

Elbit Systems Ltd.
Management's Report
For the Year Ended December 31, 2008

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 "we" or "us") for the year ended December 31, 2008.

Forward looking statements with respect to our 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, governmental authorizations, risks in product and technology development, the effect of our accounting policies as well as certain other risk factors, which are detailed from time to time in our filings with the U.S. Securities and Exchange Commission and with the Israeli Securities Authority .

General

Critical Accounting Policies and Estimates

Our significant accounting policies are described in our Consolidated Financial Statements - Note 2.

Our results of operations and financial condition are based on our consolidated financial statements, which are presented in conformity with United States generally accepted accounting principles (U.S. GAAP). The preparation of the consolidated financial statements requires management to select accounting policies for critical areas as well as estimates and assumptions and to make judgments that involve the accounting policies described below that affect the amounts reported in the consolidated financial statements. Significant changes in assumptions and/or conditions and changes in our critical accounting policies could materially impact our 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 Lives of Long-Lived Assets.
- Income Taxes.
- Valuation of Securities.
- Stock-Based Compensation Expense.

Revenue Recognition

We generate revenues principally from long-term contracts involving the design, development, manufacture and integration of defense systems and products. In addition, to a minor extent, we provide 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 we recognize revenues on the percentage-of-completion basis.

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.

We believe that the use of the percentage-of-completion method is appropriate as we have 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 we expect to perform our contractual obligations, and our 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 our consolidated financial statements.

Business Combinations and Purchase Price Allocation

We account for business combinations by using the purchase method of accounting, under which the total purchase price of the acquired companies is allocated to the tangible and intangible assets acquired and liabilities assumed, as well as to in-process research and development (IPR&D) projects based on their estimated fair values, with the excess purchase price recorded as goodwill. We use the same method to allocate the purchase price of new investments accounted for under the equity method of accounting. The amount allocated to IPR&D is charged immediately to our 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 long-lived assets other than goodwill are amortized over their estimated useful life using the straight-line method, or the accelerated method, whichever method better reflects their expected utilization pattern.

We engage third-party appraisal firms to assist management in determining the fair values of certain assets acquired and liabilities assumed. 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. Management makes estimates of fair value based upon assumptions believed to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies and are inherently uncertain. While there are a number of different methods for estimating the value of intangible assets 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 and can impact our results of operations is estimating the expected useful lives of the intangible assets. Unanticipated events and circumstances may occur that may affect the accuracy or validity of such assumptions, estimates or actual results.

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

Impairment of Long-Lived Assets and Goodwill

Our 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 the years ended December 31, 2006, 2007 and 2008, no impairment was identified.

Goodwill represents the excess of the cost of acquired businesses over the fair values of the assets acquired and net of liabilities assumed. Goodwill is not 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.

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

Other-Than-Temporary Decline in Value of Investments in Investee

Investments in companies and a partnership that are not controlled but over which we can exercise significant influence (generally, entities in which we hold between 20% and 50% of the voting rights on the investee) are presented using the equity method of accounting. Profits on intercompany sales, not realized outside the Company, are eliminated. We discontinue applying the equity method when our investment (including advances and loans) is reduced to zero and we have 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."

Investments in non-marketable equity securities of entities in which we do not have control or the ability to exercise significant influence over their operation and financial policies, are recorded at cost (generally when we hold 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 we recognize an impairment loss for the decline in value. We use our judgment in determining whether an other-than-temporary decline in the value of an 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 \$10,514,000 related to our investment in Sandel Avionics Inc. (Sandel) was recognized (see our Consolidated Financial Statements - Note 6(C)). During 2007 and 2006, no impairment loss was recorded.

Useful Lives of Long-Lived Assets

Intangible assets and property, plant and equipment are amortized over their estimated useful lives. Determining the useful lives of such assets involves the use of estimates and judgments. In determining the useful lives we take into account various factors such as the expected use of the assets, effects of obsolescence, including technological developments, competition, demand, and changes in business, acquisitions and other economic factors. If we estimate changes and the useful lives of such assets increase or decrease, it will affect our results of operations. See above "Impairment of Long-Lived Assets and Goodwill" for further discussion of the effects of changes in useful lives.

Income Taxes

We record income taxes using the asset and liability approach. Management judgment is required in determining our provision for income taxes in each of the jurisdictions in which we operate. The provision for income tax is calculated based on our assumptions as to our entitlement to various benefits under the applicable tax laws in the jurisdictions in which we operate. The entitlement to such benefits depends upon our compliance with the terms and conditions set out in these laws. We have considered future taxable income, prudent and feasible tax planning strategies and other available evidence in determining the need for a valuation allowance. Although we believe that our estimates are reasonable and that we have considered future taxable income and ongoing prudent and feasible tax strategies in estimating our tax outcome, there is no assurance that the final tax outcome will not be different than those which are reflected in our historical income tax provisions and accruals. Such differences could have a material effect on our income tax provision, net income and cash balances in the period in which such determination is made.

We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." 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. We record 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 our tax liability, management exercises considerable judgment in evaluating tax positions taken by us 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."

Valuation of Securities

Our marketable securities at December 31, 2008, included investments in Auction Rate Securities (ARS). Our ARS holdings, which we obtained as a result of the acquisition of TadComm, are private placement securities with long-term nominal maturities for which the interest rates are reset through a "dutch" auction each month. Historically, the monthly auctions have provided a liquid market for these securities. Our ARS holdings 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 our ARS holdings consists of sub-prime mortgages.

Although, as of December 31, 2008, the ARS continued to pay interest according to their stated terms, based on fair value indications received from other transactions in the market (in 2008), valuation models applied by the investment banks (in 2007) and an analysis of other-than-temporary impairment factors, we recorded an impairment charge of approximately \$10 million in 2007 and approximately \$18.7 million in 2008, reflecting the portion of ARS holdings, that we concluded have an other-than-temporary decline in value, and the loss was included in financial expenses net. There is no guarantee that our ARS will continue to pay interest in the future.

As a result of our management's intention to dispose our ARS in the short-term, our ARS holdings (in 2008) were presented as current assets under marketable securities on our consolidated balance sheet.

The valuation of our investment portfolio is subject to uncertainties that are difficult to predict. Factors that may impact our valuation include changes to credit ratings of the securities as well as to the underlying assets supporting those securities, rates of default of the underlying assets, underlying collateral value, discount rates, counterparty risk and ongoing strength and quality of market credit and liquidity.

The credit and capital markets have continued to deteriorate. If uncertainties in these markets continue, these markets deteriorate further or we experience any additional ratings downgrades on any investments in our portfolio, we may incur additional impairments to our investment portfolio, which could negatively affect our financial condition, cash flow and reported earnings. See also below "Liquidity and Capital Resources – Auction Rate Securities."

Stock-Based Compensation Expense

We apply FASB Statement No. 123 (Revised 2004), "Share-Based Payment" (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors including employee stock options based on estimated fair values. Stock-based compensation expense recognized under SFAS 123(R) for 2008 and 2007 was \$5.1 million and \$4.8 million, respectively. For fiscal 2006, stock-based compensation expense of \$195,000 had been recognized under previous accounting standards. See our Consolidated Financial Statements – Notes 2(X) and 18(D) and (E) for additional information.

Under SFAS 123(R), we estimated the value of employee stock options on the date of grant using a lattice-based option valuation model. The determination of fair value of stock options awards on the date of grant is affected by several factors including our stock price, our stock price volatility, risk-free interest rate, expected dividends and employee stock option exercise behaviors. If such factors change and we employ different assumptions in the application of SFAS 123(R) for future grants, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period.

In addition, our compensation expense is affected by our estimate of the number of awards that will ultimately vest. If in the future the numbers of equity awards that are forfeited by employees are lower than expected, the expenses recognized in such future periods will be higher.

Recent Accounting Pronouncements

See our Consolidated Financial Statements - Note 2(AB) and (AC).

Long-Term Arrangements and Commitments

Government Funding of Development. Elbit Systems and certain Israeli subsidiaries partially finance our research and development expenditures under programs sponsored by the Government of Israel Office of the Chief Scientist (OCS) for the support of research and development activities conducted in Israel. At the time the funds were received, successful development of the funded projects was not assured. In exchange for the funds, Elbit Systems and the subsidiaries agreed to pay 2% - 5% of total sales of the products developed under these programs. The obligation to pay these royalties is contingent on actual sales of the products. Elbit Systems and some of our subsidiaries may also be obligated to pay certain amounts to the IMOD and others on certain sales including sales resulting from the development of some of the technologies developed with such respective entity's funds.

Lease Commitments. The future minimum lease commitments of the Company under various non-cancelable operating lease agreements for property, motor vehicles and office equipment as of December 31, 2008 are as follows: \$32 million for 2009, \$29 million for 2010, \$21 million for 2011, and \$21 million for 2012 and thereafter. See below "Contractual Obligations."

Bank Covenants. In connection with bank credits and loans, including performance guarantees issued by banks and bank guarantees in order to secure certain advances from customers, Elbit Systems and certain subsidiaries are obligated to meet certain financial covenants. See below – "Liquidity and Capital Resources – Financial Resources." Such covenants include requirements for shareholders' equity, current ratio, operating profit margin, tangible net worth, EBITDA, interest coverage ratio and total leverage. See our Consolidated Financial Statements – Notes 17(F) and (G). As of December 31, 2008, Elbit Systems and our subsidiaries, except Elisra, were in compliance with all covenants.

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 Elisra's non-compliance with the covenants, Elisra's long-term loans as of December 31, 2008, in the amount of \$2 million (December 31, 2007 - \$14.7 million), have been recorded as short-term. See our Consolidated Financial Statements – Notes 17(F) and (G).

Bank Guarantees. As of December 31, 2008 and 2007, guarantees in the aggregate amount of approximately \$961 and \$963 million, respectively, were issued by banks on behalf of several Company entities primarily in order to secure certain advances from customers and performance bonds.

Purchase Commitments. As of December 31, 2008 and 2007, we had purchase commitments of approximately \$948 and \$906 million, respectively. These purchase orders and subcontracts are typically in standard formats proposed by us. These subcontracts and purchase orders also reflect provisions from the applicable prime contract that apply 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 requested by our customers in international contracts. These terms include our right to terminate the purchase order or subcontract in the event of the vendor's or subcontractor's default, as well as our right to terminate the order or subcontract for our convenience (or if our prime contractor has so terminated the prime contract). Such purchase orders and subcontracts typically are not subject to variable price provisions.

Backlog of Orders

Our backlog includes firm commitments received from customers for systems, products and projects that have yet to be completed. Our policy is to include orders in our backlog only when specific conditions are met. Examples of these conditions may include, among others, program funding, and receipt of advances, letters of credit and guarantees from customers. As a result, from time to time we could have unrecorded orders in excess of the level of backlog.

We reduce backlog when revenues for a specific contract are recognized. We reduce backlog as delivery or acceptance occurs or when contract milestones or engineering progress under the long-term contracts are recognized as achieved. In some cases we reduce backlog when costs are incurred. In the unusual event of a contract cancellation, we would also be required to reduce our backlog accordingly. The method of backlog recognition used may differ depending on the particular contract. Orders in currencies other than U.S. dollars are translated periodically into U.S. dollars and recorded accordingly.

Our backlog of orders as of December 31, 2008 was \$5,030 million, of which 72% was for orders outside Israel. Our backlog as of December 31, 2007 was \$4,624 million, of which 70% was for orders outside Israel. Approximately 75% of our backlog as of December 31, 2008 is scheduled to be performed during 2009 and 2010. The majority of the 25% balance is scheduled to be performed in 2011 and 2012. Backlog information and any comparison of backlog as of different dates may not necessarily represent an indication of future sales.

Trends

Trends in the defense electronics and homeland security markets in which we operate have been impacted by the nature of recent conflicts and terrorism activities throughout the world, increasing the focus of defense forces on low intensity conflicts and homeland security. Also, although it remains unclear whether and to what extent the new U.S. government administration will curtail defense spending, current indications are that overall defense spending may see budget cuts in upcoming years.

In the defense electronics market, there is an increasing demand for products and systems in the areas of C4ISR and unmanned vehicles. Accordingly, while we continue to perform platform upgrades, in recent years more emphasis is being placed on C4ISR, including information systems, intelligence gathering, situational awareness, precision guidance, all weather and day/night operations, border and perimeter security, UAVs, other unmanned vehicles, space and satellite based defense capabilities and homeland security systems. We believe that our core technologies and abilities will enable us to take advantage of many of these emerging trends, as well as to continue to participate in the "Current Force" legacy operations of our customers.

In recent years consolidation in the defense industry has affected competition. This consolidation has decreased the number but increased the relative size and resources of our competitors. We adapt to evolving market conditions by adjusting our business strategy. Our business strategy also anticipates increased competition in defense markets due to declining defense budgets in certain countries. The recent financial developments world wide may reduce defense spending. However, we believe in our ability to compete on the basis of our systems development and technological expertise, combat-proven performance and policy of offering customers overall solutions to technological, operational and financial needs and at the same time enhancing the industrial capabilities in certain of our customers' countries.

Summary of Operating Results

The following table sets forth our consolidated statements of operations for the three years ended December 31, 2008. Our financial statements for the year ended December 31, 2008 include the financial results of TadComm and Ferranti Technologies (Group) Limited (FTL) for the entire year. Our financial statements for the year ended December 31, 2007 included consolidation of TadComm's financial results from May 2007 and the financial results of FTL from August 2007.

	Year ended December 31,					
	2008		2007		2006	
	\$	%	\$	%	\$	%
	(in thousand of U.S. dollars except per share data)					
Total revenues	\$ 2,638,271	100.0	\$ 1,981,761	100.0	\$ 1,523,243	100.0
Cost of revenues	1,870,830	70.9	1,454,913	73.4	1,149,768	75.5
Restructuring expenses	-	-	10,482	0.5	-	-
Gross profit	<u>767,441</u>	<u>29.1</u>	<u>516,366</u>	<u>26.1</u>	<u>373,475</u>	<u>24.5</u>
Research and development (R&D) expenses	217,176	8.2	155,303	7.8	115,648	7.6
Less - participation	<u>(32,192)</u>	<u>(1.1)</u>	<u>(28,308)</u>	<u>(1.3)</u>	<u>(23,416)</u>	<u>1.5</u>
R&D expenses, net	184,984	7.1	126,995	6.5	92,232	6.1
Marketing and selling expenses	198,274	7.5	157,411	7.9	111,880	7.3
General and administrative expenses	134,182	5.1	107,447	5.4	77,505	5.1
IPR&D write-off	1,000	0.0	16,560	0.8	-	-
	<u>518,440</u>	<u>19.7</u>	<u>408,413</u>	<u>20.6</u>	<u>281,617</u>	<u>18.5</u>
Operating income	249,001	9.4	107,953	5.5	91,858	6.0
Financial expenses, net	(36,815)	(1.3)	(19,329)	(1.0)	(21,456)	(1.4)
Other income, net	94,294	3.6	368	0.0	1,814	0.1
Income before taxes on income	306,480	11.7	88,992	4.5	72,216	4.7
Taxes on income	54,367	2.1	13,810	0.7	20,694	1.3
	<u>252,113</u>	<u>9.6</u>	<u>75,182</u>	<u>3.8</u>	<u>51,522</u>	<u>3.4</u>
Minority interests in losses (earnings) of subsidiaries	(62,372)	(2.4)	(13,038)	(0.6)	5,977	0.3
Equity in net earnings of affiliated companies and partnership	14,435	0.5	14,565	0.7	14,743	1.0
Net income	<u>\$ 204,176</u>	<u>7.7</u>	<u>\$ 76,709</u>	<u>3.9</u>	<u>\$ 72,242</u>	<u>4.7</u>
Diluted earnings per share	<u>\$ 4.78</u>		<u>\$ 1.81</u>		<u>\$ 1.72</u>	

2008 Compared to 2007

Revenues

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

The following table sets forth our revenue distribution by areas of operation:

	Year ended			
	December 31, 2008		December 31, 2007	
	\$ millions	%	\$ millions	%
Airborne systems	634.7	24.1	596.0	30.1
Land systems	699.5	26.5	381.0	19.2
C4ISR systems	844.5	32.0	582.0	29.4
Electro-optics systems	336.7	12.7	271.3	13.7
Other (mainly non-defense engineering and production services)	<u>122.9</u>	<u>4.7</u>	<u>151.5</u>	<u>7.6</u>
Total	<u>2,638.3</u>	<u>100.0</u>	<u>1,981.8</u>	<u>100.0</u>

Our consolidated revenues increased by 33%, from \$1,981.8 million in 2007 to \$2,638.3 million in 2008.

The changes in revenue distribution by areas of operation in 2008 as compared with 2007 were influenced mainly due to a significant increase in our C4ISR business due to the inclusion of the results of TadComm, which was part of our C4ISR category for the full year in 2008 and only eight months in 2007, as well as a significant increase in our Land systems business primarily relating to short turn-around programs for the U.S. government.

The following table sets forth our distribution of revenues by geographical regions:

	Year ended			
	December 31, 2008		December 31, 2007	
	\$ millions	%	\$ millions	%
Israel	474.4	18.0	408.9	20.6
United States	907.1	34.4	702.7	35.5
Europe	653.1	24.7	485.2	24.5
Other Countries	<u>603.7</u>	<u>22.9</u>	<u>385.0</u>	<u>19.4</u>
Total	<u>2,638.3</u>	<u>100.0</u>	<u>1,981.8</u>	<u>100.0</u>

The changes in revenues by geographic distribution were influenced by the consolidation of TadComm's results with strong international content, mainly in Other Countries which resulted in a percentage increase in the Other Countries and a percentage reduction in Israel.

Cost of Revenues & Gross Profit

Cost of revenues in 2008 was \$1,870.8 million (with a gross profit margin of 29.1%), as compared to \$1,454.9 million (with a gross profit margin of 26.1%) in 2007. In 2007, cost of revenues included restructuring expenses of \$10.5 million (which constituted 0.5% of revenues). The improved gross profit margin in 2008 was a result of increased revenues and of higher mix of programs with lower cost of revenues, mainly due to short turn around (contract to delivery) programs delivered during the period. This was coupled with a significantly lower growth in our fixed cost (i.e. depreciation and amortization (D&A)). The D&A expenses rose in 2008 by approximately 10% over that of 2007, while revenues increased by 33%, which contributed to approximately 1.2% of the gross margin improvement. Cost of revenues also includes provisions for costs, including warranties and expected losses. The provision for losses in 2008 increased by approximately \$47 million, which constituted 1.8% of revenues, over 2007. The increase in the provision for losses on long-term

contracts was due primarily to several fixed priced projects in which the estimated cost exceeded expected revenues. The provisions for warranty increased by approximately \$18 million, as a result of increased revenues and the mix of programs.

Our gross profit represents the aggregate results of our activities and projects and is based on the mix of programs in which we are engaged during the reported period.

Research and Development (R&D)

We continually invest in R&D in order to maintain and further advance our technologies, in accordance with our long-term plans, based on our estimate of future market needs.

Our R&D costs, net of participation grants, include costs incurred for independent research and development and bid and proposal (B&P) efforts and are expensed as incurred.

Gross R&D expenses in 2008 totaled \$217.2 million (8.2% of revenues), as compared with \$155.3 million (7.8% of revenues) in 2007.

Net R&D expenses (after deduction of third party participation) in 2008 totaled \$185.0 million (7.1% of revenues), as compared to \$127 million (6.5% of revenues) in 2007.

The increased rate of R&D spending in 2008 was primarily a result of accelerated development programs, related to technology and products in all areas of our operations, as well as increased engineering activities to support marketing efforts worldwide and the inclusion of TadComm for the full year.

Marketing and Selling Expenses

We are active in developing new markets and pursue at any given time various business opportunities according to our plans.

Marketing and selling expenses in 2008 were \$198.3 million (7.5% of revenues), as compared to \$157.4 million (7.9% of revenues) in 2007. The increase in 2008 is partly due to the inclusion of TadComm for a full year, as well as an increase in marketing activities in support of our global business opportunities.

General and Administration (G&A) Expenses

G&A expenses in 2008 were \$134.2 million (5.1% of revenues), as compared to \$107.4 million (5.4% of revenues) in 2007.

The increase in total dollar amount in G&A expenses in 2008 compared to 2007 was related mainly to the inclusion of TadComm for the full year in 2008, compared to only eight months in 2007, as well as costs related to the settlement agreement relating to the lawsuit between IS&S and Kollsman. See our Consolidated Financial Statements – Note 17(C).

Operating Income

Our operating income in 2008 was \$249 million (9.4% of revenues), as compared to \$108 million (5.4% of revenues) in 2007. The 2007 operating income was net of the restructuring expenses and IPR&D write-off of \$27 million related to the acquisition of TadComm (which constituted 1.3% of revenues). The absence in 2008 of these one-time costs and the increase in our gross margin as discussed above, led to the significant increase in our operating income.

Financial Expense (Net)

Net financing expenses in 2008 were \$36.8 million, as compared to \$19.3 million in 2007.

The net finance expenses include the impact of the other-than-temporary decline in the value of our ARS in the amount of \$18.7 million in 2008 and \$10 million in 2007 (see “Liquidity and Capital Resources – Auction Rate Securities” below). Our net financing expense in 2008 was also negatively impacted by lower gains from marketable securities and a higher amount of financial expenses from banking activities.

Other Income (Net)

Other income net in 2008 was a \$94.3 million gain, which was mainly as a result of the capital gain related to the sale of Mediguide Inc. (Mediguide) shares in 2008 offset by the impairment of \$10.5 million in the value of our holding in Sandel. Also included in this item is \$4.1 million due to an insurance claim settlement of our subsidiary Elisra. See our Consolidated Financial Statements – Notes 6(B), 6(C), 7 and 22.

Taxes on Income

Our tax rate represents a weighted average of the tax rates to which our various entities are subject. The change in the effective tax rate is attributable mainly to the mix of the tax rates in the various tax jurisdictions in which our entities generating the taxable income operate.

Provision for taxes in 2008 was \$54.4 million (tax rate of 17.7%), as compared to a provision for taxes of \$13.8 million (tax rate of 15.5%) in 2007. The change in the effective tax rate is attributable mainly to taxes related to the sale of our holdings in Mediguide, during the fourth quarter of 2008. The 2007 provision was net of a favorable adjustment (\$10 million) from prior period taxes. We continue to enjoy a lower effective Israeli tax rate and the benefits of an “Approved and Privileged Enterprise”, which resulted in savings of \$44.0 million and \$25.2 million, respectively, in 2008 and 2007.

Company’s Share in Earnings of Affiliated Entities

The entities, in which we hold 50% or less in shares or voting rights (affiliates) and are therefore not consolidated in our financial statements, operate in complementary areas to our core business activities, including electro-optics and airborne systems.

In 2008, we had income of \$14.4 million from our share in earnings of affiliates, as compared to \$14.6 million in 2007.

Net Earnings and Earnings Per Share (EPS)

Net earnings in 2008 were \$204.2 million (7.7% of revenues), as compared to reported net earnings of \$76.7 million (3.9% of revenues) in 2007. Diluted EPS was \$4.78 in 2008, as compared to \$1.81 in 2007.

The number of shares used for computation of diluted EPS in the year ended December 31, 2008 was 42,758,000 shares, as compared to 42,342,000 shares in the year ended December 31, 2007.

Net earnings in 2008 include a net of tax gain of \$74.4 million related to the sale of Mediguide shares and were offset by the impairment of assets of Sandel in the amount of \$10.5 million and IPR&D expense of \$1 million.

Net earnings in 2007 include \$24.4 million in IPR&D and restructuring net expenses (representing \$0.58 per share), due to the acquisition of TadComm in April 2007.

2007 Compared to 2006

The consolidation of TadComm's financial results starting in May 2007 impacted most of our financial parameters in 2007 as compared to 2006.

Revenues

The following table sets forth our revenue distribution by areas of operation:

	Year ended			
	December 31, 2007		December 31, 2006	
	\$ millions	%	\$ millions	%
Airborne systems	596.0	30.1	547.8	35.9
Land systems	381.0	19.2	317.7	20.9
C4ISR systems	582.0	29.4	313.5	20.6
Electro-optics systems	271.3	13.7	223.3	14.7
Other (mainly non-defense engineering and production services)	<u>151.5</u>	<u>7.6</u>	<u>120.9</u>	<u>7.9</u>
Total	<u>1,981.8</u>	<u>100.0</u>	<u>1,523.2</u>	<u>100.0</u>

Our consolidated revenues increased by 30%, from \$1,523.2 million in 2006 to \$1,981.8 million in 2007.

The changes in revenue distribution by areas of operation are due mainly to the inclusion of the results of TadComm in the C4ISR category, starting in the second quarter of 2007.

The following table sets forth our distribution of revenues by geographical regions:

	Year ended			
	December 31, 2007		December 31, 2006	
	\$ millions	%	\$ millions	%
Israel	408.9	20.6	407.1	26.7
United States	702.7	35.5	609.5	40.0
Europe*	485.2	24.5	233.7	15.3
Other countries	<u>385.0</u>	<u>19.4</u>	<u>272.9</u>	<u>18.0</u>
Total	<u>1,981.8</u>	<u>100.0</u>	<u>1,523.2</u>	<u>100.0</u>

* includes most of the former Soviet bloc countries

The changes in revenues by geographic distribution were influenced by the consolidation of TadComm's results with strong international content, and increased revenues in Europe, mainly from United Kingdom UAV operations.

Gross Profit

Gross profit in 2007 was \$516.4 million (with a gross profit margin of 26.1%), as compared to \$373.5 million (gross profit margin of 24.5%) in 2006. In 2007, gross profit includes restructuring expenses of \$10.5 million (which constituted 0.5% of revenues).

R&D

Gross R&D expenses in 2007 totaled \$155.3 million (7.8% of revenues), as compared with \$115.6 million (7.6% of revenues) in 2006.

Net R&D expenses (after deduction of third party participation) in 2007 totaled \$127 million (6.4% of revenues), as compared to \$92.2 million (6.1% of revenues) in 2006.

Marketing and Selling Expenses

Marketing and selling expenses in 2007 were \$157.4 million (7.9% of revenues), as compared to \$111.9 million (7.3% of revenues) in 2006.

G&A Expenses

G&A expenses in 2007 were \$107.4 million (5.4% of revenues), as compared to \$77.5 million (5.1% of revenues) in 2006.

The increase in G&A expenses in 2007 compared to 2006 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.

Operating Income

Our operating income in 2007 was \$108 million, as compared to \$92 million in 2006. As a result of the restructuring expenses and an aggregate IPR&D write-off of approximately \$27 million (before tax) relating to the TadComm acquisition (which constituted 1.3% of revenues) in the second quarter of 2007, the operating income margin in 2007 decreased to 5.5%, as compared to 6.0% in 2006.

Financial Expenses (Net)

Net financing expenses in 2007 were \$19.3 million, as compared to \$21.5 million in 2006.

Net financing expenses include the impact of a write-off relating to ARS in the amount of approximately \$10 million (see "Liquidity and Capital Resources" below).

Other Income (Net)

Other income in 2007 was a \$0.4 million gain, which was mainly a result of the sale of our investment in AeroAstro Inc. in the fourth quarter of 2007, as compared to a \$1.8 million gain in 2006, which was mainly as a result of the capital gain related to the sale of Soltam Systems Ltd. shares in 2006.

Taxes on Income

Provision for taxes in 2007 was \$13.8 million (effective tax rate of 15.5%), as compared to a provision for taxes of \$20.7 million (effective tax rate of 28.7%) in 2006. The change in the effective tax rate is attributable mainly to a reduction of approximately \$10 million related to prior years due to executing tax settlements by Elbit Systems and some of our subsidiaries in the last quarter of 2007, and to the mix of the tax rates in the various tax jurisdictions in which the Company entities generating the taxable income operate. This decrease in the percentage of provision for taxes in 2007 as compared to 2006 was partly offset by the IPR&D write-off in the second quarter of 2007, related to the acquisition of the TadComm shares not being deductible for tax purposes.

Company's Share in Earnings of Affiliated Entities

In 2007, we had income of \$14.6 million from our share in earnings of affiliates, as compared to \$14.7 million in 2006.

Our share in TadComm's earnings was included until May 1, 2007, the date of commencement of consolidation of TadComm's results following the acquisition.

Net Earnings and Earnings Per Share (EPS)

Net earnings in 2007 were \$76.7 million (3.9% of revenues), as compared to reported net earnings of \$72.2 million (4.7% of revenues) in 2006. Diluted EPS was \$1.81 in 2007, as compared to \$1.72 in 2006.

The number of shares used for computation of diluted EPS in the year ended December 31, 2007 was 42,342,000 shares, as compared to 41,880,000 shares in the year ended December 31, 2006.

Net earnings in 2007 include \$24.4 million in IPR&D and restructuring net expenses (representing \$0.58 per share), due to the acquisition of TadComm in April 2007.

Liquidity and Capital Resources

In recent years, we have financed our operations through cash generated from operations. Generally, we invest our excess cash in instruments that are highly liquid, investment grade securities. At December 31, 2008, we had \$304.5 million of cash and cash equivalents and short-term and long-term investments, as compared to \$384.9 million at December 31, 2007.

Cash Flows

Our operating cash flow is affected by the cumulative cash flow generated from our various projects in the reported periods. Project cash flows are affected by the timing of the receipt of advances and the collection of accounts receivable from customers, as well as the timing of payments made by us in connection with the performance of the project. The receipt of payments usually relates to specific events during the project, while expenses are ongoing. As a result, our cash flow may vary from one period to another. Our policy is to invest our cash surplus mainly in interest bearing deposits, in accordance with our projected needs. Also see below "Auction Rate Securities."

In general, subsidiaries are able to freely transfer cash dividends, loans or advances to Elbit Systems, subject to tax considerations in their applicable jurisdiction and subject to management commitment not to distribute tax exempt earnings. Such tax considerations have not had in the past, and are not anticipated to have, a material impact on our ability to meet such obligations.

2008

Our net cash flow generated from operating activities in 2008 was approximately \$209.4 million, resulting mainly from net income and increases in trade and other payables, which were partially offset, mainly by an increase in inventories.

Net cash flow used in investment activities in 2008 was approximately \$171.7 million, which was used mainly to purchase property, plant and equipment and make investments in short-term deposits, which were partly offset by proceeds from sale of the shares of Mediguide.

Net cash flow used in financing activities in 2008 was approximately \$195.9 million, which was mainly for repayment of long-term loans and payment of dividends to our shareholders.

2007

Our net cash flow generated from operating activities in 2007 was approximately \$262.7 million, resulting mainly from net income and advances received from customers, which were partially offset, mainly by an increase in inventories.

Net cash flow used in investing activities in 2007 was approximately \$264.7 million, which was used mainly for the acquisition of the TadComm and FTL shares and in the purchase of property, plant and equipment.

Net cash flow from financing activities in 2007 was approximately \$280.2 million, resulting mainly from long-term loans received.

2006

Our net cash flow generated from operating activities in 2006 was approximately \$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 in investing activities in the year ended December 31, 2006 was approximately \$87 million, which was used mainly for acquisition of TadComm's and Sandel's shares in the second quarter of 2006 and purchase of various assets and equipment.

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

Financial Resources

The financial resources available to us include profits, collection of accounts receivable, advances from customers and government of Israel and other third parties' programs such as the OCS and development grants. In addition, we have access to bank credit lines and financing in Israel and abroad based on our capital, assets and activities.

Elbit Systems and some subsidiaries are obligated to meet various financial covenants set forth in our respective loan and credit agreements. Such covenants include requirements such as for shareholders' equity, current ratio, operating profit margin, tangible net worth, EBITDA, interest coverage ratio and total leverage. As of December 31, 2008, each of the companies subject to financial covenants, except Elisra, was in compliance with the applicable covenants. With respect to Elisra's financial covenants as of December 31, 2008 see above "Long-Term Arrangements and Commitments – Bank Covenants."

On December 31, 2008, we had total borrowings in the amount of \$290 million, including \$269.8 million in long-term loans, and \$960.7 million in guarantees issued on our behalf by banks, mainly in respect of advance payment and performance guarantees provided in the regular course of business. On December 31, 2008, we had a cash balance amounting to \$204.7 million. We also have the ability to raise funds on the capital market and through expansion of our credit lines.

As of December 31, 2008, we had working capital of \$290 million and a current ratio of 1.22. We believe that our working capital and cash flow from operations will be sufficient to support our current requirements and financial covenants.

We believe that our current cash balances, cash generated from operations and lines of credit and financing arrangements will provide sufficient resources to meet our operational needs for at least the next fiscal year. However, our ability to borrow funds from the banking system may be impacted by the ongoing global financial and liquidity situation.

For further information on the level and maturity of our borrowings, see our Consolidated Financial Statements – Notes 11 and 14.

We believe our ability to access external capital resources should be sufficient to satisfy existing short-term and long-term commitments and plans, and also to provide adequate financial flexibility to take advantage of potential strategic business opportunities should they arise within the next year.

Pensions and Other Post-Retirement Benefits

We accounts for pensions and other post-employment arrangements in accordance with SFAS 158 "Employers' Accounting for Defined Benefit Pension and Post-Retirements Plans". Accounting for pensions and other post-retirement benefits involves judgment about uncertain events, including estimated retirement dates, salary levels at retirement, mortality rates, rates of return on plan assets, determination of discount rates for measuring plan obligations, healthcare cost trend rates and rates of utilization of healthcare services by retirees. These assumptions are based on the environment in each country. For our pension and other post-retirement benefit assumptions at December 31, 2008 and 2007, see our Consolidated Financial Statements – Note 15.

At December 31, 2008 our obligations were \$34.9 million, net of related plan assets on pension arrangements and \$10.4 million on unfunded post-retirement liabilities. The pension liabilities increased following a decline in assets and a negative impact from the drop in global capital markets.

Auction Rate Securities

As of December 31, 2008, we had approximately \$31.8 million (before cumulative impairment losses of \$28.7 million) of principal invested in ARS. See above – “General Critical Accounting Policies and Estimates – Valuation of Securities.”

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

The estimated market value of our ARS holdings at December 31, 2008 and 2007 was \$3.0 and \$20.9 million, respectively, resulting in \$18.7 and \$10 million unrealized losses recognized to the principal value at December 31, 2008 and 2007, respectively.

The fair value in 2007 was determined based on evaluation models applied by investment banks that have acted as our 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, we had discussions with individuals with applicable expertise within the investment banks, and following a review of the relevant above-mentioned parameters and assumptions, we 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 our ARS are illiquid until there is a successful auction for them. Accordingly, the entire amount of such remaining ARS was reclassified in 2007 from current to non-current assets on the Company's balance sheet.

During 2008, as a result of our management's intention to realize our ARS in the short-term, observable prices in non-active markets were obtained and an other-than-temporary loss was recorded. The ARS were classified as short-term marketable securities.

Material Commitments for Capital Expenditures

We believe that we have adequate sources of funds to meet our material commitments for capital expenditures for the fiscal year ending December 31, 2009 and the subsequent fiscal year. See above “Financial Resources.” Our specific material commitments for capital expenditures (which include mainly the purchase of equipment, vehicles and buildings) as of December 31, 2008 were approximately \$30 million, which we plan to pay using cash from operations. See our Consolidated Financial Statements – Consolidated Statements of Cash Flows and Note 9.

Impact of Inflation and Exchange Rates

Functional Currency

Our reporting currency is the U.S. dollar, which is also the functional currency for most of our consolidated operations. A majority of our sales are made outside of Israel in non-Israeli currency, mainly U.S. dollars, as are a majority of our purchases of materials and components. A significant portion of our expenses, mainly labor costs, are in NIS. Some of our subsidiaries have functional currencies in Euro, GBP and other currencies. Transactions and balances originally denominated in U.S. dollars are presented in their original amounts. Transactions and balances in currencies other than the U.S. dollar are remeasured in U.S. dollars according to the principles set forth in Statement No. 52 of the Financial Accounting Standards Board. Exchange gains and losses arising from remeasurement are reflected in the consolidated statements of income.

Market Risks and Variable Interest Rates

Market risks relating to our operations result mainly from changes in interest rates and exchange rates. We use financial instruments to limit exposure to changes in exchange rates in certain cases. We also typically enter into forward contracts in connection with transactions where the contract has been signed and that are denominated in currencies other than U.S. dollars or NIS. We also enter from time to time into forward contracts and other hedging instruments related to NIS based on market conditions.

We use financial instruments and derivatives in order to limit our exposure to risks arising from changes in exchange rates. The use of such instruments does not expose us to additional exchange rate risks since the derivatives are held against an asset (for example, excess assets in Euros). Our policy in utilizing these financial instruments is to protect the dollar value of our cash and cash equivalent assets rather than to serve as a source of income.

On December 31, 2008, our liquid assets were comprised of cash and cash equivalent bank deposits, and short and long-term loans. Our deposits and loans are based on variable interest rates, and their value as of December 31, 2008 was therefore exposed to changes in interest rates. Should interest rates either increase or decrease, such change may affect our results of operations due to changes in the cost of the liabilities and the return on the assets that are based on variable rates. With respect to our exposure to ARS, see set forth above "Auction Rate Securities."

NIS/U.S. Dollar Exchange Rates

We attempt to manage our financial activities in order to reduce material financial losses in U.S. dollar resulting from the impact of inflation and exchange rate fluctuations on our non-U.S. dollar assets and liabilities. Our income and expenses in Israeli currency are translated into U.S. dollars at the prevailing exchange rates as of the date of the transaction. Consequently, we are affected by changes in the NIS/U.S. dollar exchange rates. On December 31, 2007 and 2008, we had exposure due to NIS denominated liabilities of approximately \$144.7 million and \$53.9 million, respectively, in excess of NIS denominated assets. These liabilities mostly represent provisions for wages and trade payables. We entered into other derivative instruments to limit our exposure to exchange rate fluctuations, related mainly to payroll expenses incurred in NIS. The amount of our exposure to the changes in the NIS/U.S. dollar exchange rate may vary from time to time.

Inflation and Devaluation

The U.S. dollar cost of our operations in Israel is influenced by any increase in the rate of inflation in Israel that is not fully offset by the devaluation of the NIS in relation to the U.S. dollar. Unless inflation in Israel is offset by a devaluation of the NIS, such inflation may have a negative effect on the profitability of contracts where Elbit Systems or any of our Israeli subsidiaries receives payment in U.S. dollars, NIS linked to U.S. dollars or other foreign currencies, but incurs expenses in NIS linked to the CPI. Inflation in Israel and currency fluctuations may also have a negative effect on the profitability of fixed price contracts where we receive payments in NIS.

In the past, our profitability was negatively affected when inflation in Israel (measured by the change in the CPI from the beginning to the end of the calendar year) exceeded the devaluation of the NIS against the U.S. dollar and at the same time we experienced corresponding increases in the U.S. dollar cost of our operations in Israel. For example, in 2006, the inflation rate was approximately negative 0.1% and the devaluation rate was negative 8.2% (representing a strengthening of the NIS against the U.S. dollar). In 2007, the inflation rate was approximately 3.4% and the devaluation rate was negative 9%. In 2008, the inflation rate was approximately 3.8% and the devaluation rate was 1%. There can be no assurance that we will not be materially adversely affected in the future if inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of such devaluation lags behind increases in inflation in Israel.

A devaluation of the NIS in relation to the U.S. dollar also has the effect of decreasing the dollar value of any of our assets that consist of NIS or accounts receivable denominated in NIS, unless such assets or accounts receivable are linked to the U.S. dollar. Such a devaluation also has the effect of reducing the U.S. dollar amount of any of our liabilities that are payable in NIS, unless such

payables are linked to the U.S. dollar. On the other hand, any increase in the value of the NIS in relation to the U.S. dollar will have the effect of increasing the U.S. dollar value of any unlinked NIS assets as well as the U.S. dollar amount of any unlinked NIS liabilities and expenses.

Foreign Currency Expenses, Derivatives and Hedging

While our functional currency is the U.S. dollar, we also have some non-U.S. dollar or non-U.S. dollar linked exposure to currencies other than NIS. These are mainly non-U.S. dollar customer debts, payments to suppliers and subcontractors, obligations in other currencies, assets or undertakings. Some subcontractors are paid in local currency under prime contracts where we are paid in U.S. dollars. The exposure on these transactions has not been in amounts that are material to us. However, when we view it necessary, we seek to minimize our foreign currency exposure, by entering into hedging arrangements, obtaining periodic payments upon the completion of milestones, obtaining guarantees and security from customers and sharing currency risks with subcontractors.

Most of our future cash flows that will be denominated in currencies other than the NIS and the U.S. dollar were covered as of December 31, 2008 by forward contracts. On December 31, 2008, we had forward contracts for the sale and purchase of Euro, GBP and various other currencies. On December 31, 2008, we had forward contracts for the sale and purchase of such foreign currencies totaling approximately \$229.4 million (\$133.3 million in Euros, \$85.3 million in GBP and the balance of \$10.9 million in other currencies). The fair value of financial derivatives as of December 31, 2008 accumulated to an unrealized net gain of approximately \$19.3 million, which was recorded in accumulated other comprehensive income. As of December 31, 2008, all of the forward contracts are expected to mature during the years 2009 – 2012.

We also use forward exchange contracts and options strategies in order to limit the exposure to exchange rate fluctuation associated mainly with payroll expenses incurred in NIS

We enter into other derivative instruments mainly to limit our exposure to exchange rate fluctuations related to payroll expenses incurred in NIS. These include forward contracts in the amount of \$196.8 million in NIS maturing in 2009. They also include a total of \$136.6 million in NIS – put and call options, with all of the options having maturities of 12 months or less.

The table below presents the balance of the derivative instruments held in order to limit the exposure to exchange rate fluctuations as of December 31, 2008 and is presented in millions of U.S. dollar equivalent terms.

<u>Forward</u>	<u>Notional Amount</u>	<u>Fair Value of Derivative</u>
<u>Buy US\$ and Sell:</u>		
Euro	121.0	0.7
GBP	83.3	18.7
Other various currencies	9.3	(0.1)

<u>Forward</u>	<u>Notional Amount</u>	<u>Fair Value of Derivative</u>
<u>Sell US\$ and Buy:</u>		
Euro	12.2	0.0
GBP	2.0	0.0
NIS	196.8	0.5
Other various currencies	1.5	0.0

<u>Options</u>	<u>Notional Amount</u>	<u>Fair Value of Derivative</u>
<u>Buy US\$ and Sell:</u>		
NIS	68.3	0.6
<u>Sell US\$ and Buy:</u>		
NIS	68.3	(2.6)

Contractual Obligations

	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>	<u>More than 5 years</u>
	(U.S. dollars in millions)			
1. Long-Term Debt Obligations	9	269	1	-
2. Operating Lease Obligations*	32	50	21	-
3. Purchase Obligations*	709	184	40	14
4. Other Long-Term Liabilities Reflected on the Company's Balance Sheet under U.S. GAAP**	-	-	-	-
5. Other Long-Term Liabilities***	-	-	-	-
Total	<u>750</u>	<u>503</u>	<u>62</u>	<u>14</u>

* For further description of the Purchase Obligations see above "Long-Term Arrangements and Commitments – Purchase Commitments" and See our Consolidated Financial Statements – Note 17 (H).

** The obligation amount does not include an amount of \$332.2 million of pension and employee termination liabilities. See our Consolidated Financial Statements – Notes 2(P) and 15. The obligation amount also does not include an amount of \$23.5 million of tax reserve related to FIN 48. See our Consolidated Financial Statements – Note 16.

*** See below "Off Balance Sheet Transactions"/

Off-Balance Sheet Transactions

Buy-Back

In connection with projects in certain countries, Elbit Systems and some of our subsidiaries have entered and may enter in the future into "buy-back" or "offset" agreements, required by a number of our customers as a condition to our obtaining orders for our products and services. These agreements are customary in our 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 our 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, our commitments may also be satisfied through transactions conducted by other parties.

We do not commit to buy-back agreements until orders for our products or services are definitive, but in some cases the orders for our products or services may become effective only after our corresponding buy-back commitments enter into effect. Buy-back programs generally extend at least over the relevant commercial contract period and may provide for penalties in the event we fail to perform in accordance with buy-back requirements. In some cases we provide guarantees in connection with the performance of our buy-back obligations.

Should we be unable to meet such obligations we may be subject to contractual penalties, and our chances of receiving additional business from the applicable customers could be reduced or, in certain cases, eliminated. See Item 3. Risk Factors – General Risk Related to Our Business and Market.

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

Elbit Systems Ltd.

Management Report on Internal Control over Financial Reporting for the Year-ended December 31, 2008

Elbit Systems' management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process 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. Our internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets,
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors, and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Our management recognizes that there are inherent limitations in the effectiveness of any system of internal control over financial reporting, including the possibility of human error and the circumvention or override of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation, and may not prevent or detect all misstatements. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. In conducting its assessment of internal control over financial reporting, management based its evaluation on the framework in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In conducting such assessment, our management has excluded from its assessment the effectiveness of internal control over financial reporting of Innovative Concepts, Inc. ("ICI"), Bar-Kal Systems Engineering Ltd. ("Bar-Kal") and Electro Optic Research and Development Company Ltd. ("EORD"), as ICI, Bar-Kal and EORD were acquired by us in 2008, and because we have not integrated ICI, Bar-Kal and EORD's internal control over financial reporting and related processes by December 31, 2008. ICI, Bar-Kal and EORD are now wholly-owned subsidiaries of Elbit, and are included in our 2008 consolidated financial statements, and constituted approximately \$19 million, of our total assets, as of December 31, 2008, and \$3 million of our revenues in 2008. Refer to Note 1(E) to our consolidated financial statements for further discussion of these acquisitions and its impact on our consolidated financial statements. Our management has concluded, based on its assessment, that our internal control over financial reporting was effective as of December 31, 2008, based on the framework in "Internal Control – Integrated Framework" issued by COSO.

The effectiveness of our internal control over financial reporting as of December 31, 2008, has been audited by Kost, Forer, Gabbay & Kasierer (A Member of Ernst & Young Global), an independent registered public accounting firm. Kost, Forer, Gabbay & Kasierer's attestation report with respect to the Company's internal control over financial reporting is set forth.