Company's R&D included programs which are partially funded by third parties, including the IMOD, the OCS and bi-national and European development funds. The R&D was performed in all major areas of core technological activities of the Company and mainly in the areas of advanced airborne systems, C^4I systems, cutting edge electro-optics technology and products for surveillance, aerial reconnaissance, lasers and space based sensors and homeland security technologies and products.

Gross R&D expenses in 2006 totaled $115.6 million (7.6% of revenues), as compared with $92.4 million (8.6% of revenues) in 2005.

Net R&D expenses (after deduction of third party participation) in 2006 totaled $92.2 million (6.1% of revenues), as compared to $71.9 million (6.7% of revenues) in 2005.

Marketing and Selling Expenses

The Company maintains its activities in developing new markets and pursues various business opportunities according to the Company's plans.

Marketing and selling expenses in 2006 were $111.9 million (7.3% of revenues), as compared to $78.6 million (7.4% of revenues) in 2005.

General and Administrative ("G&A") Expenses

G&A expenses in 2006 were $77.5 million (5.1% of revenues), as compared to $54.4 million (5.1% of revenues) in 2005.

The increase in G&A expenses in 2006 compared to 2005 was related to the cost of various exploratory merger and acquisition, legal, audit and control activities, including expenses related to compliance with the Sarbanes-Oxley Act.

Financing Expenses (Net)

Net financing expenses in 2006 were $21.5 million, as compared to $11.5 million in 2005.

The increase in the net financing expenses resulted mainly from a higher level of long-term loans during the first half of 2006.

Other Income (Expenses) (Net)

Other income in 2006 was a $1.8 million gain, which was mainly as a result of the capital gain related to the selling of Sultam shares, as compared to a $5.3 million loss in 2005, which included a write-off of $5.4 million related to the Company's investment in Image–Sat International B.V.

Taxes on Income

The Company's tax rate represents a weighted average of the tax rates to which the various companies in the Group are subject.

Provision for taxes in 2006 was $20.7 million (tax rate of 28.7%), as compared to a provision for taxes of $16.3 million (tax rate of 32.3%) in 2005. The change in the effective tax rate is attributable mainly to the mix of the tax rates in the various tax jurisdictions in which the Group's companies generating the taxable income operate.

Company's Share in Earnings of Affiliated Entities

In 2006, the Company had income of $14.7 million from its share in earnings of affiliated entities, as compared to a loss of $1.6 million in 2005. The Company's share in earnings of affiliated entities in 2005 included $8.5 million in IPR&D write-offs related to Tadiran.

The companies and partnerships, in which the Company holds 50% or less in shares or voting rights and are therefore not consolidated in its financial statements, operate in complementary areas to the Company's core business activities, including electro-optics, airborne systems and communications.

Net Earnings and Earnings Per Share ("EPS")

Net earnings in 2006 were $72.2 million (4.7% of revenues), as compared to reported net earnings of $32.5 million (3.0% of revenues) in 2005. Diluted EPS was $1.72 in 2006, as compared to $0.78 in 2005.

The number of shares used for computation of diluted EPS in the year ended December 31, 2006 was 41,880 thousand shares, as compared to 41,623 thousand shares in the year ended December 31, 2005.

Net earnings in 2006 include $2.2 million in IPR&D write-offs related to the acquisitions of Tadiran's and Sandel's shares in the second quarter of 2006. Net earnings in 2005 included a $8.5 million IPR&D write-off related to the acquisition of Tadiran's shares in 2005.

N. Liquidity and Capital Resources

The Company's net cash flow generated from operating activities in 2006 was $201 million, resulting mainly from net income and advances received from customers. The cash inflows were partially offset, mainly by an increase in inventories.

Net cash flow used for investment activities in the year ended December 31, 2006 was $87 million, which was used mainly for acquisition of Tadiran's and Sandel's shares in the second quarter of 2006 and purchase of various assets and equipment.

Net cash flow used for financing activities in 2006 was $123.3 million, which was mainly for repayment of long-term loans.

On December 31, 2006, the Company had total borrowings in the amount of $153.3 million, including $125.3 million in long-term loans and $765.6 million in guarantees issued on its behalf by banks, mainly in respect of advance payment and performance guarantees provided in the regular course of business. On December 31, 2006, the Company had a cash balance amounting to $84.6 million.

As of December 31, 2006, the Company had working capital of $118 million and its current ratio was 1.15. The Company's ratio of equity to total assets was 27.9%.

O. Derivatives and Hedges

Market risks relating to the Company's operations result primarily from changes in interest rates and exchange rates. The Company typically uses financial instruments to limit its exposure to those changes. The Company also typically enters into forward contracts in connection with transactions that are denominated in currencies other than U.S. dollars and New Israeli Shekels ("NIS"). The Company may enter from time to time into forward contracts related to NIS, based on market conditions.

On December 31, 2006, the Company's liquid assets were comprised of bank deposits, and it had no investments in liquid equity securities that were subject to market fluctuations, except for its shareholdings in Tadiran. The Company's deposits and loans are based on variable interest rates, and their value as of December 31, 2006 was therefore not exposed to changes in interest rates. Should interest rates either increase or decrease, such change may affect the Company's results of operations due to changes in the cost of the liabilities and the return on the assets that are based on variable rates.

The Company's functional currency is the U.S. dollar. On December 31, 2006, the Company had exposure due to liabilities denominated in NIS of $88 million in excess of its NIS denominated assets. These liabilities represent mostly wages and trade payables. The amount of the Company's exposure to the changes in the NIS-U.S. dollar exchange rate varies from time to time.

Most of the Company's assets and liabilities which are denominated in currencies other than the NIS and the U.S. dollar were covered as of December 31, 2006 by forward contracts and options. On December 31, 2006, the Company had forward contracts for the sale and purchase of such foreign currencies totaling $332.2 million ($151.1 million in Euro, $172.8 million in GBP and $8.3 million in other currencies). The financial derivative activities in the fourth quarter of 2006 resulted in an unrealized net loss of approximately $13.4 million, which was recorded as of December 31, 2006 as other comprehensive loss. On December 31, 2006, the Company had options for hedging future cash flow denominated in NIS in the amount of $19 million. The fair market value of the options as of December 31, 2006 was not material.

P. Director and Corporate Secretary Appointments

On March 13, 2007, the Board of Directors appointed David Federmann as a director of the Company. In addition, on March 13, 2007, the Company appointed Yaniv Baram as Corporate Secretary, replacing Ilan Pacholder whose intent to resign from the Company was announced on February 7, 2007.

Q. Dividends

The Board of Directors declared on March 13, 2007 a dividend of $0.16 per share for the last quarter of 2006. The total dividend declared for 2006 was $0.61 per share.

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