CABOT CORP
Form 10-K
November 29, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended September 30, 2012

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 1-5667

Cabot Corporation

(Exact name of Registrant as specified in its charter)

Delaware	**04-2271897**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
Two Seaport Lane, Suite 1300 Boston, Massachusetts	**02210**
(Address of Principal Executive Offices)	*(Zip Code)*

(617) 345-0100

(Registrant s telephone number, including area code)

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

Title of Each Class	**Name of Each Exchange on Which Registered**
Common stock, $1.00 par value per share	New York Stock Exchange

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of the last business day of the Registrant s most recently completed second fiscal quarter (March 31, 2012), the aggregate market value of the Registrant s common stock held by non-affiliates was $2,685,813,177. As of November 16, 2012, there were 63,472,522 shares of the Registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive proxy statement for its 2013 Annual Meeting of Shareholders are incorporated by reference into Part III of this annual report on Form 10-K.

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Information Relating to Forward-Looking Statements

This annual report on Form 10-K contains forward-looking statements under the Federal securities laws. These forward-looking statements include statements relating to our future business performance and overall prospects; demand for our products; when we expect commissioning of the rubber blacks facility in Xingtai City, Hebei Province, China we are constructing with our joint venture partner to occur; our expectations regarding the life of our pollucite ore reserves; when we expect operations at our lignite mine in Texas to commence; our expectations concerning the receipt of the cash proceeds due to us from the sale of our Supermetals Business; the sufficiency of our cash on hand, cash provided from operations and cash available under our credit facilities to fund our cash requirements; anticipated capital spending, including environmental-related capital expenditures; cash requirements and uses of available cash, including future cash outlays associated with long-term contractual obligations, restructurings, contributions to employee benefit plans, environmental remediation costs and future respirator liabilities; exposure to interest rate and foreign exchange risk; future benefit plan payments we expect to make; our expected tax rate for fiscal 2013; our ability to recover deferred tax assets; and the possible outcome of legal and environmental proceedings. From time to time, we also provide forward-looking statements in other materials we release to the public and in oral statements made by authorized officers.

Forward-looking statements are based on our current expectations, assumptions, estimates and projections about Cabot s businesses and strategies, market trends and conditions, economic conditions and other factors. These statements are not guarantees of future performance and are subject to risks, uncertainties, potentially inaccurate assumptions, and other factors, some of which are beyond our control and difficult to predict. If known or unknown risks materialize, or should underlying assumptions prove inaccurate, our actual results could differ materially from past results and from those expressed in the forward-looking statements. Important factors that could cause our actual results to differ materially from those expressed in our forward-looking statements are described in Item 1A in this report.

We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Investors are advised, however, to consult any further disclosures we make on related subjects in our 10-Q and 8-K reports filed with the Securities and Exchange Commission (the SEC).

PART I

Item 1. *Business*

General

Cabot is a global specialty chemicals and performance materials company headquartered in Boston, Massachusetts. Our principal products are rubber and specialty grade carbon blacks, fumed metal oxides, inkjet colorants, aerogel, cesium formate drilling fluids and activated carbon. Cabot and its affiliates have manufacturing facilities and operations in the United States and over 20 other countries. Cabot s business was founded in 1882 and incorporated in the State of Delaware in 1960. The terms Cabot , Company , we , and our as used in this report refer to Cabot Corporation and its consolidated subsidiaries.

Our strategy is to deliver earnings growth through leadership in performance materials. We intend to achieve this goal by focusing on margin improvement, capacity expansion and emerging market growth, developing new products and businesses and actively managing our portfolio of businesses. In support of this strategy, during fiscal 2012 we completed the sale of our Supermetals Business to Global Advanced Metals Pty Ltd. for a minimum of approximately $450 million in total consideration. Results of operations for the Supermetals Business prior to the sale and the gain on the sale are reported in discontinued operations. In addition, on July 31, 2012, we completed our acquisition of all of the issued and outstanding shares of Norit N.V. (Norit) from N Beta S.à r.l., an affiliate of Doughty Hanson & Co. Managers Limited and Euroland Investments B.V., for a purchase price of $1.1 billion. The acquired business is organized as a new business segment, Purification Solutions, and results of operations for the business are reported in this segment.

Our products are generally based on technical expertise and innovation in one or more of our three core competencies: making and handling very fine particles; modifying the surfaces of very fine particles to alter their functionality; and designing particles to impart specific properties to a composite. We focus on creating particles with the composition, morphology, surface functionalities and formulations to support our customers existing and emerging applications.

After the sale of our Supermetals Business and acquisition of Norit, we made changes in the composition of our segments and renamed them with names that are more descriptive of the underlying businesses. With these changes, our four business segments are: Reinforcement Materials (formerly our Core Segment); Performance Materials (formerly our Performance Segment); Advanced Technologies (the combination of our former New Business and Specialty Fluids Segments); and Purification Solutions (the newly acquired Norit business).

The business segments are discussed in more detail later in this section. Financial information about our business segments appears in Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 below (MD&A) and in Note V of the Notes to our Consolidated Financial Statements in Item 8 below (Note V).

For operational purposes, we are also organized into three geographic regions: The Americas; Europe, Middle East and Africa; and Asia Pacific. Financial information about our sales and long-lived assets in certain geographic areas appears in Note V.

Our internet address is www.cabot-corp.com. We make available free of charge on or through our internet website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after electronically filing such material with, or furnishing it to, the SEC.

Reinforcement Materials

Products

Carbon black is a form of elemental carbon that is manufactured in a highly controlled process to produce particles and aggregates of varied structure and surface chemistry, resulting in many different performance characteristics for a wide variety of applications. Rubber grade carbon blacks are used to enhance the physical properties of the systems and applications in which they are incorporated.

Our rubber blacks products are used in tires and industrial products. Rubber blacks have traditionally been used in the tire industry as a rubber reinforcing agent and are also used as a performance additive. In industrial products such as hoses, belts, extruded profiles and molded goods, rubber blacks are used to improve the physical performance of the product.

Sales and Customers

Sales of rubber blacks products are made by Cabot employees and through distributors and sales representatives. Sales to three major tire customers represent a material portion of Reinforcement Materials total net sales and operating revenues. The loss of any of these customers could have a material adverse effect on the Segment.

Under appropriate circumstances, we have entered into supply contracts with certain customers, many of which have durations of at least one year. Many of these contracts provide for sales price adjustments to account for changes in relevant feedstock indices and, in some cases, changes in other relevant costs (such as the cost of natural gas). In fiscal 2012, approximately half of our rubber blacks volume was sold under supply contracts with an initial term of at least one year in effect during the fiscal year. The majority of the volumes sold under these contracts are sold to customers in North America and Western Europe.

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Much of the rubber blacks we sell is used in automotive products and, therefore, our financial results may be affected by the cyclical nature of the automotive industry. However, a large portion of the market for our products is in replacement tires that historically have been less subject to automotive industry cycles.

Competition

We are one of the leading manufacturers of carbon black in the world. We compete in the manufacture of carbon black primarily with two companies with a global presence and a significant number of other companies which have a regional presence. Competition for products within Reinforcement Materials is based on product performance, quality, reliability, service, technical innovation, price, and logistics. We believe our product differentiation, technological leadership, global manufacturing presence, operations and logistics excellence and customer service provide us with a competitive advantage.

Raw Materials

The principal raw material used in the manufacture of carbon black is a portion of the residual heavy oils derived from petroleum refining operations and from the distillation of coal tars and the production of ethylene throughout the world. Natural gas is also used in the production of carbon black. Raw material costs generally are influenced by the availability of various types of carbon black feedstock and natural gas, and related transportation costs. Importantly, movements in the market price for crude oil typically affect carbon black feedstock costs.

Operations

We own, or have a controlling interest in, and operate plants that produce rubber blacks in Argentina, Brazil, Canada, China, Colombia, the Czech Republic, France, Indonesia, Italy, Japan, Malaysia, The Netherlands, and the United States. Our equity affiliates operate carbon black plants in Mexico and Venezuela. The following table shows our ownership interest as of September 30, 2012 in rubber blacks operations in which we own less than 100%:

Location	**Percentage Interest**
Shanghai, China	70% (consolidated subsidiary)
Tianjin, China	70% (consolidated subsidiary)
Xingtai City, China	60% (consolidated subsidiary)
Valasske Mezirici (Valmez), Czech Republic	52% (consolidated subsidiary)
Cilegon and Merak, Indonesia	85% (consolidated subsidiary)
Port Dickson, Malaysia	51% (consolidated subsidiary)
Tampico, Mexico	40% (equity affiliate)
Valencia, Venezuela	49% (equity affiliate)

We continue to expand the manufacturing capacity of Reinforcement Materials, particularly in emerging markets. We increased the capacity at our carbon black plant in Tianjin, China by 150,000 metric tons with the addition of two rubber blacks production units in fiscal 2009, and in fiscal 2012 increased the capacity at our existing facilities in Indonesia, Argentina and multiple sites in Europe by a total of approximately 50,000 metric tons. In addition, we entered into a joint venture with Risun Chemicals Company, Ltd. for the construction and operation of a rubber blacks manufacturing facility in Xingtai City, Hebei Province, China. The facility will produce approximately 130,000 metric tons of carbon black annually, with the potential to expand annual capacity to 300,000 metric tons. We expect commissioning of this facility in calendar year 2013.

We have plans to further expand the capacity at our existing plants in South America, Asia and Europe by a total of approximately 120,000 metric tons. The timing for these future expansions is dependent on a number of factors, including overall economic conditions in those regions.

As part of our 2009 global restructuring plan, over the course of fiscal 2009 and 2010 we closed our manufacturing operations in Stanlow, U.K., and in Berre, France. In addition, during fiscal 2010 we closed our manufacturing operations in Thane, India.

Performance Materials

Performance Materials is comprised of two businesses that sell the following products: specialty grades of carbon black and thermoplastic concentrates and compounds (our Specialty Carbons and Compounds Business); and fumed silica, fumed alumina and dispersions thereof (our Fumed Metal Oxides Business). In each business, we design, manufacture and sell materials that deliver performance in a broad range of customer applications across the automotive, construction and infrastructure, and electronics and consumer products sectors.

Products

Carbon black is a form of elemental carbon that is manufactured in a highly controlled process to produce particles and aggregates of varied structure and surface chemistry, resulting in many different performance characteristics for a wide variety of applications. Our specialty grades of carbon black are used to impart color, provide rheology control, enhance conductivity and static charge control, provide UV protection, enhance mechanical properties, and provide chemical flexibility through surface treatment. These products are used in a wide variety of applications, such as inks, coatings, cables, pipes, toners and electronics. In addition, we manufacture and source thermoplastic concentrates and compounds (which we refer to as specialty compounds) that are marketed to the plastics industry.

Fumed silica is an ultra-fine, high-purity particle used as a reinforcing, thickening, abrasive, thixotropic, suspending or anti-caking agent in a wide variety of products produced for the automotive, construction, microelectronics, and consumer products industries. These products include adhesives, sealants, cosmetics, inks, toners, silicone rubber, coatings, polishing slurries and pharmaceuticals. Fumed alumina, also an ultra-fine, high-purity particle, is used as an abrasive, absorbent or barrier agent in a variety of products, such as inkjet media, lighting, coatings, cosmetics and polishing slurries.

Sales and Customers

Sales of these products are made by Cabot employees and through distributors and sales representatives. In our Specialty Carbons and Compounds Business, sales are to a broad number of customers. In contrast, sales under long-term contracts (those with an initial term longer than one year) with two customers account for a substantial portion of the revenue of our Fumed Metal Oxides Business.

Competition

We are one of the leading manufacturers of carbon black in the world. We compete in the manufacture of carbon black primarily with two companies with a global presence and a significant number of other companies which have a regional presence. We are also a leading producer of specialty compounds in Europe, the Middle East and Asia. We are a leading producer and seller of fumed silica and compete primarily with three companies with a global presence and numerous other companies which have a regional presence.

Competition for these products is based on product performance, quality, reliability, service, technical innovation and price. We believe our product differentiation, technological leadership, global manufacturing presence, operations excellence and customer service provide us with a competitive advantage.

Raw Materials

The principal raw material used in the manufacture of carbon black is a portion of the residual heavy oils derived from petroleum refining operations and from the distillation of coal tars and the production of

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ethylene throughout the world. Natural gas is also used in the production of carbon black. Raw material costs generally are influenced by the availability of various types of carbon black feedstock and natural gas, and related transportation costs. Importantly, movements in the market price for crude oil typically affect carbon black feedstock costs.

Other than carbon black feedstock, the primary materials used for our specialty compounds are thermoplastic resins and mineral fillers. Raw materials for these compounds are, in general, readily available.

Raw materials for the production of fumed silica are various chlorosilane feedstocks. We purchase feedstocks and for some customers convert their feedstock to product on a fee-basis (so called toll conversion). We also purchase aluminum chloride as feedstock for the production of fumed alumina. We have long-term procurement contracts or arrangements in place for the purchase of fumed silica feedstock, which we believe will enable us to meet our raw material requirements for the foreseeable future. In addition, we buy some raw materials in the spot market to help ensure flexibility and minimize costs.

Operations

We own, or have a controlling interest in, and operate plants that produce specialty grades of carbon black in China, The Netherlands and the United States. Our specialty compounds are produced in facilities that we own, or have a controlling interest in, located in Belgium, China and the UAE. We also own, or have a controlling interest in, manufacturing plants that produce fumed metal oxides in the United States, China, the United Kingdom, and Germany. An equity affiliate operates a fumed metal oxides plant in Mettur Dam, India. The following table shows our ownership interest as of September 30, 2012 in these segment operations in which we own less than 100%:

Location	**Percentage Interest**
Tianjin, China (Specialty Carbons and Compounds Business)	90% (consolidated subsidiary)
Jiangxi Province, China (Fumed Metal Oxides Business)	90% (consolidated subsidiary)
Mettur Dam, India (Fumed Metal Oxides Business)	50% (equity affiliate)

We continue to expand the manufacturing capacity of our Specialty Carbons and Compounds Business in emerging markets. During fiscal 2011, we commissioned a specialty compounds manufacturing plant at our carbon black plant in Tianjin, China. This plant has an annual capacity of approximately 45,000 metric tons that may be expanded to 80,000 metric tons in the future. In addition, in fiscal 2010 we commenced specialty compounds manufacturing in Dubai.

We also continue to expand our fumed silica capacity. During fiscal 2012, we increased the annual capacity at our joint venture s fumed silica manufacturing facility in Jiangxi Province, China to approximately 15,000 metric tons, with the potential to further expand to 20,000 metric tons as demand in Asia grows. In addition, during calendar year 2012 we expanded production capacity by 25% at our fumed silica facility in Barry, Wales.

As part of our 2009 global restructuring plan, over the course of fiscal 2009 and 2010 we closed our specialty compounds manufacturing operations in Dukinfield, U.K. and our carbon black manufacturing operations in Stanlow, U.K. and in Berre, France. In fiscal 2011, we closed our specialty compounds manufacturing facility in Grigno, Italy and in fiscal 2012, we closed our specialty compounds manufacturing facility in Hong Kong and moved production primarily to our new facility in Tianjin, China.

Advanced Technologies

Advanced Technologies is comprised of our Inkjet Colorants, Aerogel, Security Materials, Elastomer Composites and Specialty Fluids Businesses. A discussion of each of these Businesses follows.

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Inkjet Colorants Business

Products

We produce and sell aqueous inkjet colorants primarily to the inkjet printing market. Our inkjet colorants are high-quality pigment-based black and other colorant dispersions we manufacture by surface treating specialty grades of carbon black and other pigments. The dispersions are used in aqueous inkjet inks to impart color (optical density or chroma) with improved durability (waterfastness, lightfastness and rub resistance) while maintaining high printhead reliability. Our inkjet colorants are produced for various inkjet printing applications, including small office and home office, corporate office, and commercial printing, as well as for other niche applications that require a high level of dispersibility and colloidal stability.

Sales and Customers

Sales of inkjet colorants are made by Cabot employees to inkjet printer manufacturers and to suppliers of inkjet inks in the inkjet cartridge aftermarket. Many of our commercialized products have been developed through joint research and development initiatives with inkjet printer manufacturers. These initiatives have led to the development of exclusive differentiated products for these inkjet customers.

Competition

Our inkjet colorants are designed to replace traditional pigment dispersions and dyes used in inkjet printing applications. Competitive products for inkjet colorants are organic dyes and other dispersed pigments manufactured and marketed by large chemical companies and small independent producers. Competition is based on product performance, technical innovation, quality, reliability, service and price. We believe our commercial strengths include technical innovation, product performance and service.

Raw Materials

Raw materials for inkjet colorants include carbon black sourced from our carbon black plants, organic pigments and other treating agents available from various sources. We believe that all raw materials to produce inkjet colorants are in adequate supply.

Operations

Our inkjet colorants are manufactured at our facility in Haverhill, Massachusetts. During fiscal 2012, we doubled the capacity of two of our production lines at this facility.

Aerogel Business

Products

Aerogel is a hydrophobic, silica-based particle with a high surface area that is used in a variety of thermal insulation and specialty chemical applications. In the construction industry, the product is used in insulative composite building products and translucent skylight, window, wall and roof systems for insulating eco-daylighting applications. In the oil and gas industry, aerogel is used to insulate subsea pipelines. In the specialty chemicals industry, the product is used to provide matte finishing, insulating and thickening properties for use in a variety of applications. We continue to focus on application and market development activities for use of aerogel in these and other new applications.

Sales and Customers

Sales of aerogel products are made principally by Cabot employees to engineering procurement and installation companies, traditional insulation manufacturers, building and construction materials companies, and specialty chemical and coatings producers and distributors.

Competition

Although the manufacturing processes used are different, in premium insulation applications, our aerogel products compete principally with aerogel products manufactured by Aspen Aerogel, Inc. and non-aerogel insulation products manufactured by primarily regional companies throughout the world.

Competition is based on product performance, price, quality, reliability and service. We believe our commercial strengths include technical innovation, product performance, quality and service.

Raw Materials

The principal raw materials for the production of aerogel are silica sol and/or sodium silicate, which we believe are in adequate supply.

Operations

We manufacture our aerogel products at our facility in Frankfurt, Germany using a unique and patented manufacturing process.

Security Materials Business

The principal area of commercial focus for the Security Materials Business is in developing covert taggants for a broad range of anti-counterfeiting security applications, including brand security, currency, tax stamps, identification and fuel markers. Covert taggants are invisible, unique markers that are added to products to determine their authenticity through the use of custom detectors or readers. Our taggants are manufactured using a proprietary process, which produces highly uniform materials with unique signatures. Development and manufacturing activities are conducted primarily at our facilities in Albuquerque, New Mexico and Mountain View, California.

Elastomer Composites Business

We have developed elastomer composite products that are compounds of natural latex rubber and carbon black made by a patented liquid phase process. We believe these compounds improve abrasion/wear resistance, reduce fatigue and reduce rolling resistance compared to natural rubber/carbon black compounds made by conventional methods. Our elastomer composite products are targeted for tire, defense, mining, automotive and aerospace applications. We manufacture our elastomer composite products at our facility in Port Dickson, Malaysia.

Specialty Fluids Business

Products

Our Specialty Fluids Business principally produces and markets cesium formate as a drilling and completion fluid for use primarily in high pressure and high temperature oil and gas well construction. Cesium formate products are solids-free, high-density fluids that have a low viscosity, enabling safe and efficient well construction and workover operations. The fluid is resistant to high temperatures, minimizes damage to producing reservoirs and is readily biodegradable in accordance with the testing guidelines set by the Organization for Economic Cooperation and Development. In a majority of applications, cesium formate is blended with other formates or products.

Sales, Rental and Customers

Sales of our cesium formate products are made to oil and gas operating companies directly by Cabot employees and sales representatives and indirectly through oil field service companies. We generally rent cesium formate to our customers for use in drilling operations on a short-term basis. After completion of a job, the customer returns the remaining fluid to Cabot and it is reprocessed for use in subsequent well operations. Any fluid that is lost during use and not returned to Cabot is paid for by the customer. We also make sales of cesium formate outside of a rental process.

A large portion of our fluids have been used for drilling and completion of wells in the North Sea, where we have been supplying cesium formate-based fluids for both reservoir drilling and completion activities on large gas and condensate field projects in the Norwegian Continental Shelf. Although we have expanded the use of our fluids to drilling operations outside of the North Sea, an important portion of our business continues to be with a limited number of customers for drilling and completion operations in that geography.

Competition

Formate fluids, which were introduced to the market in the mid-1990s, are a relatively small but growing part of the drilling and completion fluids market and compete mainly with traditional drilling fluid technologies. Competition in the well fluids business is based on product performance, quality, reliability, service, technical innovation, price, and proximity of inventory to customers   drilling operations. We believe our commercial strengths include our unique product offerings and their performance, and our customer service.

Raw Materials

The principal raw material used in this business is pollucite (cesium ore), which we obtain primarily from our mine in Manitoba, Canada. We own a substantial portion of the world   s known pollucite reserves, ensuring us an adequate supply of our principal raw material. Considering our current production rates, our current estimate of reserve levels in the mine and inventory on hand, we expect our supply to last at least 10 years. The process of estimating mineral reserves is inherently uncertain and requires making subjective engineering, geological, geophysical and economic assumptions. Accordingly, there is likely to be variability in the estimated reserve life of the ore body over time.

Most jobs for which cesium formate is used require a large volume of the product. Accordingly, the Specialty Fluids Business maintains a large inventory of fluid.

Operations

We have a mine and a cesium formate manufacturing facility in Manitoba, Canada, as well as fluid blending and reclamation facilities in Aberdeen, Scotland and in Bergen and Kristiansund, Norway. In addition, we warehouse fluid at various locations around the world to support existing and potential operations.

Purification Solutions

Products

Activated carbon is a porous material consisting mainly of elemental carbon treated with heat, steam and/or chemicals to create high internal porosity, resulting in a large internal surface area that resembles a sponge. It is generally produced in two forms, powdered and granular, and is manufactured in different sizes, shapes and levels of purity for a wide variety of applications. Activated carbon is used to remove contaminants from liquids and gases using a process called adsorption, whereby the interconnected pores of activated carbon trap contaminants.

Our activated carbon products are used for the purification of water, air, food and beverages, pharmaceuticals and other liquids and gases. In gas and air applications, one of the uses of activated carbon is for the removal of mercury in flue gas streams. In addition, our products are used as a catalyst or catalyst carrier; as a chemical carrier in slow release applications (such as delayed release pharmaceuticals); as either a colorant or a decolorizing agent in the production of products for food and beverage applications; and in the gold mining industry. Used activated carbon can be reactivated for further use by removing the

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contaminants from the pores. The most common applications in which our reactivated carbon is used are water treatment, food and beverage purification and gas and air purification. In addition to our activated carbon production and reactivation, we also provide activated carbon solutions through on-site equipment and services, including delivery systems for activated carbon injection in coal-fired utilities, mobile water filter units and carbon reactivation services.

Sales and Customers

Sales of activated carbon are made by Cabot employees and through distributors and sales representatives to a broad range of customers, including coal-fired utilities, food and beverage processors, water treatment plants, pharmaceutical companies and catalyst producers. Some of our sales of activated carbon are made under annual contracts or longer-term agreements, particularly in mercury removal applications.

Competition

We are one of the leading manufacturers of activated carbon and providers of activated carbon equipment and services in the world. We compete in the manufacture of activated carbon primarily with six companies with a global presence and numerous other companies which have a regional or local presence.

Competition for activated carbon and activated carbon equipment and services is based on quality, performance, price and supply-chain stability. We believe our product differentiation, technological leadership, quality, product and application diversity, cost-effective access to raw materials, and scalable manufacturing capabilities provide us with a competitive advantage.

Raw Materials

The principal raw materials we use in the manufacture of activated carbon are various forms of coal, including lignite, wood and other carbonaceous materials, all of which we believe we have in adequate supply. Our raw material supply contracts are typically for a duration of two to five years. We are also developing a lignite mine close to our Marshall, Texas facility, which we expect will begin operations in 2014.

Operations

We own, or have a controlling interest in, and operate plants that produce activated carbon in the United States, the United Kingdom, The Netherlands and Italy. Our equity affiliates operate activated carbon plants in Canada and Mexico. The following table shows our ownership interest as of September 30, 2012 in these segment operations in which we own less than 100%:

Location	Percentage Interest
Bienfait, Saskatchewan, Canada	50% (contractual joint venture)
Atitalaquia, Hidalgo, Mexico	49% (equity affiliate)

Since the beginning of 2008, our global production capacity has increased by approximately 28%. Two new production lines were added at our largest facility in Marshall, Texas to meet rising demand for mercury removal solutions, increasing that plant s capacity by approximately 74% since 2009. In addition, our Canadian joint venture began operations in 2010. We have the potential to add additional capacity at these facilities as needed to meet market demand.

Patents and Trademarks

We own and are a licensee of various patents, which expire at different times, covering many of our products as well as processes and product uses. Although the products made and sold under these patents and licenses are important to Cabot, the loss of any particular patent or license would not materially affect our business, taken as a whole. We sell our products under a variety of trademarks, the loss of any one of which would not materially affect our business, taken as a whole.

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Seasonality

Our businesses are generally not seasonal in nature, although we may experience some regional seasonal declines during holiday periods and some weather-related seasonality in Purification Solutions.

Backlog

We do not consider backlog to be a significant indicator of the level of future sales activity. In general, we do not manufacture our products against a backlog of orders. Production and inventory levels are based on the level of incoming orders as well as projections of future demand. Therefore, we believe that backlog information is not material to understanding our overall business and is not a reliable indicator of our ability to achieve any particular level of revenue or financial performance.

Employees

As of September 30, 2012, we had 4,826 employees. Some of our employees in the United States and abroad are covered by collective bargaining or similar agreements. We believe that our relations with our employees are generally satisfactory.

Research and Development

Cabot develops new and improved products and higher efficiency processes through Company-sponsored research and technical service activities, including those initiated in response to customer requests. Our expenditures for such activities generally are spread among our businesses and are shown in the consolidated statements of operations. Further discussion of our research and technical expenses incurred in each of our last three fiscal years appears in MD&A in Item 7 below.

Safety, Health and Environment (SH&E)

Cabot has been named as a potentially responsible party under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (the Superfund law) and comparable state statutes with respect to several sites primarily associated with our divested businesses. (See Legal Proceedings below.) During the next several years, as remediation of various environmental sites is carried out, we expect to spend against our $7 million environmental reserve for costs associated with such remediation. Adjustments are made to the reserve based on our continuing analysis of our share of costs likely to be incurred at each site. Inherent uncertainties exist in these estimates due to unknown conditions at the various sites, changing governmental regulations and legal standards regarding liability, and changing technologies for handling site investigation and remediation. While the reserve represents our best estimate of the costs we expect to incur, the actual costs to investigate and remediate these sites may exceed the amounts accrued in the environmental reserve. While it is always possible that an unusual event may occur with respect to a given site and have a material adverse effect on our results of operations in a particular period, we do not believe that the costs relating to these sites, in the aggregate, are likely to have a material adverse effect on our financial position. Furthermore, it is possible that we may also incur future costs relating to environmental liabilities not currently known to us or as to which it is currently not possible to make an estimate.

Our ongoing operations are subject to extensive federal, state, local, and foreign laws, regulations, rules, and ordinances relating to safety, health, and environmental matters (SH&E Requirements). These SH&E Requirements include requirements to obtain and comply with various environmental-related permits for constructing any new facilities and operating all of our existing facilities. We have expended and will continue to expend considerable sums to construct, maintain, operate, and improve facilities for safety, health and environmental protection and to comply with SH&E Requirements. We spent approximately $23 million in environmental-related capital expenditures at existing facilities in fiscal 2012 and anticipate spending approximately $24 million for such matters in fiscal 2013.

In recognition of the importance of compliance with SH&E Requirements to Cabot, our Board of Directors has a Safety, Health, and Environmental Affairs Committee. The Committee, which is comprised of independent directors, meets at least three times a year and provides oversight and guidance to Cabot s safety, health and environmental management programs. In particular, the Committee reviews Cabot s environmental reserve, safety, health and environmental risk assessment and management processes, environmental and safety audit reports, performance metrics, performance as benchmarked against industry peer groups, assessed fines or penalties, site security and safety issues, health and environmental training initiatives, and the SH&E budget. The Committee also consults with our outside and internal advisors regarding management of Cabot s safety, health and environmental programs.

The International Agency for Research on Cancer (IARC) classifies carbon black as a Group 2B substance (known animal carcinogen, possible human carcinogen). We have communicated IARC s classification of carbon black to our customers and employees and have included that information in our material safety data sheets and elsewhere, as appropriate. We continue to believe that the available evidence, taken as a whole, indicates that carbon black is not carcinogenic to humans, and does not present a health hazard when handled in accordance with good housekeeping and safe workplace practices as described in our material safety data sheets.

The California Office of Environmental Health Hazard Assessment (OEHHA) published a notice adding carbon black (airborne, unbound particles of respirable size) to the California Safe Drinking Water and Toxic Enforcement Act, commonly referred to as Proposition 65, in 2003. Proposition 65 requires businesses to warn individuals before they knowingly or intentionally expose them to chemicals subject to its requirements, and it prohibits businesses from knowingly discharging or releasing the chemicals into water or onto land where they could contaminate drinking water. We worked with the International Carbon Black Association, as well as various customers and carbon black user groups, to ensure our compliance with the requirements associated with the Proposition 65 listing of carbon black, which became effective in February 2004. OEHHA is reportedly considering certain changes that may result in removing the airborne, unbound particles of respirable size qualifying language from its listing of carbon black. If this change is adopted by OEHHA, it would result in increased labeling and other requirements for our customers under Proposition 65.

REACH (Registration, Evaluation and Authorization of Chemicals), the European Union (EU) regulatory framework for chemicals developed by the European Commission (EC), applies to all chemical substances produced or imported into the EU in quantities greater than one metric ton a year. Manufacturers or importers of these chemical substances are required to submit specified health, safety, risk and use information about the substance to the European Chemical Agency. We completed the registrations under REACH for some monomers for our specialty compounds in 2011, for carbon black, activated carbon and fumed silica in 2010 and for cesium formate in 2009. We are working to complete other substance dossiers for the 2013 registration deadline. We are also working with the manufacturers and importers of our raw materials, including our feedstocks, to ensure their registration prior to the applicable deadlines. In addition, the EC has adopted a harmonized definition of nanomaterial to be used in the EU to identify materials for which special provisions may apply, such as risk assessment and ingredient labeling. The EC definition is broad and would apply to many of our existing products, including carbon black, fumed silica and alumina.

Environmental agencies worldwide are increasingly implementing regulations and other requirements resulting in more restrictive air emission limits globally, particularly as they relate to nitrogen oxide and sulphur dioxide emissions. In addition, global efforts to reduce greenhouse gas emissions impact the carbon black and activated carbon industries as carbon dioxide is emitted in those manufacturing processes. The EU Emissions Trading Scheme applies to a number of our carbon black and activated carbon facilities. We generally expect to purchase emission credits where necessary to respond to allocation shortfalls. There are

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also ongoing discussions in other regions and countries, including the U.S., Canada, China, and Brazil, regarding greenhouse gas emission reduction programs, but those programs have not yet been fully defined and their impact on us cannot be estimated at this time. Finally, Cabot s U.S. carbon black and activated carbon facilities continued to report their greenhouse gas emissions under the U.S. Environmental Protection Agency s rule for the Mandatory Reporting of Greenhouse Gases in calendar year 2012.

A number of organizations and regulatory agencies have become increasingly focused on the issue of water scarcity and water quality, particularly in certain geographic regions. We are engaged in various activities to promote water conservation and wastewater recycling. The costs associated with these activities are not expected to have a material adverse effect on our operations.

Various U.S. agencies and international bodies have adopted security requirements applicable to certain manufacturing and industrial facilities and marine port locations. These security-related requirements involve the preparation of security assessments and security plans in some cases, and in other cases the registration of certain facilities with specified governmental authorities. We closely monitor all security-related regulatory developments and believe we are in compliance with all existing requirements. Compliance with such requirements is not expected to have a material adverse effect on our operations.

Foreign and Domestic Operations and Export Sales

A significant portion of our revenues and operating profits is derived from overseas operations. The profitability of our segments is affected by fluctuations in the value of the U.S. dollar relative to foreign currencies. (See MD&A and the Geographic Information portion of Note V for further information relating to sales and long-lived assets by geographic area.) Currency fluctuations, nationalization and expropriation of assets are risks inherent in international operations. We have taken steps we deem prudent in our international operations to diversify and otherwise to protect against these risks, including the use of foreign currency financial instruments to reduce the risk associated with changes in the value of certain foreign currencies compared to the U.S. dollar. (See the risk management discussion contained in Quantitative and Qualitative Disclosures About Market Risk in Item 7A below and Note L of the Notes to the Company s Consolidated Financial Statements).

Item 1A. ***Risk Factors***

In addition to factors described elsewhere in this report, the following are important factors that could cause our actual results to differ materially from those expressed in our forward-looking statements. The risks described below are not the only risks we face. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations and financial results.

Negative or uncertain worldwide or regional economic conditions may adversely impact our business.

Our operations and performance are affected by worldwide and regional economic conditions. Continuing concerns over the worldwide economic outlook and the sovereign debt crisis in Europe have contributed to diminished expectations for global economic growth. Continued uncertainty or a deterioration in the economic conditions affecting the businesses to which, or geographic areas in which, we sell products could reduce demand for our products, and we may experience pricing pressure on products and services, which could decrease our revenues and have an adverse effect on our financial condition and cash flows. In addition, during periods of economic uncertainty, our customers may temporarily pursue inventory reduction measures that exceed declines in the actual underlying demand. Our businesses are sensitive to industry capacity utilization, particularly in Reinforcement Materials. As a result, pricing tends to fluctuate when capacity utilization changes occur, which could affect our financial performance.

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Plant capacity expansions may be delayed and/or not achieve the expected benefits.

Our ability to complete capacity expansions as planned may be delayed or interrupted by the need to obtain environmental and other regulatory approvals, availability of labor and materials, unforeseen hazards such as weather conditions, and other risks customarily associated with construction projects. In addition, our ability to expand capacity in emerging regions depends in part on economic and political conditions in these regions and, in some cases, on our ability to establish operations, construct additional manufacturing capacity or form strategic business alliances. Moreover, the cost of expanding capacity in Reinforcement Materials, Specialty Carbons and Compounds, Fumed Metal Oxides, Purification Solutions, and Inkjet Colorants could have a negative impact on the financial performance of these businesses until capacity utilization is sufficient to absorb the incremental costs associated with the expansion.

As a chemical manufacturing company, our operations have the potential to cause environmental or other damage as well as personal injury.

The operation of a chemical manufacturing business as well as the sale and distribution of chemical products involve safety, health and environmental risks. For example, the production and/or processing of carbon black, fumed metal oxides, aerogel, activated carbon and other chemicals involve the handling, transportation, manufacture or use of certain substances or components that may be considered toxic or hazardous within the meaning of applicable federal, state, local and foreign laws, regulations, rules and ordinances relating to safety, health and environmental matters. The transportation of chemical products and other activities associated with our manufacturing processes have the potential to cause environmental or other damage as well as injury or death to employees or third parties. We could incur significant expenditures in connection with such operational risks.

Our operations are subject to extensive safety, health and environmental requirements, which could increase our costs and/or reduce our profit.

Our ongoing operations are subject to extensive federal, state, local and foreign laws, regulations, rules and ordinances relating to safety, health and environmental matters, many of which provide for substantial monetary fines and criminal sanctions for violations. These requirements include requirements to obtain and comply with various environmental-related permits for constructing any new facilities and operating all of our existing facilities. The enactment of new environmental laws and regulations and/or the more aggressive interpretation of existing requirements could require us to incur significant costs for compliance or capital improvements or limit our current or planned operations, any of which could have a material adverse effect on our earnings or cash flow. See Item 3 Legal Proceedings Environmental Proceedings.

We may not realize the expected benefits from our acquisition of Norit.

With our acquisition of Norit, we have entered into a new area of the specialty chemicals business and there may be factors that affect this business with which we are not as familiar compared with our other existing businesses. We may not be successful retaining key customers and suppliers or key technical or other employees of the former Norit business, including those with knowledge of the activated carbon industry and activated carbon manufacturing processes. This integration requires significant attention from our management. The diversion of our management s attention away from our other businesses and any difficulties encountered in the integration process, including those related to the integration of information technology and other systems, could adversely affect our results of operations. In addition, the strategic growth plan for the mercury removal products and services portion of this business relies significantly upon the enforcement of restrictive environmental laws and regulations, particularly those that would require industrial facilities to reduce the quantity of air pollutants they release. Because of the uncertainty associated with the regulatory process, we are unable to predict with certainty when and how these new standards will affect demand for our activated carbon products.

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Any failure to realize benefits from acquisitions, alliances or joint ventures could adversely affect future financial results.

As part of our strategies for growth and improved profitability, we have made and may continue to make acquisitions and investments and enter into joint ventures. The success of acquisitions of new technologies, companies and products, or arrangements with third parties is not always predictable and we may not be successful in realizing our objectives as anticipated. We may not be able to integrate any acquired businesses successfully into our existing businesses, make such businesses profitable, or realize anticipated cost savings or synergies, if any, from these acquisitions, which could adversely affect our business.

An interruption in our operations as a result of fence-line arrangements could disrupt our manufacturing operations and adversely affect our financial results.

At certain of our facilities we have fence-line arrangements with adjacent third party manufacturing operations (fence-line partners), who provide raw materials for our manufacturing operations and/or take by-products generated from our operations. Accordingly, any unplanned disruptions or curtailments in a fence-line partner s production facilities that impacts their ability to supply us with raw materials or to take our manufacturing by-products could disrupt our manufacturing operations or cause us to incur increased operating costs to mitigate such disruption.

Volatility in the price of energy and raw materials could decrease our margins.

Our manufacturing processes consume significant amounts of energy and raw materials, the costs of which are subject to worldwide supply and demand as well as other factors beyond our control. Dramatic increases in such costs or decreases in the availability of raw materials at acceptable costs could have an adverse effect on our results of operations. For example, movements in the market price for crude oil typically affect carbon black feedstock costs. Significant movements in the market price for crude oil tend to create volatility in our carbon black feedstock costs, which can affect our working capital and results of operations. Certain of our carbon black supply contracts contain provisions that adjust prices to account for changes in a relevant feedstock price index. We attempt to offset the effects of increases in raw material costs through selling price increases in our non-contract sales, productivity improvements and cost reduction efforts. Success in offsetting increased raw material costs with price increases is largely influenced by competitive and economic conditions and could vary significantly depending on the segment served. Such increases may not be accepted by our customers, may not be sufficient to compensate for increased raw material and energy costs or may decrease demand for our products and our volume of sales. If we are not able to fully offset the effects of increased raw material or energy costs, it could have a significant impact on our financial results.

We are exposed to political or country risk inherent in doing business in some countries.

Sales outside of the U.S. constituted a majority of our revenues in fiscal 2012. Although much of our international business is currently in regions where the political and economic risk levels and established legal systems are similar to those in the United States, we also conduct business in countries that have less stable legal systems and financial markets, and potentially more corrupt business environments than the U.S. Our operations in some countries may be subject to the following risks: changes in the rate of economic growth; unsettled political or economic conditions; possible expropriation or other governmental actions; corruption by government officials and other third parties; social unrest, war, terrorist activities or other armed conflict; confiscatory taxation or other adverse tax policies; deprivation of contract rights; trade regulations affecting production, pricing and marketing of products; reduced protection of intellectual property rights; restrictions on the repatriation of income or capital; exchange controls; inflation; currency fluctuations and devaluation; the effect of global health, safety and environmental matters on economic conditions and market opportunities; and changes in financial policy and availability of credit. We have an equity method investment in Venezuela, a country that has established rigid controls over the ability of foreign companies to repatriate cash. Such exchange controls could potentially impact our ability, in both the short and long term, to recover both the cost of our investment and earnings from that investment.

We depend on a group of key customers for a significant portion of our sales. A significant adverse change in a customer relationship or in a customer s performance or financial position could harm our business and financial condition.

Our success in strengthening relationships and growing business with our largest customers and retaining their business over extended time periods could affect our future results. We have a group of key customers across our businesses that together represent a significant portion of our total net sales and operating revenues. The loss of any of our important customers, or a reduction in volumes sold to them because of a work stoppage or other disruption, could adversely affect our results of operations until such business is replaced or the disruption ends. Any deterioration in the financial condition of any of our customers or the industries they serve that impairs our customers ability to make payments to us also could increase our uncollectible receivables and could affect our future results and financial condition.

Our failure to successfully develop new products and technologies that address our customers changing requirements or competitive challenges may have a negative effect on our business results.

The end markets into which we sell our products are subject to periodic technological change, ongoing product improvements and changes in customer requirements. Increased competition from existing or newly developed products offered by our competitors or companies whose products offer a similar functionality as our products may negatively affect demand for our products. We work to identify, develop and market innovative products on a timely basis to meet our customers changing requirements and competitive challenges. If we fail to develop new products or keep pace with technological developments, our sales may be negatively impacted and our business results could be adversely affected.

Fluctuations in foreign currency exchange and interest rates could affect our financial results.

We earn revenues, pay expenses, own assets and incur liabilities in countries using currencies other than the U.S. dollar. In fiscal 2012, we derived a majority of our revenues from sales outside the United States. Because our consolidated financial statements are presented in U.S. dollars, we must translate revenues, income and expenses, as well as assets and liabilities, into U.S. dollars at exchange rates in effect during or at the end of each reporting period. Therefore, increases or decreases in the value of the U.S. dollar against other currencies in countries where we operate will affect our results of operations and the value of balance sheet items denominated in foreign currencies. Due to the geographic diversity of our operations, weaknesses in some currencies might be offset by strengths in others over time. In addition, we are exposed to adverse changes in interest rates. We manage both these risks through normal operating and financing activities and, when deemed appropriate, through the use of derivative instruments as well as foreign currency debt. We cannot be certain, however, that we will be successful in reducing the risks inherent in exposures to foreign currency and interest rate fluctuations.

There are also instances where we have direct current exposures to foreign currency movements because settlement back into a different currency is intended. These situations can have a direct impact on our cash flows.

The money we spend developing new businesses and technologies may not result in a proportional increase in our revenues or profits.

We cannot be certain that the costs we incur investing in new businesses and technologies will result in a proportional increase in revenues or profits. In addition, the timely commercialization of products that we are developing may be disrupted or delayed by manufacturing or other technical difficulties, market acceptance or insufficient market size to support a new product, competitors new products, and difficulties in moving from the experimental stage to the production stage. These disruptions or delays could affect our future business results.

Our tax rate is dependent upon a number of factors, a change in any of which could impact our future tax rates and net income.

Our future tax rates may be adversely affected by a number of factors, including the enactment of tax legislation currently being considered in the U.S.; other changes in tax laws or the interpretation of such tax laws; changes in the estimated realization of our net deferred tax assets; the jurisdictions in which profits are determined to be earned and taxed; the repatriation of non-U.S. earnings for which we have not previously provided for U.S. income and non-U.S. withholding taxes; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses that are not deductible for tax purposes, including impairment of goodwill in connection with acquisitions; changes in available tax credits; and the resolution of issues arising from tax audits with various tax authorities. Losses for which no tax benefits can be recorded could materially impact our tax rate and its volatility from one quarter to another. Any significant change in our jurisdictional earnings mix or in the tax laws in those jurisdictions could impact our future tax rates and net income in those periods.

Regulations requiring a reduction of greenhouse gas emissions will likely impact our carbon black and activated carbon operations.

Global efforts to reduce greenhouse gas emissions impact the carbon black and activated carbon industries as carbon dioxide is emitted in those manufacturing processes. The European Commission s Emissions Trading Scheme applies to a number of our carbon black and activated carbon facilities, and we generally expect to purchase emission credits where necessary to respond to allocation shortfalls. However, there can be no assurance that we will be able to purchase emissions credits if our carbon black or activated carbon operations generate more CO_2 than our allocations permit or that the cost of such credits will be acceptable to us. There are also ongoing discussions in other regions and countries, including the U.S., Canada, China and Brazil, regarding greenhouse gas emission reduction programs, but those programs have not yet been defined and their potential impact on our manufacturing operations or financial results cannot be estimated at this time.

Litigation or legal proceedings could expose us to significant liabilities and thus negatively affect our financial results.

As more fully described in Item 3 Legal Proceedings , we are a party to or the subject of lawsuits, claims, and proceedings, including those involving environmental, and health and safety matters as well as product liability and personal injury claims relating to asbestosis, silicosis, and coal worker s pneumoconiosis, and exposure to various chemicals. We are also a potentially responsible party in various environmental proceedings and remediation matters wherein substantial amounts are at issue. Adverse rulings, judgments or settlements in pending or future litigation (including liabilities associated with respirator claims) or in connection with environmental remediation activities could cause our results to differ materially from those expressed or forecasted in any forward-looking statements.

Our restructuring activities and cost saving initiatives may not achieve the results we anticipate.

We have undertaken and will continue to undertake cost reduction initiatives and organizational restructurings to improve operating efficiencies, optimize our asset base and generate cost savings. We cannot be certain that we will be able to complete these initiatives as planned or that the estimated operating efficiencies or cost savings from such activities will be fully realized or maintained over time. In addition, when we close manufacturing facilities, we may not be successful in migrating our customers from those closed facilities to our other facilities.

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The reduction or elimination of tariffs placed on U.S. and European imports of Chinese or other foreign activated carbon could have a material adverse effect on Purification Solutions.

Purification Solutions faces pressure and competition in its U.S. and European markets from imports of activated carbon products that are sold at unfairly low prices. In some end-markets, low-priced imports have become accepted as viable alternatives to our products because they are frequently sold at less than fair value in the market. If the amounts and acceptance of these low-priced imports increase, especially if they are sold at less than fair value, our sales of those products could decline, which could have an adverse effect on the earnings of Purification Solutions. In addition, sales of these low-priced imports may make it more difficult for Purification Solutions to pass through raw material cost increases to its customers. U.S. and European regulatory agencies have enacted antidumping duties to limit these activities. However, the antidumping duties in the U.S. could be reduced or eliminated in the future, and the antidumping duties in the European Union may or may not be renewed beyond 2013. If these antidumping duties are reduced or eliminated, the volume of low-priced activated carbon imports in the U.S and the European Union could increase and, therefore, reduce demand or pricing for our products and services.

The continued protection of our patents, trade secrets and other proprietary intellectual property rights are important to our success.

Our patents, trade secrets and other intellectual property rights are important to our success and competitive position. We own various patents and other intellectual property rights in the U.S. and other countries covering many of our products, as well as processes and product uses. Where we believe patent protection is not appropriate or obtainable, we rely on trade secret laws and practices to protect our proprietary technology and processes, such as physical security, limited dissemination and access and confidentiality agreements with our employees, customers, consultants, business partners, potential licensees and others to protect our trade secrets and other proprietary information. However, trade secrets can be difficult to protect and the protective measures we have put in place may not prevent disclosure or unauthorized use of our proprietary information or provide an adequate remedy in the event of misappropriation or other violations of our proprietary rights. In addition, we are a licensee of various patents and intellectual property rights belonging to others in the U.S. and other countries. Because the laws and enforcement mechanisms of some countries may not allow us to protect our proprietary rights to the same extent as we are able to in the U.S., the strength of our intellectual property rights will vary from country to country.

Irrespective of our proprietary intellectual property rights, we may be subject to claims that our products, processes or product uses infringe the intellectual property rights of others. These claims, even if they are without merit, could be expensive and time consuming to defend and if we were to lose such claims, we could be enjoined from selling our products or using our processes and/or be subject to damages, or be required to enter into licensing agreements requiring royalty payments and/or use restrictions. Licensing agreements may not be available to us, and if available, may not be available on acceptable terms.

We may be required to impair or write off certain assets if our assumptions about future sales and profitability prove incorrect.

In analyzing the value of our inventory, property, plant and equipment, investments and intangible assets, we have made assumptions about future sales (pricing and volume), costs and cash generation. These assumptions are based on management s best estimates and if the actual results differ significantly from these assumptions, we may not be able to realize the value of the assets recorded as of September 30, 2012, which could lead to an impairment or write-off of certain of these assets in the future.

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On occasion we enter into derivative contracts with financial counterparties. The effectiveness of these contracts is dependent on the ability of these financial counterparties to perform their obligations and their nonperformance could harm our financial condition.

We have entered into interest rate swap contracts and foreign currency derivatives as part of our financial strategy. The effectiveness of our hedging programs using these instruments is dependent, in part, upon the counterparties to these contracts honoring their financial obligations. If any of our counterparties are unable to perform their obligations in the future, we could be exposed to increased earnings and cash flow volatility due to an instrument s failure to hedge a financial risk.

We may be subject to information technology systems failures, network disruptions and breaches of data security.

Information technology systems failures, including risks associated with upgrading our systems, network disruptions and breaches of data security could disrupt our operations by impeding our processing of transactions, our ability to protect customer or company information and our financial reporting. Our computer systems, including our back-up systems, could be damaged or interrupted by power outages, computer and telecommunications failures, computer viruses, internal or external security breaches, events such as fires, earthquakes, floods, tornadoes and hurricanes, and/or errors by our employees. Although we have taken steps to address these concerns by implementing sophisticated network security and internal control measures and back-up systems at multiple sites, there can be no assurance that a system failure or data security breach will not have a material adverse effect on our financial condition and results of operations.

Natural disasters could affect our operations and financial results.

We operate facilities in areas of the world that are exposed to natural hazards, such as floods, windstorms and earthquakes. Such events could disrupt our supply of raw materials or otherwise affect production, transportation and delivery of our products or affect demand for our products.

Item 1B. ***Unresolved Staff Comments***

None.

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Item 2. ***Properties***

Cabot s corporate headquarters are in leased office space in Boston, Massachusetts. We also own or lease office, manufacturing, storage, distribution, marketing and research and development facilities in the United States and in foreign countries. The locations of our principal manufacturing and/or administrative facilities are set forth in the table below. Unless otherwise indicated, all the properties are owned.

Location by Region	Reinforcement Materials	Performance Materials	Advanced Technologies	Purification Solutions
Americas Region				
Mountain View, CA*			X	
Alpharetta, GA*(1)	X	X	X	X
Tuscola, IL		X		
Canal, LA	X	X		
Ville Platte, LA	X			
Billerica, MA	X	X	X	X
Haverhill, MA			X	
Midland, MI		X		
Albuquerque, NM (2 plants)*			X	
Pryor, OK				X
Marshall, TX				X
Pampa, TX	X	X		
Campana, Argentina	X			
Maua, Brazil	X	X		
Sao Paulo, Brazil*(1)	X	X	X	X
Cartagena, Colombia	X			
Lac du Bonnet, Manitoba**			X	
Sarnia, Ontario	X	X		

(1) Regional shared service center

* Leased premises

** Building(s) owned by Cabot on leased land

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Location by Region	Reinforcement Materials	Performance Materials	Advanced Technologies	Purification Solutions
EMEA Region				
Loncin, Belgium		X		
Leuven, Belgium*(1)	X	X	X	X
Pepinster, Belgium		X		
Valasske Mezirici (Valmez), Czech Republic**	X			
Port Jerome, France**	X			
Frankfurt, Germany*			X	
Rheinfelden, Germany		X		
Ravenna, Italy (2 plants)	X			X
Bergen, Norway*			X	
Kristiansund, Norway*			X	
Aberdeen, Scotland*			X	
Schaffhausen, Switzerland*	X	X	X	X
Botlek, The Netherlands**	X	X		
Amersfoort, The Netherlands*				X
Klazienaveen, The Netherlands				X
Zaandam, The Netherlands				X
Dubai, United Arab Emirates*		X		
Glasgow, United Kingdom				X
Purton, United Kingdom				X
Barry, Wales**		X		
Asia Pacific Region				
Jiangxi Province, China**		X		
Tianjin, China**	X	X		
Shanghai, China*(1)	X	X	X	X
Shanghai, China** (plant)	X			
Xingtai City, China**	X			
Mumbai, India*	X	X		
Cilegon, Indonesia**	X			
Jakarta, Indonesia*	X	X		
Merak, Indonesia	X			
Chiba, Japan	X			
Shimonoseki, Japan**	X			
Tokyo, Japan*	X	X	X	X
Port Dickson, Malaysia** (2 plants)	X		X	

(1) Regional shared service center

* Leased premises

** Building(s) owned by Cabot on leased land

We conduct research and development for our various businesses primarily at facilities in Billerica, MA; Albuquerque, NM; Amersfoort, The Netherlands; Marshall, TX; Mountain View, CA; Pampa, TX; Pepinster, Belgium; Frankfurt and Rheinfelden, Germany; Port Dickson, Malaysia.

Our existing manufacturing plants, together with announced capacity expansion plans, will generally have sufficient production capacity to meet current requirements and expected near-term growth. These plants are generally well maintained, in good operating condition and suitable and adequate for their intended use. Our administrative offices and other facilities are generally suitable and adequate for their intended purposes.

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Item 3. *Legal Proceedings*

Cabot is a party in various lawsuits and environmental proceedings wherein substantial amounts are claimed. The following is a description of the significant proceedings pending on September 30, 2012, unless otherwise specified.

Environmental Proceedings

In June 2009, Cabot received an information request from the United States Environmental Protection Agency (EPA) regarding Cabot s carbon black manufacturing facility in Pampa, Texas. The information request relates to the Pampa facility s compliance with certain regulatory and permitting requirements under the Clean Air Act, including the New Source Review (NSR) construction permitting requirements. EPA has indicated that this information request is part of an EPA national initiative focused on the U.S. carbon black manufacturing sector. Cabot responded to EPA s information request in August 2009 and is in discussions with EPA. Based upon those discussions, it is anticipated that Cabot will invest significant funds for capital improvements to install technology controls at certain U.S. facilities over a number of years, and pay a civil penalty to EPA to resolve the matter, which penalty has been reserved for in our financial statements. It is expected that other carbon black manufacturers will also be required to install technology controls at their U.S. facilities in connection with this initiative and are also likely to pay a civil penalty.

In an unrelated EPA matter, in June 2012, the activated carbon facility in Marshall, Texas that Cabot acquired in its acquisition of Norit received an information request from EPA. That request focuses on historic compliance with Clean Air Act permitting and regulatory requirements, including NSR requirements. Cabot is in the process of responding to that request. It is unknown at this time what prompted this request for information and how this matter will be resolved.

Cabot is one of fourteen companies, collectively the Ashtabula River Cooperating Group II (ARCG II), which participated in the remediation of the Ashtabula River in Ohio. Our liability at this site is associated with the former Cabot Titania business, which operated two manufacturing facilities in Ashtabula in the 1960s and early 1970s. In addition to the dredging and environmental restoration of the Ashtabula River, which was completed in 2009, the ARCG II also concluded a settlement with the Ashtabula River Natural Resource Trustees for alleged natural resource damages to the river. The Consent Decree memorializing this settlement was formally approved by the court in July 2012.

In 1986, Cabot sold a beryllium manufacturing facility in Reading, Pennsylvania to NGK Metals, Inc. (NGK). In doing so, we agreed to share with NGK the costs of certain environmental remediation of the Reading plant site. After the sale, the EPA issued an order to NGK pursuant to the Resource Conservation and Recovery Act (RCRA) requiring NGK to address soil and groundwater contamination at the site. Soil remediation at the site has been completed and the groundwater remediation activities are ongoing pursuant to the RCRA order. We are contributing to the costs of the groundwater remediation activities pursuant to the cost-sharing agreement with NGK. Cabot and NGK are also pursuing various legal claims against the United States for cost recovery and participation in future remediation activities based on the United States previous involvement at the site and contractual arrangements, beginning in World War II and continuing thereafter.

Cabot continues to perform certain sampling and remediation activities at a former pine tar manufacturing site in Gainesville, Florida that Cabot sold in the 1960s. Those activities are pursuant to a formal Record of Decision and 1991 Consent Decree with EPA. Cabot installed a groundwater treatment system at the site in the early 1990s, and that system is still in operation. Cabot has also been requested by EPA and other stakeholders to carry out various other additional work at the site. Cabot continues to work cooperatively with EPA, the Florida Department of Environmental Protection and the local authorities on this matter.

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As of September 30, 2012, we had a $7 million reserve on both a discounted and undiscounted basis for environmental remediation costs at various sites. The operation and maintenance component of this reserve was $3 million on both a discounted and undiscounted basis. The $7 million reserve represents our current best estimate of costs likely to be incurred for remediation based on our analysis of the extent of cleanup required, alternative cleanup methods available, abilities of other responsible parties to contribute and our interpretation of laws and regulations applicable to each of our sites.

Other Proceedings

Respirator Liabilities

We have exposure in connection with a safety respiratory products business that a subsidiary acquired from American Optical Corporation (AO) in an April 1990 asset purchase transaction. The subsidiary manufactured respirators under the AO brand and disposed of that business in July 1995. In connection with its acquisition of the business, the subsidiary agreed, in certain circumstances, to assume a portion of AO s liabilities, including costs of legal fees together with amounts paid in settlements and judgments, allocable to AO respiratory products used prior to the 1990 purchase by the Cabot subsidiary. In exchange for the subsidiary s assumption of certain of AO s respirator liabilities, AO agreed to provide to the subsidiary the benefits of: (i) AO s insurance coverage for the period prior to the 1990 acquisition and (ii) a former owner s indemnity of AO holding it harmless from any liability allocable to AO respiratory products used prior to May 1982.

Generally, these respirator liabilities involve claims for personal injury, including asbestosis, silicosis and coal worker s pneumoconiosis, allegedly resulting from the use of respirators that are claimed to have been negligently designed or labeled. Neither Cabot, nor its past or present subsidiaries, at any time manufactured asbestos or asbestos-containing products. At no time did this respiratory product line represent a significant portion of the respirator market.

The subsidiary transferred the business to Aearo Corporation (Aearo) in July 1995. Cabot agreed to have the subsidiary retain certain liabilities associated with exposure to asbestos and silica while using respirators prior to the 1995 transaction so long as Aearo paid, and continues to pay, Cabot an annual fee of $400,000. Aearo can discontinue payment of the fee at any time, in which case it will assume the responsibility for and indemnify Cabot against those liabilities which Cabot s subsidiary had agreed to retain. We anticipate that we will continue to receive payment of the $400,000 fee from Aearo and thereby retain these liabilities for the foreseeable future. We have no liability in connection with any products manufactured by Aearo after 1995.

In addition to Cabot s subsidiary and as described above, other parties are responsible for significant portions of the costs of respirator liabilities, leaving Cabot s subsidiary with a portion of the liability in only some of the pending cases. These parties include Aearo, AO, AO s insurers, and another former owner and its insurers (collectively, with the Company s subsidiary, the Payor Group).

As of both September 30, 2012 and 2011, there were approximately 42,000 claimants in pending cases asserting claims against AO in connection with respiratory products. Cabot has contributed to the Payor Group s defense and settlement costs with respect to a percentage of pending claims depending on several factors, including the period of alleged product use. In order to quantify our estimated share of liability for pending and future respirator liability claims, we have engaged, through counsel, the assistance of Hamilton, Rabinovitz & Alschuler, Inc. (HR&A), a leading consulting firm in the field of tort liability valuation. The methodology used by HR&A addresses the complexities surrounding our potential liability by making assumptions about future claimants with respect to periods of asbestos, silica and coal mine dust exposure and respirator use. Using those and other assumptions, HR&A estimates the number of future asbestos, silica and coal mine dust claims that will be filed and the related costs that would be incurred in resolving both currently pending and future claims. On this basis, HR&A then estimates the net present value of the share of these liabilities that reflect our period of direct manufacture and our contractual obligations. Based on the HR&A estimates, we have recorded on a discounted basis a $13 million reserve ($17 million on an undiscounted basis) to cover our estimated share of liability for pending and future respirator claims. We made payments related to our respirator liability of $2 million in fiscal 2012, $5 million in fiscal 2011 and $2 million in fiscal 2010.

Our current estimate of the cost of our share of existing and future respirator liability claims is based on facts and circumstances existing at this time. Developments that could affect our estimate include, but are not limited to, (i) significant changes in the number of future claims, (ii) changes in the rate of dismissals without payment of pending silica and non-malignant asbestos claims, (iii) significant changes in the average cost of resolving claims, (iv) significant changes in the legal costs of defending these claims, (v) changes in the nature of claims received, (vi) changes in the law and procedure applicable to these claims, (vii) the financial viability of members of the Payor Group, (viii) a change in the availability of AO s insurance coverage or the indemnity provided by AO s former owner, (ix) changes in the allocation of costs among the Payor Group, and (x) a determination that the assumptions used to estimate our share of liability are inaccurate. We cannot determine the impact of these potential developments on our current estimate of our share of liability for these existing and future claims. Accordingly, the actual amount of these liabilities for existing and future claims could be different than the reserved amount. Further, if the timing of our actual payments made for respirator claims differs significantly from our estimated payment schedule, and we determine that we can no longer reasonably predict the timing of such payments, we could then be required to record the reserve amount on an undiscounted basis on our Consolidated Balance Sheets, causing an immediate impact to earnings.

Other Matters

We have various other lawsuits, claims and contingent liabilities arising in the ordinary course of our business. These include a number of claims asserting premises liability for asbestos exposure and claims in respect of our divested businesses. In our opinion, although final disposition of some or all of these other suits and claims may impact our financial statements in a particular period, they should not, in the aggregate, have a material adverse effect on our financial position.

Item 4. ***Mine Safety Disclosures***

Not applicable.

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Executive Officers of the Registrant

Set forth below is certain information about Cabot s executive officers. Ages are as of November 29, 2012.

Patrick M. Prevost, age 57, is President and Chief Executive Officer and a member of Cabot s Board of Directors, positions he has held since joining Cabot in January 2008. Prior to joining Cabot, since October 2005, Mr. Prevost served as President, Performance Chemicals, of BASF AG, an international chemical company. Prior to that, he was responsible for BASF Corporation s Chemicals and Plastics business in North America. Prior to joining BASF in 2003, he held senior management positions at BP and Amoco.

Eduardo E. Cordeiro, age 45, is Executive Vice President and Chief Financial Officer. Mr. Cordeiro joined Cabot in 1998 as Manager of Corporate Planning and served in that position until January 2000. Mr. Cordeiro was Director of Finance and Investor Relations from January 2000 to March 2002, Corporate Controller from March 2002 to July 2003, General Manager of the Fumed Metal Oxides Business from July 2003 to January 2005, General Manager of the Supermetals Business from January 2005 to May 2008, and responsible for Corporate Strategy from May 2008 until February 2009, when he became Cabot s Chief Financial Officer. Mr. Cordeiro also co-managed Cabot Superior MicroPowders from November 2004 to May 2008. Mr. Cordeiro was appointed Vice President in March 2003 and Executive Vice President in March 2009.

David A. Miller, age 53, is Executive Vice President and President of Reinforcement Materials and of the Americas region. Prior to joining Cabot in September 2009, Mr. Miller held a variety of management positions in BP s chemical business in North America, Europe and Asia, including as President, Aromatics Asia, Europe and Middle East from January 2007 to July 2009, President, Global Purified Terephthalic Acid from October 2005 to January 2007, and Senior Vice President, Olefins and Derivatives China & Asia Operations (Innovene division) from January 2004 to October 2005.

Brian A. Berube, age 50, is Senior Vice President and General Counsel. Mr. Berube joined Cabot in 1994 as an attorney in Cabot s law department and became Deputy General Counsel in June 2001. Mr. Berube was appointed Vice President in March 2002 and Senior Vice President in March 2012. Mr. Berube has been General Counsel since March 2003.

Sean D. Keohane, age 45, is Senior Vice President and President of Performance Materials. Mr. Keohane joined Cabot in August 2002 as Global Marketing Director. Mr. Keohane was General Manager of the Specialty Carbons and Compounds Business from October 2003 until May 2008, when he was named General Manager of Performance Materials. He was appointed Vice President in March 2005, and Senior Vice President in March 2012. Before joining Cabot, Mr. Keohane worked for Pratt & Whitney, a division of United Technologies, in a variety of leadership positions.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Cabot s common stock is listed for trading (symbol CBT) on the New York Stock Exchange. As of November 16, 2012, there were 954 holders of record of Cabot s common stock. The tables below show the high and low sales price for Cabot s common stock for each of the fiscal quarters ended December 31, March 31, June 30, and September 30 and the quarterly cash dividend paid on Cabot s common stock for the past two fiscal years.

Stock Price and Dividend Data

	Quarters Ended			
	December 31	**March 31**	**June 30**	**September 30**
Fiscal 2012				
Cash dividends per share	$ 0.18	$ 0.18	$ 0.20	$ 0.20
Price range of common stock:				
High	$ 34.35	$ 43.76	$ 44.97	$ 41.75
Low	$ 22.45	$ 31.70	$ 35.11	$ 33.90
Fiscal 2011				
Cash dividends per share	$ 0.18	$ 0.18	$ 0.18	$ 0.18
Price range of common stock:				
High	$ 38.89	$ 47.11	$ 48.77	$ 43.42
Low	$ 32.19	$ 38.03	$ 36.92	$ 23.75

Issuer Purchases of Equity Securities

The table below sets forth information regarding Cabot s purchases of its equity securities during the quarter ended September 30, 2012:

Period	Total Number of Shares Purchased[(1)]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[(1)]	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs[(1)]
July 1, 2012 July 31, 2012	768	$ 39.60		1,636,906
August 1, 2012 August 31, 2012		$		1,636,906
September 1, 2012 September 30, 2012		$		1,636,906
Total	768			

(1) On May 11, 2007, we publicly announced that the Board of Directors authorized us to repurchase five million shares of our common stock on the open market or in privately negotiated transactions. On September 14, 2007, the Board of Directors increased the share repurchase authorization to 10 million shares (the 2007 Authorization). This authorization does not have a set expiration date. In the fourth quarter of 2012 we did not repurchase shares under this authorization.

In addition to the 2007 Authorization, in certain circumstances the Board has authorized us to repurchase shares of restricted stock purchased by recipients of certain long-term incentive awards after such shares vest to satisfy tax withholding obligations and associated loan repayment liabilities. The shares are repurchased from employees at fair market value. During the fourth quarter of fiscal 2012, we repurchased 768 shares from employees under this authorization.

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Item 6. ***Selected Financial Data***

On July 31, 2012, Cabot completed the purchase of Norit NV. The operating results and ratios presented below for fiscal 2012 include two months of results of Norit NV. The September 30, 2012 balance sheet items presented below include those of Norit N.V.

On January 20, 2012, the Company completed the sale of its Supermetals Business. The results of its operations for all periods presented are reflected as discontinued operations in the Consolidated Statements of Operations.

	Years Ended September 30				
	2012	**2011**	**2010**	**2009**	**2008**
	(Dollars in millions, except per share amounts and ratios)				
Consolidated Net Income (Loss)					
Net sales and other operating revenues	$ 3,300	$ 3,102	$ 2,716	$ 2,108	$ 3,001
Gross profit	648	558	510	217	459
Selling and administrative expenses	285	249	241	205	238
Research and technical expenses	73	66	65	66	68
Income (loss) from operations[1]	290	243	204	(54)	153
Net interest expense and other charges[2]	(45)	(40)	(38)	(45)	(52)
Income (loss) from continuing operations	245	203	166	(99)	101
(Provision) benefit for income taxes[3]	(55)	(6)	(30)	21	(10)
Equity in earnings of affiliated companies	11	8	7	5	8
Income (loss) from discontinued operations, net of tax	205	53	26	(2)	7
Net income (loss)	406	258	169	(75)	106
Net income attributable to noncontrolling interests, net of tax	18	22	15	2	20
Net income (loss) attributable to Cabot Corporation	$ 388	$ 236	$ 154	$ (77)	$ 86
Common Share Data					
Diluted net income (loss) attributable to Cabot Corporation:					
Income (loss) from continuing operations	$ 2.83	$ 2.77	$ 1.94	$ (1.21)	$ 1.21
Income (loss) from discontinued operations	3.16	0.80	0.41	(0.04)	0.11
Net income (loss) attributable to Cabot Corporation	$ 5.99	$ 3.57	$ 2.35	$ (1.25)	$ 1.32
Dividends	$ 0.76	$ 0.72	$ 0.72	$ 0.72	$ 0.72
Closing prices	$ 36.57	$ 24.78	$ 32.57	$ 23.11	$ 31.78
Weighted-average diluted shares outstanding millions[4]	64.2	65.4	64.3	62.8	62.8
Shares outstanding at year end millions	63.3	63.9	65.4	65.3	65.3
Consolidated Financial Position					
Current assets	$ 1,443	$ 1,555	$ 1,438	$ 1,200	$ 1,408
Net property, plant, and equipment	1,552	1,036	937	972	1,035
Other assets	1,404	550	511	504	415
Total assets	$ 4,399	$ 3,141	$ 2,886	$ 2,676	$ 2,858
Current liabilities	$ 919	$ 656	$ 539	$ 477	$ 601
Long-term debt	1,172	556	600	623	586
Other long-term liabilities	369	313	330	339	312
Cabot Corporation stockholders equity	1,813	1,487	1,302	1,134	1,249

Noncontrolling interests	126	129	115	103	110
Total liabilities and stockholders equity	$ 4,399	$ 3,141	$ 2,886	$ 2,676	$ 2,858
Working capital[5]	$ 524	$ 899	$ 899	$ 723	$ 807
Selected Financial Ratios					
Adjusted return on invested capital[6]	12%	16%	14%	2%	8%
Net debt to capitalization ratio[7]	40%	20%	16%	22%	30%

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(1) Income (loss) from operations includes certain items as presented in the table below:

	Years Ended September 30				
	2012	2011	2010	2009	2008
	(Dollars in millions)				
Global restructuring activities	$ (17)	$ (18)	$ (46)	$ (87)	$ (5)
Environmental and legal reserves	(4)	(1)	(3)		(3)
Reserve for respirator claims	(4)		(2)		2
Acquisition related charges	(26)				
Long-lived asset impairment			(2)		
Debt issuance costs					(2)
Write-down of impaired investments				(1)	
Executive transition costs				(4)	(4)
Certain items, pre-tax	$ (51)	$ (19)	$ (53)	$ (92)	$ (12)

(2) Net interest expense and other charges for fiscal 2012, 2011, 2009 and 2008 include foreign currency losses of $2 million, $6 million, $15 million and $14 million, respectively. Net interest expense and other charges for fiscal 2010 includes foreign currency gains of less than $1 million.

(3) The Company s tax rate for fiscal 2012 was a provision of 22% which includes net discrete tax benefits of $8 million from the release of a valuation allowance and $3 million from settlements and miscellaneous tax items. The Company s tax rate for fiscal 2011 was a provision of 3% which includes net tax benefits of $24 million from the repatriation of high taxed income, $10 million from the settlements of various tax audits, $2 million from the renewal of the U.S. research and experimentation (R&E) credit and $2 million for investment incentive tax credits recognized in China. The Company s tax rate for fiscal 2010 was a provision of 18% which includes net tax benefits of $15 million from the settlements of various tax audits and $2 million for investment incentive tax credits. The Company s tax rate for fiscal 2009 was a benefit of 21%, which includes $12 million of net tax benefits resulting from settlements of various tax audits and tax credits during the year. The Company s tax rate for fiscal 2008 was a provision of 10%, which includes approximately $11 million of net tax benefits resulting from settlements of various tax audits and tax credits during the year.

(4) The weighted-average diluted shares outstanding for fiscal 2009 exclude approximately 4 million shares as those shares would have had an antidilutive effect due to the Company s net loss position.

(5) Working capital is total current assets less total current liabilities.

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(6) Adjusted return on invested capital (Adjusted ROIC) is a non-GAAP financial measure that management believes is useful to investors as a measure of performance and the effectiveness of our use of capital. We use Adjusted ROIC as one measure to monitor and evaluate performance. ROIC is not a measure of financial performance under GAAP and may not be defined and calculated by other companies in the same manner. Adjusted ROIC, which excludes items that management considers to be unusual and not representative of the Company s segment results, is calculated as follows.

Numerator (four quarter rolling):

Net income (loss) attributable to Cabot Corporation

Less the after-tax impact of:

Noncontrolling interest in net income

Interest expense

Interest income

Certain items

Denominator:

Previous four quarter average invested capital calculated as follows:

Total Cabot Corporation stockholders equity

Plus: Noncontrolling interests equity

Long-term debt

Current portion of long-term debt

Notes payable to banks

Less: Cash and cash equivalents

Less the four quarter rolling impact of after tax certain items.

(7) Net debt to capitalization ratio is calculated by dividing total debt (the sum of short-term and long-term debt less cash and cash equivalents) by total capitalization (the sum of Total stockholder s equity plus total debt).

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***
Critical Accounting Policies

The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosure of contingent assets and liabilities. We consider an accounting estimate to be critical to the financial statements if (i) the estimate is complex in nature or requires a high degree of judgment and (ii) different estimates and assumptions were used, the results could have a material impact on the consolidated financial statements. On an ongoing basis, we evaluate our estimates and application of our policies. We base our estimates on historical experience, current conditions and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The policies that we believe are critical to the preparation of the Consolidated Financial Statements are presented below.

Revenue Recognition and Accounts and Notes Receivable

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collectibility is reasonably assured. We generally are able to ensure that products meet customer specifications prior to shipment. If we are unable to determine that the product has met the specified objective criteria prior to shipment or if title has not transferred because of shipping terms, the revenue is considered unearned and is deferred until the revenue recognition criteria are met.

Shipping and handling charges related to sales transactions are recorded as sales revenue when billed to customers or included in the sales price.

The following table shows the relative size of the revenue recognized in each of our reportable segments.

	Years ended September 30		
	2012	**2011**	**2010**
Reinforcement Materials	63%	65%	63%
Performance Materials	28%	29%	30%
Advanced Technologies	7%	6%	7%
Purification Solutions[(1)]	2%	N/A	N/A

(1) Consists of two months of revenues for Norit, which we acquired on July 31, 2012.

We derive the substantial majority of revenues from the sale of products in Reinforcement Materials and Performance Materials. Revenue from these products is typically recognized when the product is shipped and title and risk of loss have passed to the customer. We offer certain customers cash discounts and volume rebates as sales incentives. The discounts and volume rebates are recorded as a reduction in sales at the time revenue is recognized and are estimated based on historical experience and contractual obligations. We periodically review the assumptions underlying the estimates of discounts and volume rebates and adjust revenues accordingly.

Revenue in Advanced Technologies, excluding the Specialty Fluids Business, is typically recognized when the product is shipped and title and risk of loss have passed to the customer. Depending on the nature of the contract with the customer, a portion of the revenue may be recognized using proportional performance.

A significant portion of the revenue in the Specialty Fluids Business, included in Advanced Technologies, arises from the rental of cesium formate. This revenue is recognized throughout the rental period based on the contracted rental terms. Customers are also billed and revenue is recognized, typically at the end of the job, for cesium formate product that is not returned. We also generate revenues from cesium formate sold outside of a rental process and revenue is recognized upon delivery of the fluid.

Revenue in Purification Solutions is typically recognized when the product is shipped and title and risk of loss have passed to the customer. For major activated carbon injection systems projects, revenue is recognized using the percentage-of-completion method.

We maintain allowances for doubtful accounts based on an assessment of the collectibility of specific customer accounts, the aging of accounts receivable and other economic information on both a historical and prospective basis. Customer account balances are charged against the allowance when it is probable the receivable will not be recovered. Changes in the allowance during fiscal 2012, 2011 and 2010 were not material. There is no off-balance sheet credit exposure related to customer receivable balances.

Inventory Valuation

The cost of all carbon black inventories in the U.S. is determined using the last-in, first-out (LIFO) method. Total U.S. inventories utilizing this cost flow assumption was $26 million at September 30, 2012 and $32 million at September 30, 2011. These inventories represent 5% and 8% of total worldwide inventories at the respective year-ends. Had we used the first-in, first-out (FIFO) method instead of the LIFO method for such inventories, the value of those inventories would have been $52 million and $53 million higher as of September 30, 2012 and 2011, respectively. The cost of Specialty Fluids inventories is determined using the average cost method. The cost of other U.S. and all non-U.S. inventories is determined using the FIFO method. In periods of rapidly rising or declining raw material costs, the inventory method we employ can have a significant impact on our profitability. Under our current LIFO method, when raw material costs are rising, our most recent higher priced purchases are the first to be charged to cost of sales. If, however, we were using a FIFO method, our purchases from earlier periods, which were at lower prices, would instead be the first charged to cost of sales. The opposite result could occur during a period of rapid decline in raw material costs.

At certain times, we may decrease inventory levels to the point where layers of inventory recorded under the LIFO method that were purchased in preceding years are liquidated. The inventory in these layers may be valued at an amount that is different than our current costs. If there is a liquidation of an inventory layer, there may be an impact to our cost of sales and net income for that period. If the liquidated inventory is at a cost lower than our current cost, there would be a reduction in our cost of sales and an increase to our net income during the period. Conversely, if the liquidated inventory is at a cost higher than our current cost, there will be an increase in our cost of sales and a reduction to our net income during the period.

During fiscal 2012, inventory quantities carried on a LIFO basis were reduced, leading to liquidations of LIFO inventory quantities. These LIFO layer liquidations resulted in a decrease of cost of goods sold of $1 million and an increase in consolidated net income of $1 million ($0.01 per diluted common share) for fiscal 2012. No such reductions occurred in either fiscal 2011 or 2010.

We review inventory for both potential obsolescence and potential loss of value periodically. In this review, we make assumptions about the future demand for and market value of the inventory and based on these assumptions estimate the amount of any obsolete, unmarketable or slow moving inventory. We write down the value of our inventories by an amount equal to the difference between the cost of inventory and the estimated market value. Historically, such write-downs have not been significant. If actual market conditions are less favorable than those projected by management at the time of the assessment, however, additional inventory write-downs may be required, which could reduce our gross profit and our earnings.

Stock-based Compensation

We have issued restricted stock, restricted stock units, and stock options under our equity compensation plans. The fair value of restricted stock and restricted stock units is the closing price of our stock on the day of the grant. The fair value is recognized as expense over the service period, which generally represents the vesting period. The vesting of certain restricted stock units is dependent on certain performance-based criteria. We evaluate the likelihood of achievement of such performance objectives each quarter and record stock-based compensation based on this assessment. There are no other significant estimates involved in recording compensation costs for restricted stock units with the exception of estimates we make around the probability of forfeitures. Changes in the forfeiture assumptions could impact our earnings but would not impact our cash flows.

We use the Black-Scholes option pricing model to calculate the fair value of stock options issued under our equity compensation plans. In determining the fair value of stock options, we make a variety of assumptions and estimates, including discount rates, volatility measures, expected dividends and expected option lives. Changes to such assumptions and estimates can result in different fair values and could therefore impact our earnings. Such changes would not impact our cash flows.

Goodwill and Long-Lived Assets

Goodwill is comprised of the purchase price of business acquisitions in excess of the fair value assigned to the net tangible and identifiable intangible assets acquired. We use assumptions and estimates in determining the fair value of assets acquired and liabilities assumed in a business combination. The determination of the fair value of intangible assets requires the use of significant judgment with regard to (i) assumptions used in the determination of fair value; and (ii) determination of their useful lives. We estimate the fair value of identifiable acquisition-related intangible assets principally based on projections of cash flows that will arise from these assets. The projected cash flows are discounted to determine the present value of the assets at the date of acquisition. We review definite-lived intangible assets for impairment when indication of potential impairment exists, such as a significant reduction in cash flows associated with the assets. Actual cash flows arising from a particular intangible asset could vary from projected cash flows which could imply different carrying values from those established at the date of acquisition and which could result in impairment of such asset. We evaluate indefinite-lived intangible assets for impairment annually and when events occur or circumstances change that may reduce the fair value of the asset below its carrying amount.

Goodwill is not amortized but is reviewed for impairment annually, or when events or changes in the business environment indicate that the carrying value of the reporting unit may exceed its fair value. During fiscal 2012, we adopted the authoritative guidance that simplifies how entities test goodwill for impairment and permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value amount and as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. Alternatively, we may elect to proceed directly to the two-step goodwill impairment test. If an initial qualitative assessment identifies that it is more likely than not that the carrying value of a reporting unit exceeds its estimated fair value, additional quantitative evaluation is performed under the two-step impairment test. If based on the quantitative evaluation the fair value of the reporting unit is less than its carrying amount, we perform an analysis of the fair value of all assets and liabilities of the reporting unit. If the implied fair value of the reporting unit s goodwill is determined to be less than its carrying amount, an impairment is recognized for the difference.

We primarily utilize a discounted cash flow method to calculate the fair value of our reporting units. The assumptions used to estimate the discounted cash flows are based on our best estimates of future growth rates, operating cash flows, capital expenditures, discount rates and market conditions over an estimate of the remaining operating period at the reporting unit level. The discount rate is based on the weighted average cost of capital that is determined by evaluating the risk free rate of return, cost of debt, and expected equity premiums.

As of September 30, 2012, our goodwill balance is allocated among four reportable segments: Purification Solutions, $439 million, Reinforcement Materials, $28 million, Performance Materials, $11 million, and Advanced Technologies, $2 million. The goodwill allocated to Purification Solutions is based on preliminary estimates of the fair value of assets acquired and liabilities assumed from the acquisition of Norit on July 31, 2012 as the Company is continuing to obtain information to complete its valuation of these accounts and the associated tax accounting. We performed our annual impairment assessment as of March 31, 2012 and determined that there was no impairment. During fiscal 2012, we changed our annual goodwill impairment testing date from March 31 to May 31. We performed an impairment assessment as of May 31, 2012 and consistent with the March 31, 2012 assessment, concluded that there was no impairment. See Note G of the Consolidated Financial Statements for further information. There has been no goodwill impairment charge during any of the periods presented in these consolidated financial statements.

Our long-lived assets primarily include property, plant and equipment, long-term investments, assets held for rent and sale and intangible assets. We review the carrying values of long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of an asset may not be recoverable. Such circumstances would include, but are not limited to, a significant decrease in the market price of the long-lived asset, a significant adverse change in the way the asset is being used, a decline in the physical condition of the asset or a history of operating or cash flow losses associated with the use of the asset. In the recent past, impairments have generally been recognized when we determine that we will restructure certain operations.

To test for impairment of assets we generally use a probability-weighted estimate of the future undiscounted net cash flows of the assets or asset grouping over the remaining life of the asset to determine if the asset is recoverable. If we determine that the asset is not recoverable, we determine if there is a potential impairment loss by calculating the fair value of the asset using a probability-weighted discounted estimate of future cash flows. The discount rate is based on the weighted average cost of capital that is determined by evaluating the risk free rate of return, cost of debt, and expected equity premiums. To the extent the carrying value exceeds the fair value of the asset or asset group, an impairment loss is recognized in the statement of operations in that period.

Financial Instruments

Our financial instruments consist primarily of cash and cash equivalents, accounts and notes receivables, investments, notes receivable from the sale of a business, accounts payable and accrued liabilities, short-term and long-term debt, and derivative instruments. The carrying values of our financial instruments approximate fair value with the exception of our long-term debt that has not been designated as part of a fair value hedge. The non-hedged long-term debt is recorded at amortized cost. The fair values of our financial instruments are based on quoted market prices, if such prices are available. In situations where quoted market prices are not available, we rely on valuation models to derive fair value. For interest rate swaps and cross currency swaps, we use standard models with market-based inputs. The significant inputs to these models are interest rate curves for discounting future cash flows. In determining the fair value of the commodity derivatives, the significant inputs to valuation models are quoted market prices of similar instruments in active markets. Such valuation takes into account the ability of the financial counterparty to perform.

We use derivative financial instruments primarily for purposes of hedging exposures to fluctuations in interest rates and foreign currency exchange rates, which exist as part of our on-going business operations. We do not enter into derivative contracts for speculative purposes, nor do we hold or issue any financial instruments for trading purposes. All derivatives are recognized on our Consolidated Balance Sheets at fair value. Where we have a legal right to offset derivative settlements under a master netting agreement with a counterparty, derivatives with that counterparty are presented on a net basis. The changes in the fair value of derivatives are recorded in either earnings or accumulated other comprehensive income, depending on whether or not the instrument is designated as part of a hedge transaction and, if designated as part of a hedge transaction, the type of hedge transaction. The gains or losses on derivative instruments reported in accumulated other comprehensive income are reclassified to earnings in the period in which earnings are affected by the underlying hedged item. The ineffective portion of all hedges is recognized in earnings during the period in which the ineffectiveness occurs.

In accordance with our risk management strategy, we may enter into certain derivative instruments that may not be designated as hedges for accounting purposes. Although these derivatives are not designated as hedges, we believe that such instruments are closely correlated with the underlying exposure, thus managing the associated risk. We record in earnings the gains or losses from changes in the fair value of derivative instruments that are not designated as hedges. Cash movements associated with these instruments are presented in the Consolidated Statements of Cash Flows as Cash Flows from Operating Activities because the derivatives are designed to mitigate risk to our cash flow from operations.

Assets and liabilities measured at fair value, including assets that are part of our defined benefit pension plans, are classified in the fair value hierarchy based on the inputs used for valuation. Assets that are actively traded on an exchange with a quoted price are classified as Level 1. Assets and liabilities that are valued based on quoted prices for similar assets or liabilities in active markets, or standard pricing models using observable inputs are classified as Level 2. As of September 30, 2012, we have no assets or liabilities carried at fair value that are valued using unobservable inputs and, therefore, no assets or liabilities that are classified as Level 3. The sensitivity of fair value estimates is immaterial relative to the assets and liabilities measured at fair value, as well as to our total equity, as of September 30, 2012.

Pensions and Other Postretirement Benefits

We maintain both defined benefit and defined contribution plans for our employees. In addition, we provide certain postretirement health care and life insurance benefits for our retired employees. Plan obligations and annual expense calculations are based on a number of key assumptions. The assumptions, which are specific for each of our U.S. and foreign plans, are related to both the assets we hold to fund our plans (where applicable) and the characteristics of the benefits that will ultimately be provided to our employees. The most significant assumptions relative to our plan assets include the anticipated rates of return on these assets. Assumptions relative to our pension obligations are more varied; they include estimated discount rates, rates of compensation increases for employees, mortality, employee turnover and other related demographic data. Projected health care and life insurance obligations also rely on the above mentioned demographic assumptions and assumptions surrounding health care cost trends. Actual results that differ from the assumptions are generally accumulated and amortized over future periods and could therefore affect the recognized expense and recorded obligation in such future periods. However, cash flow requirements may be different from the amounts of expense that are recorded in the consolidated financial statements. In fiscal 2012, we incurred curtailment and settlement gains and losses in the U.S. and foreign employee benefit plans as a result of the sale of the Supermetals Business and the freezing of two defined benefit plans in foreign affiliates.

Self-Insurance Reserves

We are partially self-insured for certain third-party liabilities globally, as well as workers compensation and employee medical benefits in the United States. The third-party and workers compensation liabilities are managed through a wholly-owned insurance captive and the related liabilities are included in the consolidated financial statements. The employee medical obligations are managed by a third-party provider and the related liabilities are included in the consolidated financial statements. To limit our potential liabilities for these risks in the U.S., however, we purchase insurance from third-parties that provides individual and aggregate stop loss protection. The aggregate self-insured liability in fiscal 2012 for combined U.S. third party liabilities and U.S. workers compensation is $5 million, and the retention for medical costs in the United States is at most $200,000 per person per annum. We have accrued amounts equal to the actuarially determined future liabilities. We determine the actuarial assumptions in collaboration with third-party actuaries, based on historical information along with certain assumptions about future events. Changes in assumptions for such matters as legal actions, medical costs and changes in actual experience could cause these estimates to change and impact our earnings and cash flows.

Asset Retirement Obligations

We account for asset retirement obligations by estimating incremental costs for special handling, removal and disposal costs of materials that may or will give rise to conditional asset retirement obligations

(AROs) and then discount the expected costs back to the current year using a credit adjusted risk-free rate. ARO liabilities and costs are recognized when the timing and/or settlement can be reasonably estimated. If it is unclear when, or if, an ARO will be triggered, we use probability weightings for possible timing scenarios to determine the amounts that should be recognized in our financial statements.

The estimation of AROs is subject to a number of inherent uncertainties including: (a) the timing of when any ARO may be incurred, (b) the ability to accurately identify and reasonably estimate the costs of all materials that may require special handling or treatment, (c) the ability to assess the relative probability of different scenarios that could give rise to an ARO, and (d) other factors outside our control, including changes in regulations, costs and interest rates.

AROs have not been recognized for certain of our facilities because either the present value of the obligation cannot be reasonably estimated due to an indeterminable facility life or we do not have a legal obligation associated with the retirement of those facilities. In most circumstances where AROs have been recorded, the anticipated cash outflows will likely take place far into the future. Accordingly, actual costs and the timing of such costs may vary significantly from our estimates, which may, in turn, impact our earnings. In general, however, when such estimates change, the impact is spread over future years and thus the impact on any individual year is unlikely to be material.

Litigation and Contingencies

We are involved in litigation in the ordinary course of business, including personal injury and environmental litigation. After consultation with counsel, as appropriate, we accrue a liability for litigation when it is probable that a liability has been incurred and the amount can be reasonably estimated. The estimated reserves are recorded based on our best estimate of the liability associated with such matters or the low end of the estimated range of liability if we are unable to identify a better estimate within that range. Our best estimate is determined through the evaluation of various information, including claims, settlement offers, demands by government agencies, estimates performed by independent third parties, identification of other responsible parties and an assessment of their ability to contribute, and our prior experience. Litigation is highly uncertain and there is always the possibility of an unusual result in any particular case that may reduce our earnings and cash flows.

The most significant reserves that we have established are for environmental remediation and respirator litigation claims. The amount accrued for environmental matters reflects our assumptions about remediation requirements at the contaminated sites, the nature of the remedies, the outcome of discussions with regulatory agencies and other potentially responsible parties at multi-party sites, and the number and financial viability of other potentially responsible parties. A portion of the reserve for environmental matters is recognized on a discounted basis, which requires the use of an estimated discount rate and estimates of future cash flows associated with the liability. These liabilities can be affected by the availability of new information, changes in the assumptions on which the accruals are based, unanticipated government enforcement action or changes in applicable government laws and regulations, which could result in higher or lower costs.

Our current estimate of the cost of our share of existing and future respirator liability claims is based on facts and circumstances existing at this time and the amount accrued is recognized on a discounted basis. Developments that could affect our estimate include, but are not limited to, (i) significant changes in the number of future claims, (ii) changes in the rate of dismissals without payment of pending silica and non-malignant asbestos claims, (iii) significant changes in the average cost of resolving claims, (iv) significant changes in the legal costs of defending these claims, (v) changes in the nature of claims received, (vi) changes in the law and procedure applicable to these claims, (vii) the financial viability of other parties which contribute to the settlement of respirator claims, (viii) a change in the availability of insurance coverage maintained by the entity from which we acquired the safety respirators products business or the indemnity provided by its former owner, (ix) changes in the allocation of costs among the various parties paying legal and settlement costs, and (x) a determination that the assumptions used to estimate our share of liability are inaccurate. We cannot determine the impact of these potential developments on our current estimate of our share of liability for these existing and future claims. Accordingly, the actual amount of these liabilities for existing and future claims could be different than the reserved amount. Further, if the timing of our actual payments made for respirator claims differs significantly from our estimated payment schedule, and we determine that we can no longer reasonably predict the timing of such payments, we could then be required to record the reserve amount on an undiscounted basis on our Consolidated Balance Sheets, causing an immediate impact to earnings.

Income Taxes

Our business operations are global in nature, and we are subject to taxes in numerous jurisdictions. Tax laws and tax rates vary substantially in these jurisdictions and are subject to change based on the political and economic climate in those countries. We file our tax returns in accordance with our interpretations of each jurisdiction s tax laws.

Significant judgment is required in determining our worldwide provision for income taxes and recording the related tax assets and liabilities. In the ordinary course of our business, there are operational decisions, transactions, facts and circumstances, and calculations which make the ultimate tax determination uncertain. Furthermore, our tax positions are periodically subject to challenge by taxing authorities throughout the world. We have recorded reserves for taxes and associated interest and penalties that may become payable in future years as a result of audits by tax authorities. Any significant impact as a result of changes in underlying facts, law, tax rates, tax audit, or review could lead to adjustments to our income tax expense, our effective tax rate, and/or our cash flow.

We record benefits for uncertain tax positions based on an assessment of whether the position is more likely than not to be sustained by the taxing authorities. If this threshold is not met, no tax benefit of the uncertain tax position is recognized. If the threshold is met, the tax benefit that is recognized is the largest amount that is greater than 50% likely of being realized upon ultimate settlement. This analysis presumes the taxing authorities full knowledge of the positions taken and all relevant facts, but does not consider the time value of money. We also accrue for interest and penalties on these uncertain tax positions and include such charges in the income tax provision in the Consolidated Statements of Operations.

Additionally, we have established valuation allowances against a variety of deferred tax assets, including net operating loss carry-forwards, foreign tax credits, and other income tax credits. Valuation allowances take into consideration our ability to use these deferred tax assets and reduce the value of such items to the amount that is deemed more likely than not to be recoverable. Our ability to utilize these deferred tax assets is dependent on achieving our forecast of future taxable operating income over an extended period of time. We review our forecast in relation to actual results and expected trends on a quarterly basis. Failure to achieve our operating income targets may change our assessment regarding the recoverability of our net deferred tax assets and such change could result in a valuation allowance being recorded against some or all of our net deferred tax assets. An increase in a valuation allowance would result in additional income tax expense, while a release of valuation allowances in periods when these tax attributes become realizable would reduce our income tax expense.

Highly Inflationary Environments

We monitor the currencies of countries in which we operate in order to determine if the country should be considered a highly inflationary environment. If and when a currency is determined to be highly inflationary (cumulative inflation of approximately 100 percent or more over a 3-year period), the functional currency of the affected operation would be changed to our reporting currency, the U.S. dollar. Due to cumulative inflation in Venezuela over a three-year period exceeding 100% as of January 1, 2010, the functional currency of our Venezuelan operating entity has changed to the U.S. dollar.

Restructuring Activities

Our consolidated financial statements detail specific charges relating to restructuring activities as well as the actual spending that has occurred against the resulting accruals. Our restructuring charges are estimates based on our preliminary assessments of (i) severance and other employee benefits to be granted to employees, which are based on known benefit formulas and identified job grades, (ii) costs to vacate certain facilities and (iii) asset impairments. Because these accruals are estimates, they are subject to change as a result of subsequent information that may come to our attention while executing the restructuring plans. These changes in estimates would then be reflected in our consolidated financial statements.

Significant Accounting Policies

We have other significant accounting policies that are discussed in Note A of the Notes to our Consolidated Financial Statements in Item 8 below. Certain of these policies include the use of estimates, but do not meet the definition of critical because they generally do not require estimates or judgments that are as difficult or subjective to measure. However, these policies are important to an understanding of the consolidated financial statements.

Results of Operations

Definition of Terms and Non-GAAP Financial Measures

When discussing our results of operations, we use several terms as described below.

The term product mix refers to the various types and grades, or mix, of products sold in a particular business or segment during the period, and the positive or negative impact of that mix on the revenue or profitability of the business or segment.

The discussion under the heading Provision for income taxes includes a discussion of our operating tax rate . In calculating our operating tax rate, we exclude discrete tax items, which are unusual or infrequent items, and the impact of certain items on both operating income and the tax provision.

The term LIFO includes two factors: (i) the impact of current inventory costs being recognized immediately in cost of goods sold (COGS) under a last-in first-out method, compared to the older costs that would have been included in COGS under a first-in first-out method (COGS impact); and (ii) the impact of reductions in inventory quantities, causing historical inventory costs to flow through COGS (liquidation impact).

Total Segment EBIT is a non-GAAP performance measure, and should not be considered an alternative for Income from continuing operations before taxes, the most directly comparable GAAP financial measure. In calculating Total Segment EBIT, we make certain adjustments such as excluding certain items, meaning items that management does not consider representative of our fundamental segment results. Segment EBIT includes Equity in net income of affiliated companies, net of tax, the full operating results of a contractual joint venture in Purification Solutions, royalties paid by equity affiliates and Net income attributable to noncontrolling interests, net of tax, but exclude Interest expense, foreign currency transaction gains and losses, interest income, dividend income, unearned revenue, the effects of LIFO accounting for inventory, and unallocated general and corporate costs. Our Chief Operating Decision Maker uses Segment EBIT to evaluate the operating results of each segment and to allocate resources to the segments. We believe that this non-GAAP measure provides useful supplemental information for our investors as it is an important indicator of the Company s operational strength and performance. Investors should consider the limitations associated with this non-GAAP measure, including the potential lack of comparability of this measure from one company to another. A reconciliation of Total Segment EBIT to Income from continuing operations before income taxes and equity in net earnings of affiliate companies is provided in Note V.

After the sale of our Supermetals Business and acquisition of Norit, we made changes in the composition of our segments and renamed them with names that are more descriptive of the underlying businesses. With these changes, our four business segments are: Reinforcement Materials (formerly our Core Segment); Performance Materials (formerly our Performance Segment); Advanced Technologies (the combination of our former New Business and Specialty Fluids Segments); and Purification Solutions (the

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newly acquired Norit business). Cabot is also organized for operational purposes into three geographic regions: the Americas; Europe, Middle East and Africa; and Asia Pacific. Discussions of all periods reflect these structures.

Our analysis of financial condition and operating results should be read with our Consolidated Financial Statements and accompanying notes. Unless a calendar year is specified, all references to years in this discussion are to our fiscal years ended September 30.

Drivers of Demand and Key Factors Affecting Profitability

Drivers of demand and key factors affecting our profitability differ by Segment. In Reinforcement Materials, demand is influenced on a long term basis primarily by: i) the number of vehicle miles driven globally; ii) the number of original equipment and replacement tires produced; and iii) the number of automotive builds. Over the past several years, operating results have been driven by a number of factors, including: i) increases or decreases in sales volumes; ii) changes in raw material costs and our ability to obtain sales price increases for our products commensurate with increases in raw material costs; iii) changes in pricing and product mix; iv) global and regional capacity utilization; v) fixed cost savings achieved through restructuring and other cost saving activities; vi) the growth of our volumes and market position in emerging economies; and vii) capacity management and technology investments, including the impact of energy utilization and yield improvement technologies at our manufacturing facilities.

In Performance Materials, longer term demand is driven primarily by the construction and infrastructure, automotive, electronics and consumer products industries. In recent years, operating results in Performance Materials have been driven by: i) our volume growth in emerging markets; ii) our ability to deliver differentiated products that drive enhanced performance in customers applications; iii) our ability to obtain value pricing for this differentiation; and iv) the cost of new capacity.

In Advanced Technologies, drivers of demand are specific to the various businesses. In the Inkjet Colorants Business, demand has been driven by a relative increase of printer platforms using our pigments at both new and existing customers and the broader adoption of inkjet technology in office and commercial printing applications. Demand in the Aerogel Business has been driven by the adoption of aerogel products for oil and gas, daylighting, insulation for building and construction and specialty chemical applications. In the Security Materials Business, demand has been driven principally by the number of security taggant applications incorporating our unique and proprietary particles. In the Elastomer Composites Business, demand has been driven by the penetration of our unique compound of natural rubber and carbon black made in a patented liquid phase into applications for the tire, mining and defense industries. In our Specialty Fluids Business, demand for cesium formate is primarily driven by the level of drilling activity for high pressure oil and gas wells and by the petroleum industry s acceptance of our product as a drilling and completion fluid for this application. Operating results in Advanced Technologies have been influenced by: i) our ability to improve the pace of revenue generation; ii) our ability to select the highest value opportunities and work with lead users in the appropriate markets; iii) our ability to appropriately size the overall cost platform for the opportunities; iv) the timing of milestone payments in our Elastomer Composites Business; and v) the size, type and duration of drilling jobs in our Specialty Fluids Business.

In Purification Solutions, longer term demand is driven primarily by the demand for purification solutions for water, gas and air, pharmaceuticals, food and beverages, catalysts and other chemical applications. Operating results in Purification Solutions have been influenced by i) changes in pricing and product mix; ii) industry capacity utilization; iii) the amount of coal-based power generation utilized in the U.S.; and iv) growth of volume in the various applications previously noted.

Overview of Results for Fiscal 2012

During fiscal 2012, profitability increased compared to fiscal 2011 driven by higher unit margins that resulted from price increases and a favorable product mix. This improvement was partially offset by lower volumes and higher fixed costs due mainly to the startup of additional capacity and higher spending to support growth.

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In fiscal 2012, we purchased all of the issued and outstanding shares of Norit N.V. (Norit) for a purchase price of $1.1 billion. The transaction was completed on July 31, 2012. Our results for the twelve month period ended September 30, 2012 includes two months of results of Norit, which are reported as Purification Solutions.

In addition, during fiscal 2012, we completed the sale of our Supermetals Business and received initial cash payments related to the sale of $204 million. Approximately $250 million of additional cash consideration is scheduled to be received by the end of the second quarter of fiscal 2014. Income from discontinued operations, net of tax of $205 million in fiscal 2012 includes the $191 million gain on the sale of the Supermetals Business. Operating results from the Supermetals Business are included in Income (loss) from discontinued operations, net of tax, for all periods presented on the Consolidated Statements of Operations.

Fiscal 2012 compared to Fiscal 2011 and Fiscal 2011 compared to Fiscal 2010 Consolidated

Net Sales and Gross Profit

	Years ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Net sales and other operating revenues	$ 3,300	$ 3,102	$ 2,716
Gross profit	$ 648	$ 558	$ 510

The $198 million increase in net sales from fiscal 2011 to fiscal 2012 was driven primarily by higher prices and a favorable product mix (combined $270 million) and the addition of two months of Purification Solutions sales (approximately $61 million) partially offset by lower volumes ($71 million) and the unfavorable effect of foreign currency translation ($56 million). The $386 million increase in net sales from fiscal 2010 to fiscal 2011 was due primarily to higher selling prices and a favorable product mix ($301 million) and the favorable effect of foreign currency translation ($97 million) partially offset by lower volumes ($8 million).

Gross profit increased by $90 million in fiscal 2012 when compared to fiscal 2011 and by $48 million in fiscal 2011 when compared to fiscal 2010. The increases in both periods were primarily due to higher unit margins driven by the implementation of strategic value pricing and product mix initiatives and benefits from the investments in energy centers and yield technology that more than offset higher raw material costs.

Selling and Administrative Expenses

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Selling and administrative expenses	$ 285	$ 249	$ 241

Selling and administrative expenses increased by $36 million in fiscal 2012 when compared to fiscal 2011. The comparative increase is principally due to higher professional fees and other costs related to the acquisition and integration of Norit ($17 million), the inclusion of two months of Purification Solutions operating results ($5 million), additional environmental and legal reserves, including for respirator claims ($7 million) and spending to support growth across our businesses. Selling and administrative expenses increased by $8 million in fiscal 2011 when compared to fiscal 2010. The comparative increase is principally due to increased business and business development activity levels that were partially offset by lower restructuring related expenses.

Research and Technical Expenses

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Research and technical expenses	$ 73	$ 66	$ 65

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Research and technical expenses increased $7 million in fiscal 2012 when compared to fiscal 2011 due to fees for a new technology licensing agreement ($3 million), the inclusion of two months of Purification Solutions operating results ($1 million) and higher spending to support business initiatives. Research and technical expenses were $1 million higher in fiscal 2011 when compared to fiscal 2010 as we maintained our investment in new product and process development opportunities across the businesses.

Interest and Dividend income

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Interest and dividend income	$ 4	$ 2	$ 2

Interest and dividend income was $4 million in fiscal 2012 and $2 million in both fiscal 2011 and 2010. Interest and dividend income was $2 million higher in fiscal 2012 when compared to fiscal 2011 primarily due to interest income related to the notes receivable for the sale of the Supermetals Business.

Interest Expense

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Interest expense	$ 46	$ 39	$ 40

Interest expense increased $7 million in fiscal 2012 as compared to fiscal 2011 due to a higher debt balance as a result of the financing for the Norit acquisition. Interest expense decreased by $1 million in fiscal 2011 when compared to fiscal 2010 driven by lower average debt levels in fiscal 2011 as compared to fiscal 2010.

Other Expense

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Other expense	$ 3	$ 3	$

Other expense balances are driven by foreign currency movements, including gains or losses on foreign currency transactions and the remeasurement of our foreign currency denominated debt and related derivatives. Other expense in fiscal 2012 is consistent with fiscal 2011. The $3 million increase in expense from fiscal 2010 to fiscal 2011 was principally driven by an unfavorable comparison of foreign currency movements.

Provision for Income Taxes

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Provision for income taxes	$ 55	$ 6	$ 30
Effective tax rate	22%	3%	18%
Operating tax rate	25%	22%	25%

The provision for income taxes was $55 million for fiscal 2012, resulting in an effective tax rate of 22%. This amount included net discrete tax benefits of $8 million from the release of a Cabot state tax valuation allowance as a result of the Norit acquisition and $3 million from settlements and miscellaneous tax items. The operating tax rate for fiscal 2012 was approximately 25%.

The provision for income taxes was $6 million for fiscal 2011, resulting in an effective tax rate of 3%. This amount included discrete tax benefits of $38 million comprised of: i) $24 million related to the repatriation of high tax income in response to changes in U.S. tax legislation; ii) $10 million from audit settlements; iii) $2 million from the recognition of investment tax credits in China; and iv) $2 million from the renewal of the U.S. research and experimentation (R&E) credit. The operating tax rate for fiscal 2011 was 22%.

The provision for income taxes was $30 million for fiscal 2010, resulting in an effective tax rate of 18%. This amount included discrete tax benefits of $15 million related to the settlement of various tax audits and $2 million for investment incentive credits earned, partially offset by a $1 million charge for miscellaneous adjustments. The operating tax rate for fiscal 2010 was 25%.

Our anticipated operating tax rate for fiscal 2013 is 25% to 26%. The IRS has not yet commenced the audit of our 2007 and later tax years and certain Cabot subsidiaries are under audit in a number of jurisdictions outside of the U.S. It is possible that some of these audits will be resolved in fiscal 2013 and could impact our anticipated effective tax rate. We have filed our tax returns in accordance with the tax laws in each jurisdiction and maintain tax reserves for uncertain tax positions.

Equity in Earnings of Affiliates and Noncontrolling Interest in Net Income, net of tax

	Years Ended September 30		
	2012	**2011**	**2010**
		(Dollars in millions)	
Equity in earnings of affiliated companies, net of tax	$ 11	$ 8	$ 7
Net income attributable to noncontrolling interests, net of tax	$ 18	$ 22	$ 15

Equity in earnings of affiliated companies, net of tax, for fiscal 2012 increased $3 million from fiscal 2011 as earnings of our affiliate in Mexico improved. Equity in earnings of affiliated companies, net of tax, increased by $1 million in fiscal 2011 when compared to fiscal 2010 due primarily to an improvement in profitability at our equity affiliates in Mexico and Venezuela.

For fiscal 2012, net income attributable to noncontrolling interests decreased $4 million as compared to fiscal 2011. The decrease was due to a decrease in profitability of our joint ventures in Malaysia, China and Indonesia. For fiscal 2011, the $7 million increase in net income attributable to noncontrolling interests, net of tax, is due to the improved profitability of our joint ventures in China, the Czech Republic and Malaysia.

Income from Discontinued Operations, net of tax

During fiscal 2011, we entered into an agreement to sell our Supermetals Business and accordingly for all periods we have classified income from the Supermetals Business as Income from discontinued operations, net of tax. The sale of the Supermetals Business was completed during the second quarter of fiscal 2012. Income from discontinued operations, net of tax, increased $152 million in fiscal 2012 when compared to fiscal 2011 driven by the gain on the sale of the Supermetals Business.

Net Income Attributable to Cabot Corporation

In fiscal 2012, we reported net income of $388 million ($5.99 per diluted common share). This is compared to net income of $236 million ($3.57 per diluted common share) in fiscal 2011 and net income of $154 million ($2.35 per diluted common share) in fiscal 2010.

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Fiscal 2012 compared to Fiscal 2011 and Fiscal 2011 compared to Fiscal 2010 By Business Segment

Total Segment EBIT, certain items, other unallocated items and income from continuing operations before taxes for fiscal 2012, 2011 and 2010 are set forth in the table below. The details of certain items and other unallocated items are shown below and in Note V of our Consolidated Financial Statements.

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Total Segment EBIT	$ 409	$ 354	$ 314
Certain items	(51)	(19)	(53)
Other unallocated items	(113)	(132)	(95)
Income from continuing operations before income taxes	$ 245	$ 203	$ 166

In fiscal 2012, total Segment EBIT increased by $55 million when compared to fiscal 2011. The increase was principally driven by higher unit margins ($94 million) driven by the implementation of strategic value pricing and product mix initiatives and benefits from the investments in energy centers and yield technology that more than offset higher raw material costs, the inclusion of two months of Purification Solutions operating results ($5 million), and the favorable effect of foreign currency translation ($11 million). The results were partially offset by lower volumes ($8 million) in Reinforcement Materials and higher fixed costs from the startup of new capacity and spending to support our growth initiatives ($51 million combined).

In fiscal 2011, total Segment EBIT increased by $40 million when compared to fiscal 2010. The increase was principally driven by higher unit margins ($101 million) from increased prices, a favorable product mix and the benefits from investments in energy centers and yield technology that more than offset higher raw material costs. Higher fixed manufacturing costs ($44 million) from higher maintenance and other plant operating costs, lower volumes ($9 million) in Reinforcement Materials and the Specialty Fluids Business, and an increase in selling and administrative costs ($9 million) primarily related to increased headcount to support business activities in Performance Materials and Advanced Technologies partially offset this improvement.

Certain Items:

Details of the certain items for fiscal 2012, 2011, and 2010 are as follows:

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Global restructuring activities	$ (17)	$ (18)	$ (46)
Environmental and legal reserves	(4)	(1)	(3)
Reserve for respirator claims	(4)		(2)
Acquisition related charges	(26)		
Long-lived asset impairment			(2)
Certain items, pre-tax	(51)	(19)	(53)
Tax-related certain items			
Tax impact of certain items	$ 9	$ 3	$ 7
Tax impact of certain foreign exchange losses	1		
Tax impact of non-deductible interest expense	(2)		
Discrete tax items	11	39	16
Total tax-related certain items	19	42	23
Total certain items after tax	$ (32)	$ 23	$ (30)

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Acquisition related charges include legal and professional fees, the incremental value of inventory as a result of purchase accounting adjustments, and other expenses related to the completion of the acquisition and the integration of Norit, which is described in Note C of the Consolidated Financial Statements. Details of restructuring activities are included in Note P of the Consolidated Financial Statements. Tax certain items include discrete tax items, which are unusual and infrequent, the tax impact of certain foreign exchange losses, and the tax impact of non-deductible interest expense.

Other Unallocated Items:

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Interest expense	$ (46)	$ (39)	$ (40)
Equity in net income of affiliated companies	(11)	(8)	(7)
Unallocated corporate costs	(56)	(53)	(48)
General unallocated (expense) income		(32)	
Total other unallocated items	$ (113)	$ (132)	$ (95)

Other unallocated items include Interest expense, Equity in net income of affiliated companies, Unallocated corporate costs, and General unallocated (expense) income. The balances of unallocated corporate costs are primarily comprised of expenditures related to managing a public company that are not allocated to the segments and corporate business development costs related to new technology efforts. The balances of General unallocated (expense) income primarily include foreign currency transaction gains (losses), interest income, dividend income, the elimination of profit related to unearned revenue, and the COGS impact of LIFO accounting.

In fiscal 2012, costs from total other unallocated items decreased by $19 million when compared to fiscal 2011. The decrease was primarily driven by a $32 million decrease in General unallocated income (expense) due to i) the COGS impact of LIFO accounting from changes in carbon black raw material costs that resulted in a favorable comparison ($18 million); ii) the favorable comparison of foreign exchange currency transactions ($4 million); iii) the absence in fiscal 2012 of certain corporate pension and currency charges that occurred in fiscal 2011 ($2 million); and (iv) the impact of a change in the net worth tax in Colombia in fiscal 2011 that did not repeat in fiscal 2012 ($3 million). These decreases were partially offset by an increase in Unallocated corporate costs driven by fees for a new technology licensing agreement ($3 million).

In fiscal 2011, costs from total other unallocated items increased by $37 million when compared to the same period of fiscal 2010. The increase was driven by charges associated with: i) the COGS impact of LIFO accounting ($16 million) due to rising carbon black raw material costs in fiscal 2011; ii) the unfavorable comparative of foreign currency transactions ($7 million); and iii) the unfavorable impact of a change in the net worth tax in Colombia ($3 million). In addition, there were higher costs commensurate with an increase in business activity levels and higher spending for corporate business development activities.

Reinforcement Materials

Sales and EBIT for Reinforcement Materials for fiscal 2012, 2011 and 2010 are as follows:

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Reinforcement Materials Sales	$ 2,019	$ 1,952	$ 1,660
Reinforcement Materials EBIT	$ 227	$ 183	$ 139

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In fiscal 2012, sales in Reinforcement Materials increased by $67 million when compared to fiscal 2011. The increase was principally driven by higher prices and a favorable product mix (combined $225 million), partially offset by 6% lower volumes ($123 million) and the unfavorable impact of foreign currency translation ($35 million). In fiscal 2011, sales in Reinforcement Materials increased by $292 million when compared to fiscal 2010. The increase was principally driven by higher prices and a favorable product mix ($252 million) and the favorable effect of foreign currency translation ($73 million). Global volumes decreased by 2% in fiscal 2011 relative to fiscal 2010 driven by the closure of our carbon black facility in India. Excluding the impact of the closure of the India facility, global volumes were consistent with the prior year.

In fiscal 2012, Reinforcement Materials EBIT increased by $44 million when compared to fiscal 2011 driven principally by higher unit margins ($91 million), with higher pricing and a favorable product mix more than offsetting higher raw material costs, and the favorable impact of foreign currency translation ($10 million). The impact of higher unit margins more than offset lower volumes ($39 million) and the effect of higher fixed manufacturing costs ($17 million). In fiscal 2011, Reinforcement Materials EBIT increased by $44 million when compared to fiscal 2010. The increase was principally driven by higher unit margins ($79 million) from higher pricing, a favorable product mix and benefits from investments in energy centers and yield technology that more than offset higher raw material costs. Higher fixed manufacturing costs ($23 million) from higher maintenance and other plant operating costs and lower volumes ($11 million) partially offset these positive factors.

Performance Materials

Sales and EBIT for Performance Materials for fiscal 2012, 2011 and 2010 are as follows:

	Years Ended September 30		
	2012	2011	2010
	(Dollars in millions)		
Specialty Carbons and Compounds Sales	$ 664	$ 626	$ 531
Fumed Metal Oxides Sales	250	254	252
Segment Sales	$ 914	$ 880	$ 783
Segment EBIT	$ 128	$ 140	$ 125

In fiscal 2012, sales in Performance Materials increased $34 million when compared to fiscal 2011 due to higher prices and a favorable product mix (combined $34 million), and the impact of higher volumes ($23 million), partially offset by the unfavorable impact of foreign currency translation ($22 million). During fiscal 2012, volumes in Specialty Carbons and Compounds increased by 3% and volumes in Fumed Metal Oxides increased by 2%. In fiscal 2011, sales for Performance Materials increased by $97 million when compared to fiscal 2010. The increase was principally driven by higher prices and a favorable product mix ($53 million), higher volumes ($22 million), and the positive impact of foreign currency translation ($21 million). During fiscal 2011, volumes in Specialty Carbons and Compounds increased by 5% due to availability of new capacity to serve higher demand for our specialty compounds products. Volumes in fiscal 2011 in Fumed Metal Oxides decreased by 2% due to our strategic value pricing initiative, which resulted in lower volumes sold.

In fiscal 2012, EBIT in Performance Materials was $12 million lower when compared to fiscal 2011 driven by higher fixed manufacturing costs from new capacity and higher segment management costs ($23 million combined). This decrease was partially offset by higher volumes ($10 million) and improved unit margins ($2 million) from higher pricing and a favorable product mix that more than offset higher raw material costs. EBIT in Performance Materials increased by $15 million in fiscal 2011 when compared to fiscal 2010. The increase was principally driven by higher unit margins ($22 million) from higher pricing and a favorable product mix that more than offset the impact of higher raw materials costs and higher volumes ($6 million). Higher fixed manufacturing costs ($14 million) associated with the start-up of new capacity and higher maintenance and other plant operating costs partially offset these positive factors.

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Advanced Technologies

Sales and EBIT for Advanced Technologies for fiscal 2012, 2011 and 2010 are as follows:

	Years Ended September 30		
	(758)	(418)	(592)
Total	$1,495	$ (1,244)	$ 3,755

Our operating profit in 2018 increased mainly due to the increase in sales in all of our segments of operations and major business units, as well as the results of our cost saving initiatives.

Key Factors Affecting our Business

Our operations and the operating metrics discussed below have been, and will likely continue to be affected by certain key factors as well as certain historical events and actions. The key factors affecting our business and results of operations include among others, reliance on large orders from a small number of customers, reliance on government contracts and competition. For further discussion of the factors affecting our results of operations, see “Risk Factors.”

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Reliance on large orders from a small number of customers

We receive relatively large orders for products from a relatively small number of customers. Consequently, a single order from one customer may represent a substantial portion of our sales in any one period and significant orders by any customer during one period may not be followed by further orders from the same customer in subsequent periods. Our sales and operating results are subject to very substantial periodic variations. Since quarterly performance is likely to vary significantly, our results of operations for any quarter or calendar year are not necessarily indicative of the results that we might achieve for any subsequent period. Accordingly, quarter-to-quarter and year-to-year comparisons of our operating results may not be meaningful. In addition, we have a limited order backlog that is generally composed of orders that are fulfilled within a period of three to twelve months after receipt, which makes revenues in any quarter substantially dependent upon orders received in prior quarters.

Growth Strategy

In the first quarter of 2016 we initiated a strategic plan to implement our growth strategy for the following 3-4 years. The strategic plan was adopted by our board of directors in the third quarter of 2016. Pursuant to the plan, we reorganized our group structure and clearly separated our two core areas of operation - Products and Projects. We also streamlined our product sales activity to concentrate on three regions, the Americas, EMEA and APAC. We intend to continue to expand our sales team in the U.S., which is the main strategic market for our product activity. In 2018, we consolidated, our EMEA operations under a new in-region leadership.

We may not be able to implement our growth strategy plan and may not be able to successfully expand our business activity and increase our sales. If we are successful in the implementation of our strategic plan, we may be required to hire additional employees in order to meet customer demands. If we are unable to attract or retain qualified employees, our business could be adversely affected.

Our failure to successfully integrate the operations of an acquired business or to retain key employees of acquired businesses and integrate and manage our growth may have a material adverse effect on our business, financial condition, results of operation or prospects. We may not be able to realize the anticipated benefits of any acquisition. Moreover, future acquisitions by us could result in potentially dilutive issuances of our equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to identifiable intangible assets, any of which could materially adversely affect our operating results and financial position. Acquisitions also involve other risks, including risks inherent in entering markets in which we have no or limited prior experience.

Reliance on government contracts

Our products are primarily sold to governmental agencies, governmental authorities and government-owned companies, many of which have complex and time consuming procurement procedures. A substantial period of time often elapses from the time we begin marketing a product until we actually sell that product to a particular customer. In addition, our sales to governmental agencies, authorities and companies are directly affected by these customers' budgetary constraints and the priority given in their budgets to the procurement of our products. A decrease in governmental funding for our customers' budgets would adversely affect our results of operations. This risk is heightened during periods of global economic slowdown. Accordingly, governmental purchases of our systems, products and services may decline in the future if governmental purchasing agencies terminate, reduce or modify contracts.

Competition

The global market for safety, security, video management, site management solutions and products is highly fragmented and intensely competitive. It is characterized by changing technology, new product introductions and changing customer requirements. We compete principally in the market for perimeter intrusion detection systems, or PIDS, video management systems, and turnkey projects and solutions. Some of our competitors and potential competitors have greater research, development, financial and personnel resources, including governmental support. We cannot assure you that we will be able to maintain the quality of our products relative to those of our competitors or continue to develop and market new products effectively. Continued competitive pressures could cause us to lose significant market share.

Explanation of Key Income Statement Items

Cost of revenues. Our cost of revenues for perimeter products consists of component and material costs, direct labor costs, subcontractor costs, shipping expenses, overhead related to manufacturing and depreciation. Our cost of revenues for turnkey projects consists primarily of component and material costs, subcontractor costs, direct labor costs and overhead related to the turnkey projects. Our cost of revenues for Video and Cyber Security sales consists primarily of direct labor costs, some component, material and subcontractor costs and overhead related to those sales.

Our gross margin is affected by the proportion of our revenues generated from perimeter products, turnkey projects and the Video and Cyber Security segments. Our revenues from Video and Cyber Security products generally have higher gross margins than our other segments.

Research and development expenses, net. Research and development expenses, net consists primarily of expenses for on-going research and development activities and other related costs.

Selling and marketing expenses. Selling and marketing expenses consist primarily of commission payments, compensation and related expenses of our sales teams, attendance at trade shows and advertising expenses and related costs for facilities and equipment.

General and administrative expenses. Our general and administrative expenses consist primarily of salary and related costs associated with our executive and administrative functions, public company related expenses, legal and accounting expenses, allowances for doubtful accounts and bad debts and other miscellaneous expenses. Staff costs include direct salary costs and related costs, such as severance pay, social security and retirement fund contributions, vacation and other pay.

Depreciation, Amortization and Impairment of goodwill. The amount of depreciation, amortization and Impairment of goodwill attributable to our perimeter products, turnkey projects and Video and Cyber-security segments for the three years ended December 31, 2018 were as follows:

	Year Ended December 31,		
	2016	2017	2018
	(in thousands)		
Products	$632	$614	$586
Turnkey projects	512	498	879
Video and Cyber-security	596	764	1,759
Total	$1,740	$1,876	$3,224

Financial Expenses, Net. Financial expenses, net include exchange rate differences arising from changes in the value of monetary assets and monetary liabilities stated in currencies other than the functional currency of each entity, currency transactions as well as interest income on our cash and cash equivalents and short term investments.

Discussion of Critical Accounting Policies

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and the use of different assumptions would likely result in materially different results of operations. Critical accounting policies are those that are both most important to the portrayal of our financial position and results of operations and require management’s most difficult, subjective or complex judgments. Although not all of our significant accounting policies require management to make difficult, subjective or complex judgments or estimates, the following policies and estimates are those that we deem most critical.

Revenue Recognition

We generates our revenues mainly from (1) installation of comprehensive security systems for which revenues are generated from long-term fixed price contracts; (2) sales of security products; (3) services and maintenance, which are performed either on a fixed-price basis or as time-and-materials based contracts; and (4) software license fees and related services.

Revenues from our contracts are recognized using the five-step model in ASC 606 - "Revenue from Contracts with Customers" ("ASC 606"). At first, we determine if an agreement with a customer is considered to be a contract to the extent it has a commercial substance, it is approved in writing by both parties, all rights and obligations including payment terms are identifiable, the agreement between the parties creates enforceable rights and obligations, and collectability in exchange for goods and services that will be transferred to the customer is considered as probable. We then assess the transaction price for a contract in order to determine the consideration we expects to receive for satisfying the performance obligations called for in the contract. To the extent, the transaction price includes variable consideration (e.g., contract penalties, unpriced change orders or like measures), we usually estimate the most likely amount that should be included in the transaction price subject to constraints based on the specific facts and circumstances.

At the inception of a contract, we also evaluate and determines if a contract should be separated into more than one performance obligation. Our installation of comprehensive security systems contracts usually includes one-performance obligations due to a significant customization for each customer's specific needs and integrated system or solution.

For most of our installation of comprehensive security systems contracts, where our performance does not create an asset with an alternative use, we recognizes revenue over performance time because of continuous transfer of control to the customer. For these performance obligations that are satisfied over time, we generally recognize revenue using an input method with revenue amounts being recognized proportionately as costs are incurred relative to the total expected costs to satisfy the performance obligation. We believe that costs incurred as a portion of total estimated costs is an appropriate measure of progress towards satisfaction of the performance obligation since this measure reasonably depicts the progress of the work effort and 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, the manner, and the terms of settlement, including in cases of termination for convenience. Project costs include materials purchased to produce the system, related labor, overhead expenses and subcontractor's costs. The performance costs are measured by monitoring costs and efforts devoted using records of actual costs incurred to date in the project compared to the total estimated project requirements, which corresponds to the costs related to earned revenues. We estimate the profit on a contract as the difference between the total estimated transaction price and the total expected performance costs of the contract and recognizes revenue and costs over the life of the 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 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.

For contracts that are deemed to be loss contracts, we establishe forward loss reserves for total estimated costs that are in excess of total estimated consideration under a contract in the period in which they become probable.

Fees are payable upon completion of agreed upon milestones and subject to customer acceptance. Amounts of revenues recognized in advance of contractual billing are recorded as unbilled accounts receivable. In most instances, the period between the advanced recognition of revenues and the customers' billing generally ranges between one to six months.

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Revenues for performance obligations that are not recognized over time are recognized at the point in time when control is transferred to the customer (which is generally upon delivery) and include mainly revenues from the sales of security products and software license fees without significant installation work. We generally do not provide a right of return to our customers. For performance obligations that are satisfied at a point in time, we evaluates the point in time when the customer can direct the use of, and obtain the benefits from, the products. Shipping and handling costs are not considered performance obligations and are included in cost of sales as incurred.

Services and maintenance are performed under either fixed-price or time-and-materials based contracts. Under fixed-price contracts, we agree to perform certain work for a fixed price. Under time-and-materials contracts, we are reimbursed for labor hours at negotiated hourly billing rates and for materials. Our service contracts include contracts in which the customer simultaneously receives and consumes the benefits provided as the performance obligations are satisfied, accordingly, related revenues are recognized, as those services are performed or over the term of the related agreements.

Maintenance and support agreements provide customers with rights to unspecified software product updates, if and when available. These services grant the customers on line and telephone access to technical support personnel during the term of the service. We recognize maintenance and support services revenues ratably over the term of the agreement, usually one year.

We generate revenues from the sales of our software products user licenses as well as from maintenance, support, consulting and training services.

As required by ASC 606, following the determination of the performance obligations in the contract, we allocate the total transaction price to each performance obligation in an amount based on the estimated relative standalone selling prices of the promised license fees or services underlying each performance obligation. Standalone selling price is the price at which we would sell a promised license or service separately to a customer.

We capitalizes sales commission as costs of obtaining a contract when they are incremental and if they are expected to be recovered. Amortization of sales commission expense is included in selling and marketing expenses in the accompanying consolidated statements of income. For costs that we would have capitalized and amortized over one year or less, we have elected to apply the practical expedient and expense these contract costs as incurred.

Inventories

Inventories are stated at the lower of cost or market value. We periodically evaluate the quantities on hand relative to historical and projected sales volumes, current and historical selling prices and contractual obligations to maintain certain levels of parts. Based on these evaluations, inventory write-offs are provided to cover risks arising from slow-moving items, discontinued products, excess inventories, market prices lower than cost and adjusted revenue forecasts. Cost is determined as follows:

- Raw materials, parts and supplies – using the “first-in, first-out” method.

- Work-in-progress and finished products –on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

During the years ended December 31, 2016, 2017 and 2018 we recorded inventory write-offs from continuing operations in the amounts of $0.2 million, $0.1 million and $0.1 million, respectively. Such write-offs were included in cost of revenues.

Income taxes

We account for income taxes in accordance with ASC 740 “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 provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and we must establish a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Increases in the valuation allowance result in additional expense to be reflected within the tax provision in the consolidated statement of income.

As of December 31, 2018, we had a net deferred tax asset of $3.3 million attributable to our subsidiaries. We had total estimated available tax loss carryforwards of $8.9 million with respect to our operations in Israel and our non-Israeli subsidiaries, had estimated total available tax loss carryforwards of $8.7 million, of which $6.1 million was attributable to our U.S. subsidiaries, which may be used as an offset against future taxable income for periods ranging between 1 and 20 years. As of December 31, 2018, we recorded a partial valuation allowance on these carryforward tax losses due to the uncertainty of their future realization. Utilization of U.S. net operating losses may be subject to a substantial annual limitation due to the “change in ownership” provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

Goodwill

We have recorded goodwill as a result of acquisitions, which represents the excess of the cost over the net fair value of the assets of the businesses acquired. We follow ASC 350, “Intangibles – Goodwill and Other,” which requires goodwill to be tested for impairment, at the reporting unit level, at least annually or between annual tests in certain circumstances, and written down when impaired, rather than being amortized.

ASC 350 allows an entity to first assess qualitative factors to determine whether it is necessary to perform the quantitative goodwill impairment test. If the qualitative assessment does not result in a more likely than not indication of impairment, no further impairment testing is required. If it does result in a more likely than not indication of impairment, the quantitative impairment test is performed. Alternatively, ASC 350 permits an entity to bypass the qualitative assessment for any reporting unit and proceed directly to performing the first step of the goodwill impairment test. We perform annual impairment test of goodwill as of December 31 of each year, or more frequently if impairment indicators are present

In January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-04, “Intangibles—Goodwill and Other (Topic 350): - Simplifying the Test for Goodwill Impairment”, which eliminates the requirement to calculate the implied fair value of goodwill (i.e., Step 2 of the goodwill impairment test) for the purpose of measuring a goodwill impairment charge. Instead, an impairment charge shall be recognized based on the excess of a reporting unit’s carrying amount over its fair value. The standard shall be applied prospectively and is effective for annual and interim impairment tests performed in periods beginning after December 15, 2019, for public entities. Early adoption is permitted for annual and interim goodwill impairment testing dates after January 1, 2017. We early adopted the new guidance on January 1, 2018.

We evaluate the risk of goodwill impairment at a reporting unit level. Our goodwill as of December 31, 2018, relates to our Video reporting unit, PIDS reporting unit and BAZ reporting unit. As of December 31, 2018, the fair values of these reporting units significantly exceeded their carrying values. Accordingly, we determined that (i) the estimated fair value of each reporting unit was substantially in excess of its carrying value, (ii) each reporting unit's goodwill balance was not at risk of impairment, and (iii) therefore, no additional disclosure was required.

During the three years ended December 31, 2018, we did not record any impairment charges relating to the goodwill allocated to our Product segment, BAZ reporting unit within the Project segment and Video reporting unit within the Video and Cyber security segment.

In 2018, we recorded an impairment loss of goodwill in the amount of $1 million with respect to our Cyber security reporting unit within the Video and Cyber security segment. During the years ended December 31, 2017 and 2016, we did not record any impairment charges relates to the goodwill allocated to the Cyber security reporting unit within the Video and Cyber security segment.

Goodwill annual impairment tests

As required by ASC 820, "Fair Value Measurements and Disclosures," we apply assumptions that marketplace participants would consider in determining the fair value of the reporting unit.

The material assumptions used for the goodwill annual impairment test for the PIDS reporting unit within the Products segment, according to the income approach for 2018, were five years of projected net cash flows, a weighted average cost of capital rate of 13% and a long-term growth rate of 3%. We consider historical rates and current market conditions when determining the discount and growth rates to use in its analyses. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for the goodwill associated with the PIDS reporting unit within the Products segment.

The material assumptions used for the goodwill annual impairment test for the Cyber security reporting unit within the Video and Cyber security segment, according to the income approach for 2018, were five years of projected net cash flows, a weighted average cost of capital rate of 14% and a long-term growth rate of 2%. We consider current market conditions when determining the discount and growth rates to use in our analyses. As a result of our impairment testing we have determined that an impairment charge of $1 million was recorded, which was the remaining good will for that reporting unit.

The material assumptions used for the goodwill annual impairment test for the Video reporting unit within the Video and Cyber security segment, according to the income approach for 2018, were five years of projected net cash flows, a weighted average cost of capital rate of 16.4% and a long-term growth rate of 3%. We considered historical rates and current market conditions when determining the discount and growth rates to use in our analyses. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for goodwill.

The material assumptions used for the goodwill annual impairment test for the BAZ reporting unit within the Project segment, according to the income approach for 2018, were five years of projected net cash flows, a weighted average cost of capital rate of 15% and a long-term growth rate of 1.5%. We considered historical rates and current market conditions when determining the discount and growth rates to use in our analyses. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for goodwill.

Intangible assets

Our intangible assets are comprised of patents, acquired technology, customer relations and backlog. Intangible assets are amortized over their useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with ASC 350, “Intangibles – Goodwill and Other.”

During the three years ended December 31, 2018, we did not record any impairment charges relating to intangible assets.

Impairment of long lived assets

We periodically evaluate our intangible assets and long-lived assets (mainly property and equipment) in all of our reporting units for potential impairment indicators in accordance with ASC 360, “Property, Plant and Equipment”, or “ASC 360”. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions, operational performance and prospects of our acquired businesses and investments. Our long-lived assets are reviewed for impairment 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 the assets to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. In measuring the recoverability of assets, we are required to make estimates and judgments in assessing our future cash flows which derive from the estimated useful life of our current primary assets, and compare that with the carrying amount of the assets. Additional significant estimates used by management in the methodologies employed to assess the recoverability of our long-lived assets include estimates of future short-term and long-term growth rates, useful lives of assets, market acceptance of products and services, our success in winning bids and other judgmental assumptions, which are also affected by factors detailed in our risk factors section in this annual report.

During the three years ended December 31, 2018, we did not record any impairment charges relating to long lived assets.

Functional Currency and Financial Statements in U.S. Dollars

While our functional currency in Israel is the NIS, our reporting currency is the U.S. dollar. Translation adjustments resulting from translating our financial statements from NIS and other local operation currencies to the U.S. dollar are reported as a separate component in shareholders' equity.

The first step in the translation process is to identify the functional currency for each entity included in the financial statements. The accounts of each entity are then "re-measured" in its functional currency. All transaction gains and losses from the re-measurement of monetary balance sheet items are reflected in the statement of operations as financial income or expenses, as appropriate. Non-monetary assets and liabilities denominated in foreign currency and measured at cost are translated at the exchange rate at the date of the transaction.

After the re-measurement process is complete the financial statements are translated into our reporting currency, which is the U.S. dollar, using the current rate method. Equity accounts are translated using historical exchange rates. All other balance sheet accounts are translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the year. The resulting translation adjustments are reported as a component of shareholders' equity. For the years ended December 31, 2016, 2017 and 2018, our foreign currency translation adjustments totaled $0.4 million, $5.9 million and $2.8 million, respectively. The losses in 2016 and 2017 were exacerbated as a result of our increased cash balances. In late 2016 we completed a rights offering that provided us with proceeds of $ 23.6 million, which we deposited into our bank accounts in Israel. These balances were translated into NIS, which depreciated by 1.5% and 9.8% against the U.S. dollar in 2016 and 2017, respectively and in 2018 we recorded a gain of approximately $ million as the NIS appreciated by 8.1% against the U.S. dollar.

Concentrations of credit risk

Financial instruments that are potentially subject to concentrations of credit risk consist principally of cash and cash equivalents, short and long-term bank deposits, unbilled accounts receivable, trade receivables, long-term trade receivables and long-term loans.

Of our cash and cash equivalents and short-term and restricted bank deposits at December 31, 2018, $25.6 million was deposited with major Israeli banks. An additional $29.4 million was deposited mainly with the Royal Bank of Canada, BBVA Bankcomer, Comerica Bank and Deutsche Bank. Cash and cash equivalents deposited with U.S. banks or other banks may be in excess of insured limits and are not insured in other jurisdictions. Generally these deposits maybe redeemed upon demand and therefore bear low risk.

The trade receivables and the unbilled accounts receivable of our company and our subsidiaries are derived from sales to large and solid organizations located mainly in Israel, the United States, Canada, Africa, Mexico and Europe. We perform ongoing credit evaluations of our customers and to date have generally not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that we have determined to be doubtful of collection and in accordance with an aging policy. In certain circumstances, we may require letters of credit, other collateral or additional guarantees. During the years ended December 31, 2016, 2017 and 2018 we recorded $0.4 million, $0.3 million and $1.5 million of expenses related to doubtful accounts, respectively. As of December 31, 2018, our allowance for doubtful accounts amounted to $2.8 million.

We have no significant off-balance sheet concentration of credit risks, such as foreign exchange contracts or foreign hedging arrangements, except derivative instruments, which are detailed below.

Results of Operations

Due to the nature of our customers and products, our revenues are often generated from a relatively small number of large orders. Consequently, individual orders from individual customers can represent a substantial portion of our revenues in any one period and significant revenues from a customer during one period may not be followed by additional significant revenues from the same customer in subsequent periods. Accordingly, our revenues and operating results may vary substantially from period to period. Consequently, we do not believe that our revenues and operating results should necessarily be judged on a quarter-to-quarter comparative basis.

The following table presents certain financial data expressed as a percentage of revenues for the periods indicated:

	Year Ended December 31		
	2016	2017	2018
Revenues	100 %	100 %	100 %
Cost of revenues	51.0	51.3	56.5
Gross profit	49.0	48.7	43.5
Operating expenses:			
Research and development, net	10.0	10.2	7.4
Selling and marketing, net	25.9	28.2	20.0
General and administrative	11.0	12.2	11.0
Impairment of goodwill	-	-	1.1
Operating income (loss)	2.2	(1.9)	4.1
Financial income (expenses), net	(0.9)	(6.2)	1.5
Income before income taxes	1.3	(8.1)	5.5
Taxes on income (tax benefit)	0.2	(2.6)	(2.2)
Net income	1.5	(10.8)	3.3

Year Ended December 31, 2018 Compared with Year Ended December 31, 2017

Revenues. Revenues increased by 44% to $92.6 million for the year ended December 31, 2018 from $64.3 million for the year ended December 31, 2017. Revenues from sales of perimeter products increased by 23.9% to $27.6 million in 2018 from $22.3 million in 2017, primarily due to the improved management and improved market conditions in North America and EMEA markets. Revenues from turnkey projects increased by 64.3% to $57.1 million in 2018 from $34.7 million in 2017, primarily due to the increased bookings and executions in our worldwide projects mainly in the Americas and Israel, as well as consolidation of revenues from the ESC BAZ reporting unit. Revenues of the Video and Cyber security segment increased by 13.3% to $9.5 million in 2018 from $8.4 million in 2017, primarily due to the increase in VMS software and hardware sales.

Cost of revenues. Cost of revenues increased by 58.6% to $52.3 million for the year ended December 31, 2018 from $33 million for the year ended December 31, 2017. This increase was primarily due to the increase in revenues. Cost of revenues as a percentage of revenues increased slightly to 56.5% in 2018 from 51.3% in 2017, primarily due to the increased percentage of lower margin projects and video hardware sales within our revenue mix.

Research and development expenses, net. Research and development expenses, net increased by 4.5% to $6.9 million for the year ended December 31, 2018 from $6.6 million for the year ended December 31, 2017. The increase in mainly due to the acquisition of ESC BAZ during 2018.

Selling and marketing expenses. Selling and marketing expenses increased by 2.2% to $18.6 million for the year ended December 31, 2018 from $18.2 million for the year ended December 31, 2017. Selling and marketing expenses as a percentage of revenues, decreased to 20% in 2018 from 28.2% in 2017, primarily due to the increase in revenues in 2018.

General and administrative expenses. General and administrative expenses increased by 29.4% to $10.2 million for the year ended December 31, 2018 from $7.9 million for the year ended December 31, 2017. The increase is mainly due to the acquisition of ESC BAZ, an increase in the provision for a doubtful account and to severance costs. General and administrative expenses amounted to 11% and 12.2% of revenues in 2018 and 2017, respectively.

Impairment of goodwill. Impairment of goodwill amounted to $1 million for the year ended December 31, 2018, which impairment relates to our Cyber security reporting unit within the Video and Cyber security segment. There were no impairment charges in 2017.

Operating income (loss). We had operating income of $3.8 million for the year ended December 31, 2018 compared to an operating loss of $1.2 million for the year ended December 31, 2017. The increase in operating income was primarily attributable to increase in sales and gross profit, as well as the beneficial impact of operating cost reduction initiatives. The operating income (loss) of our business segments in the years ended December 31, 2017 and 2018 were as follows:

	Year Ended December 31	
	2017	2018
	(In thousands)	
Perimeter products	$242	$2,863
Turnkey projects	1,762	2,782
Video and Cyber Security	(2,830)	(1,298)
Eliminations	(418)	(592)
Total	$(1,244)	$3,755

Our perimeter products segment recorded operating income of $2.9 million for the year ended December 31, 2018 compared to operating income of $0.2 million for the year ended December 31, 2017, primarily as a result of an increase in revenues and gross profit, partially offset by the increase in the provision for a doubtful account. Our turnkey project segment recorded operating income of $2.8 million in the year ended December 31, 2018 compared to an operating income of $1.8 million for the year ended December 31, 2017, primarily as a result of an increase in revenues. Our Video and Cyber security segment recorded an operating loss of $1.3 million in the year ended December 31, 2018 compared to an operating loss of $2.8 million for the year ended December 31, 2017. The improved result is primarily due to an increase in revenues and operating costs reductions, partially offset by the goodwill impairment.

Financial income, net. Our financial income, net, for the year ended December 31, 2018 was $1.4 million compared to financial expense, net of $4 million for the year ended December 31, 2017. The financial income in 2018 were primarily attributable to foreign exchange gain, net of $1.1 million compared to foreign exchange loss, net of $4 million in 2017.

Income taxes. We recorded tax expenses of $2.1 million in the year ended December 31, 2018 compared to tax expenses of $1.7 million in the year ended December 31, 2017, primarily due to the increase in pre-tax income and changes in our net deferred tax assets.

Year Ended December 31, 2017 Compared with Year Ended December 31, 2016

Revenues. Revenues decreased by 5.2% to $64.3 million for the year ended December 31, 2017 from $67.8 million for the year ended December 31, 2016. Revenues from sales of perimeter products decreased by 31.1% to $22.3 million in 2017 from $32.4 million in 2016, primarily due to the decrease in sales in North America. Revenues from turnkey projects increased by 9.2% to $34.7 million in 2017 from $31.8 million in 2016, primarily due to the executions in our worldwide projects. Revenues of the Video and Cyber security segment increased by 48.4% to $8.4 million in 2017 from $5.6 million in 2016, primarily due to additional quarter of revenues in 2017, as Aimetis was acquired on April 1, 2016 and to an increase in sales.

Cost of revenues. Cost of revenues decreased by 4.6% to $33 million for the year ended December 31, 2017 from $34.6 million for the year ended December 31, 2016. This decrease was primarily due to the decrease in revenues. Cost of revenues as a percentage of revenues increased slightly to 51.3% in 2017 from 51% in 2016, primarily due to the revenue mix.

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Research and development expenses, net. Research and development expenses, net decreased by 3.3% to $6.6 million for the year ended December 31, 2017 from $6.8 million for the year ended December 31, 2016.

Selling and marketing expenses. Selling and marketing expenses increased by 3.5% to $18.2 million for the year ended December 31, 2017 from $17.5 million for the year ended December 31, 2016. Selling and marketing expenses amounted to 28.2% and 25.9% of revenues in 2017 and 2016, respectively.

General and administrative expenses. General and administrative expenses increased by 5.5% to $7.9 million for the year ended December 31, 2017 from $7.4 million for the year ended December 31, 2016. General and administrative expenses amounted to 12.2% and 11% of revenues in 2017 and 2016, respectively.

Operating income (loss). We had operating loss of $1.2 million for the year ended December 31, 2017 compared to operating income of $1.5 million for the year ended December 31, 2016. The decrease in operating income was primarily attributable to loss incurred by the Video and Cyber Security segment. The operating income (loss) of our business segments in the years ended December 31, 2016 and 2017 were as follows:

	Year Ended December 31	
	2016	2017
	(In thousands)	
Perimeter products	$5,799	$242
Turnkey projects	(163)	1,762
Video and Cyber Security	(3,383)	(2,830)
Eliminations	(758)	(418)
Total	$1,495	$(1,244)

Our perimeter products segment recorded operating income of $0.2 million for the year ended December 31, 2017 compared to operating income of $5.8 million for the year ended December 31, 2016, primarily as a result of reduction in revenues. Our turnkey project segment recorded operating income of $1.8 million in the year ended December 31, 2017 compared to an operating loss of $0.2 million for the year ended December 31, 2016, primarily as a result of the increase in revenues. Our Video and Cyber security segment recorded an operating loss of $2.8 million in the year ended December 31, 2017 compared to an operating loss of $3.4 million for the year ended December 31, 2016.

Financial income, net. Our financial expenses, net, for the year ended December 31, 2017 was $4 million compared to financial expense, net of $0.6 million for the year ended December 31, 2016. The financial expenses in 2017 were primarily attributable to foreign exchange loss, net of 4 million compared to foreign exchange loss, net of $0.6 million in 2016.

Income taxes. We recorded tax expenses of $1.7 million in the year ended December 31, 2017 compared to a tax benefit of $0.2 million in the year ended December 31, 2016, primarily due to changes in our net deferred tax assets.

Seasonality

Our operating results are characterized by a seasonal pattern, with a higher volume of revenues towards the end of the year and lower revenues in the first part of the year. This pattern, which is expected to continue, is mainly due to two factors:

- our customers are mainly budget-oriented organizations with lengthy decision processes, which tend to mature late in the year; and

- due to harsh weather conditions in certain areas in which we operate during the first quarter of the calendar year, certain projects and services are put on hold and consequently revenues are delayed.

Our revenues are dependent on government procurement procedures and practices, and because we receive large product orders from a relatively small number of customers, our revenues and operating results are subject to substantial periodic variations.

Impact of Inflation and Currency Fluctuations on Results of Operations, Liabilities and Assets

We sell most of our products in North America, Africa, Latin America Europe and Israel. Our financial results, which are reported in U.S. dollars, are affected by changes in foreign currency. Our revenues are primarily denominated in U.S. dollars, Euros, Mexican Peso and NIS, while a portion of our expenses, primarily labor expenses, is incurred in NIS, CAD and Mexican Peso. Additionally, certain assets, especially cash, trade receivables and other accounts receivables, as well as part of our liabilities are denominated in NIS and CAD. As a result, fluctuations in rates of exchange between the U.S. dollar and non-U.S. dollar currencies may affect our operating results and financial condition. The dollar cost of our operations in Israel and Canada may be adversely affected by the appreciation of the NIS and the CAD against the U.S. dollar. In addition, the value of our non-U.S. dollar revenues could be adversely affected by the depreciation of the U.S. dollar against such currencies.

The appreciation of the NIS, the Mexican Pesos and the CAD in relation to the U.S. dollar has the effect of increasing the U.S. dollar value of any unlinked assets and the U.S. dollar amounts of any unlinked liabilities and increasing the U.S. dollar value of revenues and expenses denominated in other currencies. Conversely, the depreciation of the NIS, the Mexican Peso and the CAD in relation to the U.S. dollar has the effect of reducing the U.S. dollar value of any of our liabilities which are payable in NIS, Mexican Pesos or in Canadian dollars (unless such costs or payables are linked to the U.S. dollar). Such depreciation also has the effect of decreasing the U.S. dollar value of any asset that is denominated in NIS, Mexican Pesos and CADs or receivables payable in NIS, Mexican Pesos or CAD (unless such receivables are linked to the U.S. dollar). In addition, the U.S. dollar value of revenues and expenses denominated in NIS, Mexican Pesos or CAD would increase. Because foreign currency exchange rates fluctuate continuously, exchange rate fluctuations may have an impact on our profitability and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in our consolidated financial statements in current operations.

The following table presents information about the rate of inflation in Israel, the rate of devaluation or appreciation of the NIS against the dollar, and the rate of inflation in Israel adjusted for the devaluation:

Year ended December 31,	Israeli inflation rate %	NIS devaluation (appreciation) rate %	Israeli inflation adjusted for devaluation (appreciation) %

2014	(0.2)	12.0	(12.2)
2015	(1.0)	(0.3)	(0.7)
2016	(0.2)	(1.5)	1.3
2017	0.4	(9.8)	10.2
2018	1.3	8.1	(6.8)

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The U.S. dollar cost of our operations in Canada is influenced by the exchange rate between the U.S. dollar and the CAD. In 2016 and 2017 the CAD appreciated against the U.S. dollar by 2.7% and 7%, respectively. In 2018 the CAD depreciated against the U.S. dollar by 8.6%. In addition, the U.S. dollar cost of our operations in Mexico is influenced by the exchange rate between the U.S. dollar and the Mexican Peso. In 2016 Peso depreciated against the U.S. dollar by 19.2%. In 2017 and 2018 the Mexican Peso appreciated against the U.S. dollar by 4.5% and 0.4%, respectively.

In 2018, foreign currency fluctuations had a positive impact on our results of operations as we recorded foreign exchange gain, net of $1.1 million, compared to $4 million of foreign exchange loss, net in 2017. We expect that our results of operations will continue to be affected by currency fluctuations in the future.

Conditions in Israel

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. See Item 3D “Key Information – Risk Factors – Risks Relating to Our Location in Israel” for a description of governmental, economic, fiscal, monetary and political policies or factors that have materially affected or could materially affect our operations.

Effective Corporate Tax Rate

The Israeli corporate tax rate was 25% in 2016, 24% in 2017 and 23% in 2018.

Our effective corporate tax rate may substantially exceed the Israeli tax rate since our U.S.-based subsidiaries will generally be subject to applicable federal, state, local and foreign taxation, and we may also be subject to taxation in the other foreign jurisdictions in which we own assets, have employees or conduct activities. Because of the complexity of these local tax provisions, it is not possible to anticipate the actual combined effective corporate tax rate, which will apply to us.

As of December 31, 2018, we had net deferred tax assets of $3.3 million attributable to our subsidiaries. We had total estimated available carryforward tax losses of $8.9 million with respect to our operations in Israel to offset against future taxable income. We have recorded a full valuation allowance for such carryforward tax losses due to the uncertainty of their future realization. As of December 31, 2018, our subsidiaries outside of Israel had estimated total available carryforward tax losses of $8.7 million, which may be used as an offset against future taxable income for periods ranging between 1 and 20 years. Utilization of U.S. net operating losses may be subject to a substantial annual limitation due to the “change in ownership” provisions of the Internal Revenue Code of 1986 and similar state tax law provisions. The annual limitation may result in the expiration of net operating losses before utilization.

Trade Relations

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a member of the World Trade Organization and is a signatory to the General Agreement on Tariffs and Trade. Israel is also a member of the Organization for Economic Co-operation and Development, or the OECD, an international organization whose members are governments of mostly developed economies. The OECD’s main goal is to promote policies that will improve the economic and social well-being of people around the world. In addition, Israel has been granted preferences under the Generalized System of Preferences from the United States, Australia, Canada and Japan. These preferences allow Israel to export products covered under such programs either duty-free or at reduced tariffs.

Israel and the European Union Community, known as the "European Union," concluded a Free Trade Agreement in July 1975 that confers some advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and some non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as the "EFTA," established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes a redefinition of rules of origin and other improvements, such as allowing Israel to become a member of the Research and Technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including Russia, China, India, Turkey and other nations in Eastern Europe and the Asia-Pacific region. In addition, Israel has entered into a free trade agreement with the MercoSur countries (Brazil, Paraguay, Argentina and Uruguay) which became fully effective in September 2011. Generally, the purpose of this agreement is to reduce the custom rates between Israel and these countries and to abolish them completely in certain cases. Israel is the first country outside of Latin America to enter into such an agreement with the MercoSur countries.

B. Liquidity and Capital Resources

Our working capital at December 31, 2018 and 2017 was $60.8 million and $59.4 million, respectively. Cash and cash equivalents amounted to $38.7 million at December 31, 2018 compared to $22.5 million at December 31, 2017. The increase in cash and cash equivalents is primarily due to the decrease in Short-term and long-term deposits, restricted bank deposits and escrow deposits, which amounted to $16.4 million at December 31, 2018 compared to $30 million at December 31, 2017. Our cash and cash equivalents, short and long-term bank deposits are held in various banks, mainly in U.S. dollars, Euros, NIS and CAD.

From our inception until our initial public offering in March 1993, we financed our activities mainly through cash flow from operations and bank loans. In March 1993, we received proceeds of $9.8 million from our initial public offering of 1,380,000 ordinary shares. Subsequently, we made follow-on public offerings, in February 1997 (of 2,085,000 ordinary shares) and in April 2005 (of 1,700,000 ordinary shares), in which we raised $9.4 million and $14.9 million, respectively. To allow us to begin to implement a new strategic plan, on September 8, 2010, a company affiliated with Mr. Nathan Kirsh, our former principal shareholder, provided us with a bridge loan of $10.0 million. To repay the loan and to raise permanent capital for general working capital purposes including facilitating the implementation of our new business strategy, in July and August 2011 we raised $16.2 million from a rights offering of 5,273,274 ordinary shares and a private placement of 150,000 of our ordinary shares.

In October 2016, we completed a rights offering in which we received gross proceeds of approximately $23.8 million from the sale of 6,170,386 ordinary shares. Our controlling shareholders, FIMI V Funds purchased 3,392,869 ordinary shares including through an exercise of over-subscription rights.

In 2016, we paid approximately $12.1 million, (including $0.8 million placed in escrow to secure potential indemnity obligations and net of cash acquired) in consideration of our acquisition of Aimetis in 2016, and approximately $0.4 million (net of $2.4 million of acquired cash) in consideration of our acquisition of a majority interest in ESC BAZ Ltd. in 2018.

In connection with our acquisition of CyberSeal, we issued warrants to purchase 898,203 of our ordinary shares at an exercise price of $ 4.16 per share to CyberSeal's former owners. Of such warrants, 60,000 warrants were exercised in 2017. In October 2018, we agreed to purchase the remaining 838,203 warrants from the warrant holders for an aggregate consideration of $375,000. Under Israeli law, the consummation of such transaction was subject to court approval, which was granted on January 16, 2019. The closing of the purchase of the warrants occurred on March

2019.

We expect that our total research and development expenses in 2019 will be approximately $7.7 million. Our research and development plan for 2019 covers development of new and innovative products, as well as improvement of existing technologies.

We believe that our cash and cash equivalents, bank facilities, bank deposits and our expected cash flows from operations will be sufficient to meet our ongoing cash requirements through 2019. However, our liquidity could be negatively affected by a decrease in demand for our products, including the impact of potential reductions in customer purchases that may result from the current general economic climate.

Cash Flows

The following table summarizes our cash flows for the periods presented:

	Year ended December 31, 2016 (in thousands)	2017	2018
Net cash provided by (used in) operating activities	8,933	(1,952)	7,326
Net cash provided by (used in) investing activities	(40,703)	3,176	10,121
Net cash provided by (used in) financing activities	25,006	504	77
Effect of exchange rate changes on cash and cash equivalents	160	2,076	(1,029)
Increase (decrease) in cash, cash equivalents and restricted cash	(6,604)	3,804	16,495
Cash, cash equivalents and restricted cash at the beginning of the year	28,105	21,501	25,305
Cash, cash equivalents and restricted cash at the end of the year	$ 21,501	$ 25,305	$ 41,800

Net cash provided by operating activities was approximately $8.9 million and $7.3 million in the years ended December 31, 2016 and 2018, respectively compared to net cash used in operating activities of approximately $2 million in the year ended December 31, 2017.

Net cash provided by operating activities in the year ended December 31, 2018 was primarily attributable to 2018 profit, as well as $3.2 million of depreciation and amortization expenses, an increase of $3.2 million in customer advances, an increase of $3.1 million in other accounts payable and accrued expenses and deferred revenues, an increase of $1.1 million in trade payables and a decrease of $0.6 million in trade receivables. This was offset in part by an increase of $4 million in inventories, an increase of $1 million in deferred income taxes, an increase of $1.3 million in other accounts receivables and prepaid expenses and an increase of $0.5 million in accrued interest and exchange differences on short-term and other long-term liabilities.

Net cash used in operating activities in the year ended December 31, 2017 was primarily attributable to our 2017 loss, as well as an increase of $2.1 million in inventories, an increase of $1.6 million in unbilled receivables and an increase of $0.5 million in deferred income taxes. This was offset in part by an increase of $3 million in accrued interest and exchange differences on short-term and other long-term liabilities, $1.9 million of depreciation and amortization expenses, an increase of $1.5 million in other accounts payable and accrued expenses and deferred revenues, an increase of $1.2 in customer advances, an increase of $0.8 million in trade payables and a decrease of $0.5 million in short-term and long-term trade receivables.

Net cash provided by operating activities in the year ended December 31, 2016 was primarily attributable to 2016 income, as well as an increase of $3.4 million in customer advances, a decrease of $1.5 million in trade receivables, net, a decrease of $1.4 million in unbilled receivables, a decrease of $1.2 million in inventory and $1.7 million of depreciation and amortization expenses. This was offset in part by an increase of $1.7 million in deferred income taxes.

Net cash provided by investing activities was approximately $10.1 million in the year ended December 31, 2018 compared to net cash provided by investing activities of approximately $3.2 million in the year ended December 31, 2017 and net cash used in investing activities was approximately $40.7 million in the year ended December 31, 2016.

In the year ended December 31, 2018, our net cash provided by investing activities was primarily attributable sale of short-term bank deposits of $12.9. This was offset in part by purchase of property and equipment for $2.1 million, payments for business acquisitions of ESC BAZ of $0.4 million (net of acquired cash) and investment in technology of $0.3 million.

In the year ended December 31, 2017, our net cash provided by investing activities was primarily attributable sale of short-term bank deposits of $4.1 million. This was offset in part by purchase of property and equipment for $0.9 million.

In the year ended December 31, 2016, our net cash used in investing activities was primarily attributable to investments of short-term bank deposits and restricted deposit of $28.9 million, payments for business acquisitions of Aimetis of $12.1 million and a purchase of property and equipment for $0.8 million.

Net cash provided by financing activities was $0.1 million in the year ended December 31, 2018 compared to net cash provided by financing activities of approximately $0.5 million in the year ended December 31, 2017 and net cash used in financing activities of approximately $25 million in the year ended December 31, 2016.

In the year ended December 31, 2018, our net cash provided by financing activities was attributable to issuance of shares upon exercise of options of $0.1 million.

In the year ended December 31, 2017, our net cash provided by financing activities was primarily attributable to issuance of shares upon exercise of options and warrants of $0.6 million.

In the year ended December 31, 2016, net cash provided by financing activities was $25 million. In 2016 we received net proceeds of $23.6 million from a rights offering and $1.4 million from the exercise of options and issuance of shares under our employee stock purchase plan.

We had capital expenditures of approximately $0.8 million, $0.9 million and $2.1 million in the years ended December 31, 2016, 2017 and 2018, respectively. We estimate that our capital expenditures for 2019 will total approximately $0.7 million. We expect to finance these expenditures primarily from our cash and cash equivalents and our operating cash flows. However, the actual amount of our capital expenditures will depend on a variety of factors, including general economic conditions and changes in the demand for our products.

Credit Lines and Other Debt

As of December 31, 2018, we had credit lines with Bank Leumi Le-Israel B.M., or Bank Leumi and Union Bank of Israel Ltd., or Union Bank, totaling $15 million in the aggregate (of which $11.9 million is reserved exclusively for guarantees out of which $2.8 million was available as of December 31, 2018). Our credit lines at Bank Leumi and Union Bank have no restrictions as to our use of the credit. We are not under any obligation to maintain financial ratios or other terms in respect of our credit lines. In addition, as of December 31, 2018, our foreign subsidiary had credit lines with the Royal Bank of Canada of $1.4 million in the aggregate, of which $1.2 million was available at December 31, 2018.

Our Canadian subsidiary has undertaken to maintain a general covenant and the following financial ratio and term in respect of its outstanding credit lines: a ratio of total liabilities to tangible net worth of not greater than 0.75:1. As of December 31, 2018, the Canadian subsidiary was in a default of its covenant. After the balance sheet date, the bank acknowledged the default and agreed to the Company's plan to remedy such default until May 31, 2019. Such default has no impact on the Company's financial statements as of December 31, 2018.

As of December 31, 2018, our outstanding balances under our credit lines in Israel consisted of several bank performance, advance payment and bid guarantees totaling approximately $9.1 million, at an annual cost of 0.65%-1.15%. As of December 31, 2018, the outstanding balances under the credit lines of our subsidiary consisted of several bank performance, advance payment and bid guarantees totaling approximately $0.2 million, at an annual cost of 1% -2%.

C. Research and Development, Patents and Licenses.

Government Grants

We participate in programs sponsored by the Israeli Government for the support of research and development activities. In the past we have received royalty-bearing grants from the Innovation Authority (formerly the Office of the Chief Scientist) for certain of our research and development projects for perimeter security products. We are obligated to pay royalties to the Innovation Authority amounting to 3.5% of revenues derived from sales of the products funded with these grants and ancillary services, up to 100% of the grants received, linked to the U.S. dollar. All grants received after January 1, 1999 also bear interest equal to the 12 month LIBOR rate. The obligation to pay these royalties is contingent on actual sales of the products, and in the absence of such sales no payment is required.

In 2015, CyberSeal received $134,000 from the Innovation Authority. Following the cancelation of the 2015 project, CyberSeal returned the $134,000 grant received in 2015.

In 2018, Magal received approval for a grant of $301,000 from the Innovation Authority, subject to development milestones achievement. The grant is for further development of Roboguard.

For the years ended December 31, 2016, 2017 and 2018, we paid the Innovation Authority royalties in the amount of $17,000, $33,000 and $6,000, respectively. These royalties related to sales of perimeter security products and management security systems. As of December 31, 2018, we had a contingent obligation to pay royalties to the Innovation Authority in the amount of approximately $1.7 million upon the successful sale of perimeter security products developed under research and development programs sponsored by the Innovation Authority.

We participate in programs sponsored by the Industrial Research Assistance Program (IRAP) in Canada. During 2018 our Canadian subsidiary received grants in the amount of $ 6,000.

Investment Tax Credit

Our Canadian subsidiary is eligible for investment tax credits for its research and development activities and for certain current and capital expenditures. For the years ended December 31, 2018, 2017 and 2016, our Canadian subsidiary recognized $179,000, $117,000 and $149,000, respectively, of investment tax credits.

In addition, as of December 31, 2018, our U.S. subsidiary had available investment tax credits of approximately $245,000 million to reduce future federal and state income taxes payable. These credits will expire in 2019 through 2025 in the U.S. As of December 31, 2018, our subsidiaries made a full valuation allowance in respect of such investment tax credits.

D. Trend Information.

Our 2018 results were impacted by delays in infrastructure security spending in North America. On the other hand, the continuous spending on critical infrastructure security in developing regions, coupled with the growth in VMS and IVA global demand and the signs of gradual recovery in North America will affect the industry in the near future.

E. Off-Balance Sheet Arrangements.

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

F. Tabular Disclosure of Contractual Obligations.

The following table summarizes our minimum contractual obligations and commercial commitments as of December 31, 2018 and the effect we expect them to have on our liquidity and cash flow in future periods.

	Payments due by period				
Contractual Obligations	Total	Less than 1 year	1-2 years	3-5 years	More than 5 years
	(in thousands)				
Operating lease obligations	4,893	1,119	720	1,581	1,473
Other long-term liabilities reflected on our balance sheet under U.S. GAAP	2,181	-	-	-	2,181
Total	7,074	1,119	720	1,581	3,654

In addition, we have guaranteed advance payments, the performance of our work and provided warranties for the performance of our work to certain of our customers (usually governmental entities). Such guarantees are required by contract for our performance during the installation and operational period of projects throughout Israel and the rest of the world. The performance guarantees typically expire soon after certain milestones are met and warranty guarantees typically expire at the end of the warranty period. The maximum potential amount of future payments we could be required to make under our guarantees at December 31, 2018 was $9.3 million. We have not recorded any liability for such amounts as we believe our performance will not result in any claims.

ITEM 6. Directors, Senior Management and Employees

A. Directors and Senior Management.

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

Name	Age	Position
Gillon Beck	57	Chairman of the Board of Directors
Ron Ben-Haim	49	Director
Jacob Berman	70	Director
Avraham Bigger (1)(2)	73	Director
Liza Singer (1)(2)	48	External Director
Moshe Tsabari (1)(2)	65	External Director
Dror Sharon	53	Chief Executive Officer
Yaacov Vinokur	41	Chief Financial Officer
Brian Rich	62	Deputy CEO, CTO and President of Senstar Corporation
Doron Kerbel	47	Vice President – General Counsel and Company Secretary
Yaniv Shachar	45	Senior Vice President & General Manager Magal Israel
Jeremy Weese	42	Senior Vice President & COO of Senstar Corporation
Kristen Cory	36	Vice President North America Sales
Carlos Garcia Almeida	48	General Manager Latin America
Fabien Haubert	44	Vice President EMEA Sales
Gord Loney	66	Vice President APAC Sales

(1) Member of our Audit Committees.
(2) Member of our Compensation Committee

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Gillon Beck has served as a director and Executive Chairman of our board of directors since September 2014. Since 2003, Mr. Beck has been a Senior Partner at FIMI Opportunity Funds, the controlling shareholder of Magal, as well as a Director of the FIMI Opportunity Funds' General Partners and SPV companies. In addition, Mr. Beck currently serves as Chairman of the Board of ImageSat NV, Bet Shemesh Engines LTD (TASE), Ham-Let (Israel-Canada) Ltd. (TASE), Rivulis Irrigation Ltd., Inrom Industries Ltd., Oxygen and Argon Works Ltd and Overseas Commerce Ltd., Bird Aerosystems Ltd, and is a director of Inrom Construction Industries Ltd. (TASE), Orbit Technologies Ltd (TASE), Carmel Forge Ltd., Monfort Medical Ltd, AITECH Ltd, and Unitronics (1989) (R"G) Ltd (TASE). During the past five years, Mr. Beck had served as a member of the Board of Directors of the following public companies: Overseas Commerce Ltd (TASE), Ormat Technologies Inc. (NYSE) and Ormat Industries Ltd. From 1999 to 2003, Mr. Beck served as Chief Executive Officer and President of Arad Ltd., a publicly-traded water measurement and automatic meter reading company, and from 1995 to 1999, he served as Chief Operating Officer of Arad Ltd. Mr. Beck received a Bachelor of Science degree (Cum Laude) in Industrial Engineering in 1990 from the Technion – Israel Institute of Technology, and a Master of Business Administration in Finance in 1992 from Bar-Ilan University.

Ron Ben-Haim has served as a director since September 2014. Mr. Ben-Haim has been a partner in FIMI Opportunity Funds since 2006. Mr. Ben-Haim currently serves on the boards of directors of Poliram Plastic Industries Ltd., Oxygen and Argon Works Ltd., Tadir-Gan (Precision Products) 1993, Ltd. (TASE), Aitech Rugged Group, Inc., Rivulis Irrigation Ltd., Inrom Industries Ltd., Inrom Construction Industries Ltd. (TASE), Nirlat Paints Ltd., Alony Ltd., Orbit Technologies, Ltd. (TASE), G1 Security Solutions, Ltd (TASE) and TAT Technologies, Ltd. (TASE, NASDAQ). Mr. Ben Haim formerly served as a member of the boards of directors of the following public companies: Hadera Paper Ltd., Overseas Commerce, Ltd., Medtechnica, Ltd., Ginegar Plastic Products, Ltd., Raval Acs, Ltd., Merhav Ceramic and Building Materials Center, Ltd. and Ophir Optronics, Ltd. Mr. Ben Haim was previously with Compass Advisers, LLP, an investment banking firm based in New York and in Tel Aviv and with the Merrill Lynch Mergers and Acquisitions group in New York. Prior to Merrill Lynch, Mr. Ben-Haim worked at Teva Pharmaceuticals in production management. Mr. Ben-Haim holds a B.Sc. degree in industrial engineering from the Tel Aviv University and an M.B.A. degree from New York University.

Jacob Berman has served as a director since November 2013. Since November 2014, Mr. Berman serves as the chairman of the board of directors of Israel Discount Bank of New York and acted as a member of our audit committee and compensation committee between September 2014 and December 2014. Mr. Berman has been President of JB Advisors, Inc., a New York based financial advisory firm with extensive experience in international private banking, real estate investment counseling, and commercial/retail banking since 2002. Mr. Berman served as a director of Micronet Enertec Technologies, Inc. Previously, Mr. Berman was the founder, President and CEO of the Commercial Bank of New York.

Avraham Bigger has served as a director since September 2014. Mr. Bigger has been, since 2010, the owner and a member of the Board of Directors of Bigger Investments Ltd. Mr. Bigger currently serves as a board member of Migdal insurance, chairman of the board at Recha, board member at MCA (car import and distributor), international board member of the Weitzman Science Institute and president of the Israel Nature and Heritage Foundation. He formerly served as the Chief Executive Officer and Chairman of the Board of Directors of Makhteshim Agam Industries Ltd., Chairman of the Boards of Directors of Supersol Ltd. (TASE), Caniel Beverages & Caniel Packaging Industries Ltd., the Edmond Benjamin de Rothschild Caesarea Foundation and as managing director of Paz Oil Company Ltd. (TASE) and Israel General Bank (U Bank). Mr. Bigger also served as a member of the Boards of Directors of Bank Leumi Le-Israel Ltd. (TASE), First International Bank of Israel Ltd. (TASE), Strauss Group Ltd. (formerly known as Strauss-Elite Ltd.) (TASE), Partner Communications Company Ltd. (TASE), Cellcom Israel Ltd. (TASE, NYSE), El-Al Israel Airlines Ltd. and various private companies. Mr. Bigger received a Bachelor of Economics degree and an M.B.A. degree, both from the Hebrew University of Jerusalem.

Liza Singer has served as an external director since June 2010. Since 2003, Ms. Singer has served as the owner's representative of the Lewis Trust Group, an investment assessment and development entity that focuses on tourist projects and the development of marine and hotels resorts. Ms. Singer serves as a director of the Haifa Port and Diners Club Israel Ltd. During 2007, Ms. Singer served as the chief operating officer and country manager of Brack Capital Real Estate. Previously, Ms. Singer served as the Vice President of Business Development of the Baran Group, a provider of engineering and construction services, as investment director of Syntek Capital, a private-equity investment company and as an associate at APAX Partners & Co., a venture capital fund. Previously Ms. Singer worked at Kesselman & Kesselman, the Israeli member firm of PriceWaterhouseCoopers and at Gornitzky & Co. a leading Israeli law firm. Ms. Singer has an LL.B degree, a B.A. degree in accounting and an M.B.A. degree, all from Tel Aviv University. Ms. Singer is a certified public accountant (Israel) and a registered lawyer with the Israeli Bar Association.

Moshe Tsabari has served as an external director since December 2014. Mr. Tsabari is the owner and serves as the joint CEO of GME Trust, a company that advises on crisis management and improvement of work processes, in Israel and worldwide. Since 2005, Mr. Tsabari has served as the owner and director of Osher – Training & Consulting Ltd. From 2006 to 2011 Mr. Tsabari served as a senior partner in the International Company for Defense and Rescue Ltd. and in QG Company, two companies that are engaged in the provision of consultancy and training projects in the security field in Israel. In addition, Mr. Tsabari is the founder of the International Institute for Researching the Arab World, is a former director in Links Aviation and is the former CEO of SYS-TRY, an electronic equipment development company. Prior to that, Mr. Tsabari served for 15 years, until 2004, in the Israeli Security Agency (ISA) in a number of positions, including Director of Personal in the Human Resources Division, Director of Security Assistance Division (rank in both positions equivalent to Major General) and Head of the Operations Division (rank equivalent to Brigadier). Mr. Tsabari holds a B.Sc. degree in Geodetic Engineering, a M.A. degree in Industrial and Management Engineering and a PhD degree in Science, all from the Technion – The Israeli Institute of Technology. In addition, Mr. Tsabari is an A.M.P. graduate from the Wharton School of the University of Pennsylvania.

Dror Sharon has served as our Chief Executive Officer since June 24, 2018 following a six years career as President and CEO at Controp Precision Technology Ltd., a company specializing in developing, manufacturing and selling Electro Optical and Precision Motion Control Systems for the global defense and homeland security (HLS) markets. Prior to that, Mr. Sharon served in various positions at Opgal Optronics Ltd., the last four years as its President and CEO. Mr. Sharon holds an MBA degree from Derby University, United Kingdom and a B.Sc. degree in Mechanical Engineering (Dean's award of excellence) from the Technion -Israel Institute of Technology, Haifa, Israel.

Yaacov (Kobi) Vinokur joined our company as Chief Financial Officer in September 2016. Prior to joining our company, Mr. Vinokur served for three years as Chief Financial Officer of Miya (Arison Group), a global provider of comprehensive water efficiency solutions and a water utilities operator. Prior to that, Mr. Vinokur served in several key leadership positions at Brink's Company (NYSE: BCO), a global leader in cash logistics, including Chief Financial Officer - Developing Markets division, Director of Procurement - EMEA division and Director of Finance - Global Services division. Prior to his career with Brink's, Mr. Vinokur served as an Executive Director at Shapira Films, one of the leading film distribution and production companies in Israel, as well as a Head of Treasury at the Ministry of Defense of Israel. In 2017, the Israeli CFO Forum honored Mr. Vinokur with its annual CFO Excellence award. Mr. Vinokur, a certified public accountant in the United States and Israel, holds a B.A. degree in Accounting and Economics (magna cum laude) from Haifa University and a M.B.A. degree (cum laude) from Tel Aviv University. Mr. Vinokur is also a graduate of Harvard Business School's Leadership Development Program.

Brian Rich serves as Deputy CEO, CTO and President of Senstar Corporation, our Canadian subsidiary since May 2015. Prior to such date, he served as President of Senstar Corporation since September 2000. Prior to joining Magal, Mr. Rich served as Vice President, Engineering and Operations at Intelligent Detection Systems (IDS), a designer and manufacturer of trace explosives and narcotics detection equipment. Prior to IDS he was a founding member of Senstar Corporation Canada from October 1981 to February 1998, during which time he held positions of increasing responsibility ending as Vice President, Engineering and Systems, and prior to that was a research engineer at Computing Devices Company of Canada (a Control Data company). Mr. Rich holds a B.A.Sc. degree in Electrical Engineering from the University of Toronto.

Doron Kerbel has served as our General Counsel since July 2015. Prior to joining Magal, Mr. Kerbel had served for more than eight years as legal counsel at Elbit Systems Ltd. (NASDAQ: ESLT) Aerospace Division. Mr. Kerbel has extensive experience in advising on variety of commercial legal issues, mergers and acquisitions as well as (private finance initiatives) PFI and BOT (Build Operate Transfer) projects, both locally and internationally. Prior to his work at Elbit Systems, Mr. Kerbel was an associate lawyer at M. Firon & Co. and Senior Legal Counsel for International Law at the Israeli Embassy to the Netherlands. Mr. Kerbel holds a LL.B. degree from the Interdisciplinary Center (IDC) Herzliya and a LL.M. degree (with distinction) from the International Law School, University of Amsterdam.

Yaniv Shachar serves as Vice President Projects and Operations. Mr. Shachar joined Magal in June 2015. Prior to joining Magal, he worked for five and half years at Logic Industries Ltd. (a subsidiary of AGT International) as Project, Program, and Division Manager, leading large-scale homeland security projects and operations in the Middle East. Prior to joining Logic, Mr. Shachar served for 17 years in the Israeli Navy. Mr. Shachar is a graduate of the Executive M.B.A. program of the Hebrew University in Jerusalem, where he majored in integrative management. He also holds a B.A. degree in Economics and Communications from Haifa University.

Jeremy Weese joined Magal in 1999 in a design engineering role. During his tenure with the company Mr. Weese has moved through progressive levels of responsibility within the research and development department. Prior to taking the position of Chief Operations Officer, Mr. Weese was responsible for the Company’s product portfolio and research and development activities as VP of Engineering. Mr. Weese has served in his current role as Senior VP & COO since April 2016. Mr. Weese is a Professional Engineer and member of the IEEE. He holds a B.A.Sc. degree in Computer Engineering from the University of Ottawa.

Kristen Cory joined our company in January 2019 as Vice President - North American Sales of Senstar Corporation, our Canadian subsidiary. Prior to Senstar, Ms. Cory held the position of Director of Business Development with Hikvision USA – world’s largest provider of video surveillance solutions – where she focused on the demand creation side of generating rapid business growth. Prior to Hikvision, Ms. Cory controlled the operations (sales, technical, support, etc.) for Raytec Systems, Inc.; a high end security LED lighting solution for the enterprise and oil & gas industries.

Carlos Garcia Almeida joined our company in February 2013 with more than 23 years of experience in the security market. Prior to joining our company, Mr. Garcia served as General Manager of Prosegur Mexico. Prior to Prosegur, Mr. Garcia served in several leadership and general management roles in leading security organizations, among them UTC Fire & Security and Tyco Fire & Security. Mr. Garcia holds a degree in Telecom Engineering and has successfully participated in various executive programs, including the Management Development Program (D-1) from the IPADE Business School.

Fabien Haubert joined our company in February 2018 as Vice President Sales – EMEA Region, based in Paris, France. Mr. Haubert’s most recent experience (February 2014 – February 2018) was with UK based CCTV solution provider Indigo Vision located in Edinburgh where he was Regional Director – EMEA South. Previous to his 4 years at Indigo he worked with several companies in the VMS, IP CCTV, intrusion, access control and integration areas since 2002. He has extensive experience in sales management with past responsibility for the EMEA region. Mr. Haubert has a technical background with a Master of Science degree in Electronics Engineering (Ecole Supérieure d’Ingénieurs en Electrontechnique et Electronique) as well as a Master of Strategy and Engineering of International business (Ecole Supérieure des Sciences Economiques et Commerciales). He speaks French, English, Spanish, and Italian and has a working knowledge of Dutch.

Gord Loney joined our company in 1995 when he was responsible for product sales in Canada, the Middle East and Africa, before assuming responsibility for strategic OEM accounts and the Far East. During 2016 Mr. Loney was appointed as Vice President for Sales - Asia Pacific. In this role Mr. Loney is responsible for establishment of an office in the Clark Freeport Zone in the Philippines, from which he is leading a support and sales team to better serve the high growth Asian market. Mr. Loney is an engineering graduate of the Royal Military College of Canada who served twenty-five years in the Royal Canadian Air Force.

The terms of office of Messrs. Beck, Berman, Ben-Haim and Bigger will expire at our 2019 annual general meeting of shareholders. The terms of our external directors, Mr. Tsabari and Ms. Singer, expire in 2020 and 2019, respectively.

Mr. Dror Sharon replaced Saar Koursh as our CEO in June 2018. Mr. Yaniv Shachar, E.V.P. and General Manager of Magal Israel, acted as CEO in the interim period after Mr. Koursh left our company on April 30, 2018.

B. Compensation

Compensation of Directors and Executive Officers

The aggregate compensation costs on behalf of our directors and executive officers as a group during 2018 (including the former Chief Executive Officer who was replaced during the course of 2018) consisted of approximately $3.1 million in salary, fees, bonus, equity based compensation, commissions and directors' fees, but excluding dues for professional and business associations, business travel and other expenses commonly reimbursed or paid by companies. As of December 31, 2018, the aggregate amount set aside or accrued for pension, retirement and vacation or similar benefits for our directors and executive officers was approximately $0.1 million. In addition, we e provide automobiles to our executive officers at our expense.

We pay our directors an annual fee of NIS 90,000 (approximately $24,000) and a fee of NIS 4,000 (approximately $1,050) for each board or committee meeting that they attend. Such amounts are linked to the Israeli consumer price index, or CPI, and are updated on a semi-annual basis and accordingly, are adjusted to reflect changes in the CPI in February and August, each year. In addition, we pay to our Executive Chairman a monthly payment of NIS 15,000 (approximately $4,000).

As of December 31, 2018, our directors and executive officers as a group, then consisting of 16 persons, held options to purchase an aggregate of 669,500 ordinary shares, having exercise prices ranging from $4.15 to $5.61. Generally, the options vest over a two to four year period. Of such options, no options to purchase ordinary shares expire in 2019; and options to purchase 669,500 ordinary shares expire in each of 2020 -2026. See this Item 6E. "Directors, Senior Management and Employees – Share Ownership – Stock Option Plans."

Compensation of Senior Office Holders – Israel Companies Law Disclosure

The table below sets forth the compensation paid to our five most highly compensated senior office holders (as defined in the Israeli Companies Law) during the year ended December 31, 2018 (which include one former executive officer), in the disclosure format of Regulation 21 of the Israeli Securities Regulations (Periodic and Immediate Reports), 1970. We refer to the five individuals for whom disclosure is provided herein as our "Covered Executives."

Information Regarding the Covered Executive[1]
(in thousands)

Name and Principal Position[2]	Base Salary	Benefits and Perquisites[3]	Variable Compensation[4]	Equity-Based Compensation[5]	Total
Dror Sharon – Chief Executive Officer	148	73	134	116	471
Saar Koursh – Former Chief Executive Officer	102	219	146	(63)	404
Yaniv Shachar - Senior Vice President & General Manager Magal Israel	167	74	58	31	330
Fabien Haubert - Vice President EMEA Sales	161	76	51	15	303
Yaacov Vinokur	141	60	63	11	275

-
Chief
Financial
Officer

(1) All amounts reported in the table are in terms of cost to our company, as recorded in our financial statements.

(2) All current Covered Executives listed in the table are full-time employees. Cash compensation amounts denominated in currencies other than the U.S. dollar were converted into U.S. dollars at the average conversion rate for the year ended December 31, 2018.

(3) Amounts reported in this column include benefits and perquisites or on account of such benefits and perquisites, including those mandated by applicable law. Such benefits and perquisites may include, to the extent applicable to each executive, payments, contributions and/or allocations for savings funds, pension, severance, vacation, car or car allowance, medical insurances and benefits, risk insurances (e.g., life, disability, accident), convalescence pay, payments for social security, tax gross-up payments and other benefits and perquisites consistent with our guidelines.

(4) Amounts reported in this column refer to Variable Compensation such as commission, incentive and bonus payments as recorded in our financial statements for the year ended December 31, 2018.

(5) Amounts reported in this column represent the expense recorded in our financial statements for the year ended December 31, 2018.

Pursuant to the Israeli Companies Law, we have adopted a compensation policy and are required to follow certain approval requirements with respect to the compensation of our directors and executive officers. See below “Board of Directors – Compensation Committee” and Item 10. Additional Information — Office Holders.

We follow Israeli law and practice instead of the requirements of the NASDAQ Stock Market Rules regarding the compensation of our chief executive office and other executive officers. See Item 16G. “Corporate Governance.”

C. Board Practices

Introduction

According to the Israeli Companies Law and our articles of association, the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. Our executive officers are responsible for our day-to-day management. The executive officers have individual responsibilities established by our chief executive officer and board of directors. Executive officers are appointed by and serve at the discretion of the board of directors, subject to any applicable agreements.

Election of Directors

Our articles of association provide for a board of directors of not less than three and not more than 11 members, as may be determined from time to time at our annual general meeting. Our board of directors is currently composed of seven (6) directors.

Our directors (except the external directors, as detailed below), are elected by our shareholders at our annual general meeting and hold office until the next annual general meeting. All the members of our board of directors (except the external directors), may be reelected upon completion of their term of office. Our annual general meetings of shareholders are held at least once every calendar year, but not more than 15 months after the last preceding annual general meeting. In the intervals between our annual general meetings of shareholders, the board of directors may from time to time appoint a new director to fill a casual vacancy or to add to their number, and any director so appointed will remain in office until our next annual general meeting of shareholders and may be re-elected.

Under the Israeli Companies Law, our board of directors is required to determine the minimum number of directors who must have "accounting and financial expertise," as such term is defined in regulations promulgated under the Israeli Companies Law. Our board of directors has determined that at least one director must have "accounting and financial expertise." Our board of directors has further determined that Ms. Liza Singer has the requisite "accounting and financial expertise."

We do not follow the requirements of the NASDAQ Stock Market Rules regarding the nomination process of directors, and instead, we follow Israeli law and practice, in accordance with which our directors are recommended by our board of directors for election by our shareholders. See Item 16G. "Corporate Governance."

External and Independent Directors

External directors. The Israeli Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint at least two external directors. The Israeli Companies Law provides that a person may not be appointed as an external director if the person, or the person's relative, partner, employer or an entity under that person's control, has or had during the two years preceding the date of appointment any affiliation with the company, or any entity controlling, controlled by or under common control with the company. The term "relative" means a spouse, sibling, parent, grandparent, child or child of spouse or spouse of any of the above as well as a sibling, brother, sister or parent of the foregoing relatives. In general, the term "affiliation" includes an employment relationship, a business or professional relationship maintained on a regular basis, control and service as an office holder. Furthermore, if the company does not have a controlling shareholder or a shareholder holding at least 25% of the voting rights, "affiliation" also includes a relationship, at the time of the appointment, with the chairman of the board, the chief executive officer, a substantial shareholder or the most senior financial officer of such company. Regulations promulgated under the Israeli Companies Law include certain additional relationships that would not be deemed an "affiliation" with a company for the purpose of service as an external director. In addition, no person may serve as an external director if the person's position or other activities create, or may create a conflict of interest with the person's responsibilities as director or may otherwise interfere with the person's ability to serve as director or if such person is an employee of the Israel Securities Authority or of an Israeli stock exchange. If, at the time an external director is appointed, all current members of the board of directors are of the same gender, then that external director must be of the other gender. A director of one company may not be appointed as an external director of another company if a director of the other company is acting as an external director of the first company at such time.

At least one of the elected external directors must have "accounting and financial expertise" and any other external director must have "accounting and financial expertise" or "professional qualification," as such terms are defined by regulations promulgated under the Israeli Companies Law.

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The external directors are elected by shareholders at a general meeting. The shareholders voting in favor of their election must include at least a majority of the shares voted by shareholders other than controlling shareholders or shareholders who have a personal interest in the election of the external director (unless such personal interest is not related to such persons relationship with the controlling shareholder) present and voting at such meeting (excluding abstentions). This majority requirement will not be required if the total number of shares of such non-controlling shareholders and disinterested shareholders who vote against the election of the external director represent 2% or less of the voting rights in the company.

In general, under the Israeli Companies Law, external directors serve for a three-year term and may be reelected to two (2) additional three-year terms. However, Israeli companies listed on certain stock exchanges outside Israel, including The NASDAQ Global Market, such as our company, may appoint an external director for additional terms of not more than three years subject to certain conditions. Such conditions include the determination by the audit committee and board of directors, that in view of the director’s professional expertise and special contribution to the company’s board of directors and its committees, the appointment of the external director for an additional term is in the best interest of the company. External directors can be removed from office only by the same special percentage of shareholders that can elect them, or by a court order, and then only if the external directors cease to meet the statutory qualifications with respect to their appointment or if they violate their fiduciary duty to the company.

Pursuant to the Israeli Companies Law, external directors up for re-election are nominated either by the board of directors or by any shareholder(s) holding at least 1% of the voting rights in the company. If the board of directors proposed the nominee, the reelection must be approved by the shareholders in the same manner required to appoint external directors for an initial term, as described above. If such reelection is proposed by shareholders, such reelection requires the approval of the majority of the shareholders voting on the matter, and satisfaction of all of the following requirements: (i) In calculating the majority votes, the votes of the controlling shareholders and other shareholders that have personal interest in such reelection (unless such personal interest is not related to such persons relationship with the controlling shareholder) as well as abstentions are not included; (ii) the votes of the non-controlling shareholders in favor of the reelection and of the shareholders who do not have personal interest in the reelection (unless such personal interest is not related to such person’s relationship with the controlling shareholder) is greater than 2% of the voting rights in the company; and (iii) the external director is not, at the time of such reelection, a related shareholder or competitor or a relative thereof and does not have any affiliation to any related shareholder, competitor or any relative thereof during the two years prior to such re-election. A related shareholder or a competitor are defined as the shareholder proposing the reelection, any substantial shareholder (within the meaning of the Israeli Companies Law) if at the time of reelection either such shareholder, its controlling shareholder or any company controlled by either of them has business relations with the company or that either such shareholder, its controlling shareholder or a company controlled by either of them is a competitor of the company.

Each committee of the board of directors that is authorized to exercise powers vested in the board of directors must include at least one external director and the audit committee must include all the external directors. An external director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with such service.

Ms. Singer and Mr. Tsabari serve as our external directors under the Israeli Companies Law. Ms. Singer’s term will expire in 2019 and Mr. Tsabari’s term will expire in 2020.

Independent Directors. Pursuant to the Israeli Companies Law, a director may be qualified as an independent director if such director is either (i) an external director; or (ii) or a director who is appointed or classified as such, and who meets the qualifications of an external director (other than the professional qualifications/accounting and financial expertise requirement), who the audit committee has confirmed meets the external director qualifications, and who has not served as a director for more than nine consecutive years (with any period of up to two years during which such person does not serve as a director not being viewed as interrupting a nine-year period).

In general, NASDAQ Stock Market Rules require that the board of directors of a NASDAQ-listed company has a majority of independent directors and that its audit committee has at least three members and be comprised only of independent directors, each of whom satisfies the "independence" requirements of NASDAQ and the SEC. However, foreign private issuers, such as our company, may follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Stock Market Rules. On June 30, 2006, we provided NASDAQ with a notice that instead of maintaining a majority of independent directors, we follow Israeli law, under which we are required to appoint at least two external directors, within the meaning of the Israeli Companies Law, to our board of directors. In addition, in accordance with the rules of the SEC and NASDAQ, our audit committee is composed of three independent directors, as defined in the rules of the SEC and NASDAQ. At present the majority of our directors satisfy the independence requirements of NASDAQ and the SEC.

Our board of directors has determined that our external directors, Ms. Singer and Mr. Tsabari, qualify as independent directors under the requirements of the SEC and NASDAQ. Our board of directors has further determined that Messrs. Bigger and Berman also qualify as independent directors under the requirements of the SEC and NASDAQ.

Audit Committee under Israeli Law

Under the Israeli Companies Law, the board of directors of any public company must establish an audit committee, or the Israeli Audit Committee. The Israeli Audit Committee must consist of at least three directors and must include all of the external directors, the majority of which must be independent directors. The Israeli Audit Committee may not include the chairman of the board of directors; any director employed by the company or providing services to the company on an ongoing basis (other than as a director); a controlling shareholder or any of the controlling shareholder's relatives; and any director who is employed by, or rendered services to, the controlling shareholder or an entity controlled by the controlling shareholder, or a director whose main livelihood is from the controlling shareholder. Any person who is not permitted to be a member of the Israeli Audit Committee may not be present in the meetings of the Israeli Audit Committee unless the chairman of the Israeli Audit Committee determines that such person's presence is necessary in order to present a specific matter. However, an employee who is not a controlling shareholder or relative of a controlling shareholder may participate in the audit committee's discussions but not in any vote, and at the request of the Israeli Audit Committee, the secretary of the company and its legal counsel may be present during the meeting. The chairman of the Israeli Audit Committee must be an external director.

The role of the Israeli Audit Committee, pursuant to the Israeli Companies Law, includes:

- monitoring deficiencies in the management of the company, including in consultation with the independent auditors or the internal auditor, and to advise the board of directors on how to correct such deficiencies. If the audit committee finds a material deficiency, it will hold at least one meeting regarding such material deficiency, with the presence of the internal auditor or the independent auditors but without the presence of the senior management of the company. However, a member of the company's senior management can participate in the meeting in order to present an issue which is under his or her responsibility;

- determining, on the basis of detailed arguments, whether to classify certain engagements or transactions as material or extraordinary, as applicable, and therefore as requiring special approval under the Israeli Companies Law. The audit committee may make such determination according to principles and guidelines predetermined on an annual basis;

- determining if transactions (excluding extraordinary transactions) with a controlling shareholder, or in which a controlling shareholder has a personal interest, are required to be rendered pursuant to a competitive procedure;

- deciding whether to approve engagements or transactions that require the Israeli Audit Committee approval under the Israeli Companies Law;

- determining the approval procedure of non-extraordinary transactions, following classification as such by the Israeli Audit Committee, including whether such specific non-extraordinary transactions require the approval of the Israeli Audit Committee;

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- examining and approving the annual and periodical working plan of the internal auditor;
- overseeing the company's internal auditing and the performance of the internal auditor; confirm that the internal auditor has sufficient tools and resources at his disposal, taking into account, among other, the special requirements of the company and its size;
- examining the scope of work of the independent auditor and its pay, and bringing such recommendations on these issue before the Board;
- determining the procedure of addressing complaints of employees regarding shortcomings in the management of the company and ensure the protection of employees who have filed such complaints;
- determining with respect to transactions with the controlling shareholder or in which such controlling shareholder has personal interest, whether such transactions are extraordinary or not, an obligation to conduct competitive process under supervisions of the audit committee or determination that prior to entering into such transactions the company shall conduct other process as the audit committee may deem fit, all taking into account the type of the company; and
- determining the manner of approval of transactions with the controlling shareholder or in which it has personal interest which (i) are not negligible transactions (pursuant to the committee's determination) and (ii) are not qualified by the Israeli Audit Committee as extraordinary transactions.

Our Israeli Audit Committee is currently composed of Ms. Singer and Messrs. Bigger and Tsabari. Both Ms. Singer and Mr. Tsabari satisfy the "independence" requirements of the Israeli Companies Law. Our board of directors has determined that Ms. Singer has the requisite accounting and financial expertise to serve as our audit committee financial expert. Ms. Singer also serves as the chairperson of our Israeli Audit Committee. The Israeli Audit Committee meets at least once each quarter.

Audit Committee under U.S. Laws and Regulations

The NASDAQ Stock Market Rules require us to establish an audit committee consisting of at least three members, each of whom must be financially literate and satisfy the respective ''independence'' requirements of the SEC and NASDAQ and one of whom has accounting or related financial management expertise. Such audit committee is established for the primary purpose of assisting the Board in overseeing the:

- integrity of the Company's financial statements;
- independent auditor's qualifications, independence and performance;
- Company's financial reporting processes and accounting policies; performance of the Company's internal audit function; and
- Company's compliance with legal and regulatory requirements.

Ms. Singer and Messrs. Bigger and Tsabari satisfy the respective "independence" requirements of the SEC and NASDAQ. Our board of directors has determined that Ms. Singer has the requisite accounting and financial expertise to serve as our Audit Committee financial expert and that both Mr. Bigger and Mr. Tsabari are financially literate, having a basic understanding of financial controls and reporting. The U.S. Audit Committee meets at least once each quarter. Mr. Bigger serves as chairperson of our U.S. Audit Committee for purposes of compliance with U.S. law and regulations.

Compensation Committee

Pursuant to the Israeli Companies Law, each publicly traded company is required to establish a compensation committee which must be comprised of at least three directors, including all of the external directors. The additional members of the compensation committee must be directors that receive compensation in accordance with the provisions and limitations set forth in the regulations promulgated under the Israeli Companies Law with respect to external directors. An external director shall serve as the chairman of the compensation committee. Under the Israeli Companies Law, the external directors shall constitute a majority of the compensation committee. Similar to the rules that apply to the audit committee, the compensation committee may not include the chairman of the board, or any director employed by us, by a controlling shareholder or by any entity controlled by a controlling shareholder, or any director providing services to us, to a controlling shareholder or to any entity controlled by a controlling shareholder on a regular basis, or any director whose primary income is dependent on a controlling shareholder, and may not include a controlling shareholder or any of its relatives. Individuals who are not permitted to be compensation committee members may not participate in the committee's meetings other than to present a particular issue; provided, however, that an employee that is not a controlling shareholder or relative may participate in the committee's discussions but not in any vote, and the company's legal counsel and corporate secretary may participate in the committee's discussions and votes if requested by the committee.

The compensation committee is responsible for (i) recommending the compensation policy to the board of directors for its approval (and subsequent approval by shareholders) and (ii) duties related to the compensation policy and to the approval of the terms of engagement of office holders, including: recommending whether a compensation policy should continue in effect, if the then-current policy has a term of greater than three (3) years (approval of either a new compensation policy or the continuation of an existing compensation policy must in any case occur every three years), recommending to the board of directors periodic updates to the compensation policy, assessing implementation of the compensation policy; determining whether the compensation terms of a proposed new Chief Executive Officer of the company need not be brought to approval of the shareholders; and determining whether to approve transactions concerning the terms of engagement and employment of the company's officers and directors that require compensation committee approval under the Israeli Companies Law or the company's compensation plans and policies.

We have established a compensation committee that is currently composed of Ms. Singer and Messrs. Bigger and Tsabari. Mr. Tsabari serves as the chairperson of our Compensation Committee. The composition and function of the Compensation Committee comply with the requirements of the Israeli Companies Law and NASDAQ Stock Market Rules.

Israeli Regulations

In March 2016, the Israeli Companies Law Regulations were amended to reduce certain duplicative regulatory burden to which Israeli companies publicly-traded on NASDAQ are subject to.

Generally, pursuant to the new regulations, an Israeli company traded on NASDAQ that does not have a "controlling shareholder" (as defined in the Israeli Companies Law) will be able to elect not to appoint External Directors to its Board of Directors and not to comply with the Audit Committee and Compensation Committee composition and chairman requirements of the Israeli Companies Law (as described above under); provided, the company complies with the applicable NASDAQ independent director requirements and the NASDAQ Audit Committee and Compensation Committee composition requirements.

Since our largest shareholder, the limited partnerships managed by FIMI FIVE 2012 Ltd., are deemed to be a "controlling shareholder" under the Israeli Companies Law, we are not currently eligible to benefit from the relief provided by these new amended Israeli regulations.

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Internal Auditor

Under the Israeli Companies Law, the board of directors of a publicly traded company must appoint an internal auditor nominated by the audit committee. The role of the internal auditor is to examine whether the company's actions comply with the law, integrity and orderly business practice. Under the Israeli Companies Law, the internal auditor may not be an interested party, an office holder, or an affiliate, or a relative of an interested party, office holder or affiliate, nor may the internal auditor be the company's independent accountant or its representative. KPMG serves as our Internal Auditor.

Directors' Service Contracts

There are no arrangements or understandings between us and any of our subsidiaries, on the one hand, and any of our directors, on the other hand, providing for benefits upon termination of their employment or service as directors of our company or any of our subsidiaries.

Chairman of the Board

Under the Israeli Companies Law, the general manager of a company (or a relative of the general manager) may not serve as the chairman of the board of directors, and the chairman of the board of directors (or a relative of the chairman of the board of directors) may not serve as the general manager, unless approved by the shareholders by a special majority vote prescribed by the Israeli Companies Law. The shareholder vote cannot authorize the appointment for a period of longer than three years, which period may be extended from time to time by the shareholders with a similar special majority vote. The chairman of the board of directors shall not hold any other position with the company (except as general manager if approved in accordance with the above procedure) or in any entity controlled by the company, other than as chairman of the board of directors of a controlled entity, and the company shall not delegate to the chairman duties that, directly or indirectly, make him or her subordinate to the general manager.

Approval of Related Party Transactions under Israeli Law

Fiduciary Duties of Office Holders

The Israeli Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An "office holder" is defined in the Israeli Companies Law as a director, general manager, chief business manager, deputy general manager, vice general manager, other manager directly subordinate to the general manager or any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title. An office holder's fiduciary duties consist of a duty of care and a fiduciary duty. The duty of care requires an office holder to act at a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to utilize reasonable means to obtain (i) information regarding the appropriateness of a given action brought for his approval or performed by him by virtue of his position and (ii) all other information of importance pertaining to the foregoing actions. The fiduciary duty includes (i) avoiding any conflict of interest between the office holder's position in the company and any other position he holds or his personal affairs, (ii) avoiding any competition with the company's business, (iii) avoiding exploiting any business opportunity of the company in order to receive personal gain for the office holder or others, and (iv) disclosing to the company any information or documents relating to the company's affairs that the office holder has received due to his position as an office holder.

Disclosure of Personal Interests of an Office Holder; Approval of Transactions with Office Holders

The Israeli Companies Law requires that an office holder promptly, and no later than the first board meeting at which such transaction is considered, disclose any personal interest that he or she may have and all related material information known to him or her and any documents in their position, in connection with any existing or proposed transaction by us. In addition, if the transaction is an extraordinary transaction, that is, a transaction other than in the ordinary course of business, other than on market terms, or likely to have a material impact on the company's profitability, assets or liabilities, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder or a relative is a 5% or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager.

Some transactions, actions and arrangements involving an office holder (or a third party in which an office holder has an interest) must be approved by the board of directors or as otherwise provided for in a company's articles of association, however, a transaction that is adverse to the company's interest may not be approved. In some cases, such a transaction must be approved by the audit committee and by the board of directors itself, and under certain circumstances shareholder approval may also be required. A director who has a personal interest in a transaction that is considered at a meeting of the board of directors or the audit committee may not be present during the board of directors or audit committee discussions and may not vote on the transaction, unless the transaction is not an extraordinary transaction or the majority of the members of the board or the audit committee have a personal interest, as the case may be. In the event the majority of the members of the board of directors or the audit committee have a personal interest, then the approval of the general meeting of shareholders is also required.

Approval of a Compensation Policy for Office Holders

The Israeli Companies Law and the regulations adopted thereunder require the compensation committee to adopt a policy for director and office holders. In adopting the compensation policy, the compensation committee must take into account factors such as the office holder's education, experience, past compensation arrangements with the company, and the proportional difference between the person's cost of compensation and the average cost of compensation of the company's employees.

The compensation policy must be approved at least once every three years at the company's general meeting of shareholders, and is subject to the approval of a majority vote of the votes of the shareholders present and voting at a shareholders' meeting, provided that either: (i) such majority includes at least a majority of the votes of all shareholders who are not controlling shareholders and do not have a personal interest in the approval of the compensation policy, present and voting at such meeting (excluding abstentions); or (ii) the total number of ordinary shares of non-controlling shareholders and shareholders who do not have a personal interest in the approval of the compensation policy, voting against the resolution does not exceed 2% of the aggregate voting rights in the company.

The Board may approve the compensation policy even if such policy was not approved by the shareholders, provided that the compensation committee and the board of directors resolve, based on detailed consideration of the compensation policy that approval of the policy, is in the best interest of the company, despite the fact that it was not approved at the shareholders' meeting.

The compensation policy serves as the basis for decisions concerning the financial terms of employment or engagement of officer holders, including exculpation, insurance, indemnification or any monetary payment or obligation of payment in respect of employment or engagement. The compensation policy must relate to certain factors, including advancement of the company's objectives, the company's business and its long-term strategy, and creation of appropriate incentives for executives. It must also consider, among other things, the company's risk management, size and the nature of its operations. The compensation committee must also consider among others, the ratio between the cost of terms offered to the relevant director or office holder and the average and median cost of compensation of the other employees of the company, including those employed through manpower companies, the effect of disparities in salary upon work relationships in the company, the possibility of reducing variable compensation at the discretion of the board of directors; the possibility of setting a limit on the exercise value of non-cash variable compensation; and as to severance compensation (in excess of those promulgated by applicable labor law), the period of service of the director or office holder, the terms of his or her compensation during such service period, the company's performance during that period of service, the person's contribution towards the company's achievement of its goals and the maximization of its profits, and the circumstances under which the person is leaving the company.

The compensation policy must also include the link between variable compensation and long-term performance and measurable criteria, the relationship between variable and fixed compensation, and the upper limit for the value of variable compensation, the conditions under which a director or an office holder would be required to repay compensation paid to him or her if it was later shown that the data upon which such compensation was based was inaccurate and was required to be restated in the company's financial statements, the minimum holding or vesting period for variable, equity-based compensation whilst referring to appropriate a long-term perspective based incentives; and maximum limits for severance compensation.

Once a compensation policy is properly adopted, the Israeli Companies Law requires the compensation policy to be approved by the company's compensation committee, with subsequent approval of the board of directors. In addition, compensation of the directors and the chief executive officer is also subject to the approval of the shareholders at a general meeting. The approval of the compensation of the chief executive officer that complies with the compensation policy is subject to the same majority requirements as the approval of a transaction between a company and its controlling shareholder. Where the director is also a controlling shareholder, the requirements for approval of transactions with controlling shareholders apply. The terms of employment of the company's directors and executive officers must satisfy the requirements of the compensation policy in respect of matters relating to compensation. Any deviations from the compensation policy in respect of the compensation of the office holders require the approval of the compensation committee, the board of directors and the shareholders. If the deviation is with respect to the compensation of the chief executive office then such approval must be made by the majority of the shareholders provided that such majority includes the majority of the votes of the non-controlling shareholder and other shareholders who have personal interest in the proposal (unless such personal interest is not related to the controlling shareholder) present and voting (excluding abstention). Such special majority is not required if the number of votes of the non-controlling shareholders and shareholder who do not have personal interest in the proposal as previously mentioned is lower than 2% of the aggregate voting rights in the company.

Under the Israeli Companies Law, all arrangements as to compensation of office holders who are not directors require the approval of the compensation committee prior, and in addition, to the approval of the board of directors. However, if the Company duly adopts a compensation plan for its office holders, the approval of the board of directors is not required if the new arrangement only modifies an existing arrangement and the compensation committee determines that such modification is not material. Generally, the compensation of the CEO must be approved by the compensation committee, the board of directors and by the majority of the shareholders provided that either: (i) such majority includes a majority of the total votes of shareholders who are not controlling shareholders and do not have a Personal Interest in the approval of the compensation policy and who participate in the voting, in person, by proxy or by written ballot, at the meeting (abstentions not taken into account); or (ii) the total number of votes of shareholders mentioned in (i) above that are voted against the approval of the compensation policy do not represent more than 2% of the total voting rights in the company. The compensation of office holders who are directors must be approved by the compensation committee, board of directors and simple majority vote of the shareholders.

External directors of the company are prohibited from receiving, directly or indirectly, any compensation from the company, other than for their services as external directors pursuant to the provisions and limitations set forth in regulations promulgated under the Israeli Companies Law, which compensation is determined prior to their appointment and may not be changed throughout the term of their service as external directors (except for certain exceptions set forth in such regulations).

Disclosure of Personal Interests of a Controlling Shareholder; Approval of Transactions with Controlling Shareholders

Pursuant to the Israeli Companies Law, the disclosure requirements regarding personal interests that apply to directors and executive officers also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, but excludes a shareholder whose power derives solely from its position on the board of directors or any other position at the company. A person is presumed to be a "controlling shareholder" if it holds or controls, by itself or together with others, one half or more of any one of the "Means of Control" of the company. "Means of Control" is defined as any one of the following: (i) the right to vote at a General Meeting of the company, or (ii) the right to appoint directors of the company or its chief executive officer. For the purpose of related party translations, under the Israeli Companies Law, a controlling shareholder is also a shareholder who holds 25% or more of the voting rights if no other shareholder who holds more than 50% of the voting rights. For this purpose, the holdings of all shareholders who have a personal interest in the same transaction will be aggregated.

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Certain shareholders also have a duty of fairness toward the company. These shareholders include any controlling shareholder, together with any shareholder who knows that it has the power to determine the outcome of a shareholder vote and any shareholder who has the power to appoint or to prevent the appointment of an office holder of the company or exercise any other rights available to it under the company's articles of association with respect to the company. The Israeli Companies Law does not define the substance of this duty of fairness, except to state that the remedies generally available upon a breach of contract will also apply in the event of a breach of the duty of fairness.

An extraordinary transaction between a public company and a controlling shareholder, or in which a controlling shareholder has a personal interest, including a private placement in which the controlling shareholder has a personal interest, and the terms of engagement of the company, directly or indirectly, with a controlling shareholder or a controlling shareholder's relative (including through a corporation controlled by a controlling shareholder), regarding the company's receipt of services from the controlling shareholder, and if such controlling shareholder is also an office holder of the company, regarding his or her terms of employment, require the approval of a company's audit committee (or compensation committee with respect to compensation arrangements), board of directors and shareholders, in that order. Such transaction must be elected by a majority vote of the Ordinary Shares present and voting at a shareholders' meeting, provided that either: (i) such majority includes at least a majority of votes held by all shareholders who do not have a personal interest in such transaction, present and voting at such meeting (excluding abstentions); or (ii) the total number of votes of shareholders who do not have a personal interest in such transaction voting against the approval of the transaction, does not exceed 2% of the aggregate voting rights in the company.

Pursuant to the Israeli Companies Law, the audit committee of the company should determine in connection with such transaction if it requires rendering pursuant to a competitive procedure or pursuant to other proceedings. See "Audit Committee" above.

To the extent that any such transaction with a controlling shareholder or his relative is for a period extending beyond three years, shareholder approval is required once every three years, unless, in respect to certain transactions, the audit committee determines that the longer duration of the transaction is reasonable under the circumstances.

Pursuant to regulations promulgated pursuant to the Israeli Companies Law, a transaction with a controlling shareholder that would otherwise require approval of the shareholders is exempt from shareholders' approval if each of the audit committee and the board of directors determine that the transaction meets certain criteria that are set out in specific regulations promulgated under the Israeli Companies Law. Under these regulations, a shareholder holding at least 1% of the issued share capital of the company may require, within 14 days of the publication of such determination, that despite such determination by the audit committee and the board of directors, such transaction will require shareholder approval under the same majority requirements that otherwise apply to such transactions.

The Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company. This rule does not apply if there is already another 25% or greater shareholder of the company. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold greater than a 45% interest in the company, unless there is another shareholder holding more than a 45% interest in the company. These requirements do not apply if, in general, (i) the acquisition was made in a private placement that received shareholder approval, (ii) was from a 25% or greater shareholder of the company which resulted in the acquirer becoming a 25% or greater shareholder of the company, if there is not already a 25% or greater shareholder of the company, or (iii) was from a shareholder holding a 45% interest in the company which resulted in the acquirer becoming a holder of a 45% interest in the company if there is not already a 45% or greater shareholder of the company.

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of a public company's outstanding shares or a class of shares, the acquisition must be made by means of a tender offer for all of the outstanding shares or a class of shares. If less than 5% of the outstanding shares are not tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to the acquirer. If more than 5% of the outstanding shares are not tendered in the tender offer, then the acquirer may not acquire shares in the tender offer that will cause his shareholding to exceed 90% of the outstanding shares. The Israeli Companies Law provides for appraisal rights if any shareholder files a request in court within six months following the consummation of a full tender offer. However, in the event of a full tender offer, the offeror may determine that any shareholder who accepts the offer will not be entitled to appraisal rights. Such determination will be effective only if the offeror or the company has timely published all the information that is required to be published in connection with such full tender offer pursuant to all applicable laws.

Exculpation, Indemnification and Insurance of Directors and Officers

Exculpation of Office Holders. The Israeli Companies Law provides that an Israeli company cannot exculpate an office holder from liability with respect to a breach of his or her fiduciary duty. If permitted by its articles of association, a company may exculpate in advance an office holder from his or her liability to the company, in whole or in part, with respect to a breach of his or her duty of care. However, a company may not exculpate in advance a director from his or her liability to the company with respect to a breach of his duty of care in the event of distributions.

Office Holders' Insurance. Israeli law provides that a company may, if permitted by its articles of association, enter into a contract to insure its office holders for liabilities incurred by the office holder with a respect to an act performed in his or her capacity as an office holder, as a result of: (i) a breach of the office holder's duty of care to the company or another person; (ii) a breach of the office holder's fiduciary duty to the company, provided that the office holder acted in good faith and had reasonable cause to assume that the act would not prejudice the company's interests; and (iii) a financial liability imposed upon the office holder in favor of another person.

Indemnification of Office Holders. Under Israeli law a company may, if permitted by its articles of association, indemnify an office holder for acts performed by the office holder in such capacity for (i) a monetary liability imposed upon the office holder in favor of another person by any court judgment, including a settlement or an arbitration award approved by a court; (ii) reasonable litigation expenses, including attorney's fees, actually incurred by the office holder as a result of an investigation or proceeding instituted against him by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against the office holder or the imposition of any monetary liability in lieu of criminal proceedings, or concluded without the filing of an indictment against the office holder and a monetary liability was imposed on him or her in lieu of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and (iii) reasonable litigation expenses, including attorneys' fees, actually incurred by the office holder or imposed upon the office holder by a court: in an action, suit or proceeding brought against the office holder by or on behalf of the company or another person, or in connection with a criminal action in which the office holder was acquitted, or in connection with a criminal action in which the office holder was convicted of a criminal offence that does not require proof of criminal intent.

Israeli law provides that a company's articles of association may permit the company to (a) indemnify an office holder retroactively, following a determination to this effect made by the company after the occurrence of the event in respect of which the office holder will be indemnified; and (b) undertake in advance to indemnify an office holder, except that with respect to a monetary liability imposed on the office holder by any judgment, settlement or court-approved arbitration award, the undertaking must be limited to types of occurrences, which, in the opinion of the company's board of directors, are, at the time of the undertaking, foreseeable due to the company's activities and to an amount or standard that the board of directors has determined is reasonable under the circumstances.

Limitations on Exculpation, Insurance and Indemnification. The Israeli Companies Law provides that neither a provision of the articles of association permitting the company to enter into a contract to insure the liability of an office holder, nor a provision in the articles of association or a resolution of the board of directors permitting the indemnification of an office holder, nor a provision in the articles of association exculpating an office holder from duty to the company shall be valid, where such insurance, indemnification or exculpation relates to any of the following: (i) a breach by the office holder of his fiduciary duty unless, with respect to insurance coverage or indemnification, the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the company; (ii) a breach by the office holder of his duty of care if such breach was committed intentionally or recklessly, unless the breach was committed only negligently; (iii) any act or omission done with the intent to unlawfully yield a personal benefit; or (iv) any fine or forfeiture imposed on the office holder.

Pursuant to the Israeli Companies Law, exculpation of, procurement of insurance coverage for, and an undertaking to indemnify or indemnification of, our office holders must be approved by our audit committee and board of directors and, if the office holder is a director, also by our shareholders.

Our articles of association allow us to insure, indemnify and exempt our office holders to the fullest extent permitted by Israeli law. We maintain a directors' and officers' liability insurance policy with a per claim and aggregate coverage limit of $10 million, including legal costs incurred in Israel. In addition, our audit committee, board of directors and shareholders resolved to indemnify our office holders, pursuant to a standard indemnification agreement that provides for indemnification of an office holder in an amount up to $5 million. To date, we have provided letters of indemnification to all of our officers and directors.

D. Employees

As of December 31, 2018, we employed 411 full-time employees, of whom 55 were employed in general management and administration, 79 were employed in selling and marketing, 18 were employed in projects management, 194 were employed in production, installation and maintenance, and 65 were employed in engineering and research and development. Of such full-time employees, 158 were located in Israel, 29 were in the United States, 119 were in Canada and 105 were in various other countries.

As of December 31, 2017, we employed 360 full-time employees, of whom 45 were employed in general management and administration, 83 were employed in selling and marketing, 16 were employed in projects management, 158 were employed in production, installation and maintenance, and 58 were employed in engineering and research and development. Of such full-time employees, 112 were located in Israel, 31 were in the United States, 110 were in Canada and 107 were in various other countries.

As of December 31, 2016, we employed 406 full-time employees, of whom 50 were employed in general management and administration, 81 were employed in selling and marketing, 21 were employed in projects management, 182 were employed in production, installation and maintenance, and 72 were employed in engineering and research and development. Of such full-time employees, 128 were located in Israel, 29 were in the United States, 133 were in Canada and 116 were in various other countries.

Our relationships with our employees in Israel are governed by Israeli labor legislation and regulations, extension orders of the Israeli Ministry of Labor and personal employment agreements. We are subject to various Israeli labor laws, collective bargaining agreements entered into from time to time between the Manufacturers Association and the New General Federation of Workers (the Histadrut), as well as collective bargaining arrangements. Such laws, agreements and arrangements cover a wide range of areas, including minimum employment standards, such as working hours, minimum wages, vacation, procedures for dismissing employees, severance pay and pension plans and special issues, such as equal pay for equal work, equal opportunity in employment and employment of youth and army veterans. We are currently engaged in negotiations with the Histadrut in relation to a collective agreement which will apply to our employees in Israel. Israeli law requires severance pay upon certain circumstances, including upon the retirement or death of an employee or termination of employment without due cause. Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the U.S. Social Security Administration, which amounts also include payments for national health insurance. In addition, certain of our employees are parties to individual employment agreements. We generally provide our employees with benefits and working conditions beyond the required minimums. Each of our subsidiaries provides a benefits package and working conditions which we believe are competitive with other companies in their field of operations.

E. Share Ownership.

The following table sets forth certain information regarding the ownership of our ordinary shares by our directors and executive officers as of April 12, 2019.

Name	Number of Ordinary Shares Owned (1)	Percentage of Outstanding Ordinary Shares (2)
Gillon Beck (3)	-	-
Ron Ben-Haim (3)	-	-
Jacob Berman	13,750	*
Avraham Bigger	-	-
Liza Singer	-	-
Moshe Tsabari	-	-
Dror Sharon	-	*
Yaacov Vinokur (4)	8,000	-
Brian Rich (5)	8,333	*
Doron Kerbel (6)	13,166	*
Yaniv Shachar (7)	24,000	*
Jeremy Weese (8)	16,548	*
Kristen Cory	-	-
Carlos Garcia Almeida	-	-
Fabien Haubert	-	-
Gord Loney	100	*
All directors and executive officers as a group (16 persons)	83,897	*

* Less than 1%

(1) Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible debenture notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 23,143,985 ordinary shares issued and outstanding as of April 12, 2019.

(3) Does not include any ordinary shares held by the FIMI Funds.

(4) Includes 8,000 ordinary shares issuable upon the exercise of currently exercisable options.

(5) Includes 8,333 ordinary shares issuable upon the exercise of currently exercisable options.

(6) Includes 13,166 ordinary shares issuable upon the exercise of currently exercisable options.

(7) Includes 24,000 ordinary shares issuable upon the exercise of currently exercisable options.

(8) Includes 16,548 ordinary shares issuable upon the exercise of currently exercisable options.

Share Option Plans

2010 Israeli Share Option Plan

In June 2010, we adopted our 2010 Israeli Share Option Plan, or the 2010 Plan. Under the 2010 Plan, stock options to purchase 510,575 ordinary shares may be granted to our employees, officers, directors and consultants of our company and subsidiaries. In addition, an aggregate 498,384 ordinary shares that remained available for future option grants under the 2003 Plan and any ordinary shares that become available in the future under the 2003 Plan as a result of expiration, cancellation or relinquishment of any option were rolled over to the 2010 Plan. In June 2013, our shareholders approved an increase to the number of ordinary shares available for issuance under the 2010 Plan by additional 500,000 shares. The 2010 Plan has a term of ten years.

The 2010 Plan is designed to allow the grantees to benefit from the tax benefits under Section 102 of the Israeli Income Tax Ordinance [New Version], 1961. Our Board of Directors has resolved that all options that will be granted to Israeli residents under the 2010 Plan will be taxable under the "capital gains route." Pursuant to this route, the profit realized by an employee is taxed as a capital gain (25%) if the options or underlying shares are held by a trustee for at least 24 months from their date of the grant or issuance. Any difference between the exercise price of the options and the average price of the company's shares during the 30 trading days before the date of grant of the options will be treated as ordinary income and will be taxed according to the employee's marginal tax rates plus social contribution. If the underlying shares are sold before the elapse of such period, the profit is re-characterized as ordinary income. As of December 31, 2018, options to purchase 889,118 ordinary shares were outstanding under the 2010 Plan, exercisable at an average exercise price of $4.865 per share. During 2018, 555,000 options were awarded under the 2010 Plan. Options to purchase 17,191 ordinary shares were exercised during 2018.

ITEM 7. Major Shareholders and Related Party Transactions

A. Major Shareholders

The following table sets forth certain information as of April 12, 2019 regarding the beneficial ownership of our ordinary shares, by each person or entity known to us to own beneficially 5% or more of our ordinary shares.

Name	Number of Ordinary Shares Beneficially Owned (1)	Percentage of Outstanding Ordinary Shares (2)	
FIMI Opportunity Five (Delaware), Limited Partnership (3)	4,646,924	20.1	%
FIMI Israel Opportunity Five, Limited Partnership (3)	5,207,235	22.5	%
Grace & White, Inc. (4)	1,409,399	6.1	%

(1) Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Ordinary shares relating to options or convertible notes currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 23,143,985 ordinary shares issued and outstanding as of April 12, 2019.

(3) Based on Schedule 13D/A filed with the SEC on October 11, 2016 and other information available to us. The address of FIMI Opportunity Five (Delaware), Limited Partnership and FIMI Israel Opportunity Five, Limited Partnership is c/o FIMI FIVE 2012 Ltd., Electra Tower, 98 Yigal Alon St., Tel-Aviv 6789141, Israel.

(4) Based upon a Schedule 13G/A filed with the SEC on January 29, 2019 by Grace & White, Inc. The Schedule 13G/A indicates that Grace & White, Inc. is a registered investment adviser. The address of Grace & White, Inc. is 515 Madison Avenue, Suite 1700, New York, NY 10022.

Significant Changes in the Ownership of Major Shareholders

On October 11, 2016, FIMI Five 2012 Ltd., FIMI Opportunity Five (Delaware), Limited Partnership and FIMI Israel Opportunity Five, Limited Partnership, or the FIMI Partnerships, filed a Schedule 13D/A reflecting beneficial ownership of 9,854,159 ordinary shares, or 42.6%, of our issued and outstanding ordinary shares, as of such date.

On February 7, 2017, Grace & White, Inc. filed an amendment to its Schedule 13G reflecting beneficial ownership of 1,569,833, or 6.8%, of our issued and outstanding ordinary shares. On February 1, 2018, Grace & White, Inc. filed an amendment to its Schedule 13G reflecting beneficial ownership of 1,415,703, or 6.15%, of our issued and outstanding ordinary shares. On January 29, 2019, Grace & White, Inc. filed an amendment to its Schedule 13G reflecting beneficial ownership of 1,409,399, or 6.12%, of our issued and outstanding ordinary shares.

Major Shareholders Voting Rights

The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares.

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Record Holders

Based on a review of the information provided to us by our transfer agent, as of March 26, 2019, there were 29 holders of record of our ordinary shares, of which 26 record holders holding approximately 91.2% of our ordinary shares had registered addresses in the United States. These numbers are not representative of the number of beneficial holders of our shares nor is it representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees, including CEDE & Co., the nominee for the Depositary Trust Company (the central depositary for the U.S. brokerage community), which held approximately 91.1% of our outstanding ordinary shares as of such date.

B. Related Party Transactions.

In October 2017, we completed a rights offering in which we received gross proceeds of approximately $23.8 million from the sale of 6,170,386 ordinary shares. In the rights offering, we distributed to each of our shareholders one subscription right for each eight ordinary shares held by such holder. Our controlling shareholders, FIMI V Funds, purchased 3,392,870 ordinary shares including through an exercise of over-subscription rights for a total subscription price of $ 13,096,478.20.

C. Interests of Experts and Counsel.

Not applicable.

ITEM 8. Financial Information

A. Consolidated Statements and Other Financial Information.

Consolidated Financial Statements

See the consolidated financial statements included under Item 18, “Financial Statements.”

Export Sales

In the years ended December 31, 2016, 2017 and 2018, our operations based outside of Israel generated income to customers outside of Israel of approximately $48.2 million, $45.2 million and $67.4 million, respectively, or 71.1%, 70.2% and 72.8% of our total revenues, respectively. In the years ended December 31, 2016, 2017 and 2018, the total amount of our export revenues generated by our Israeli facilities to countries outside of Israel was approximately $10.9 million, $9.6 million and $11.7 million, respectively, or 16.%, 14.9% and 12.6%, of our total revenues, respectively.

Legal Proceedings

We are subject to legal proceedings arising in the normal course of business. Based on the advice of our legal counsel, management believes that these proceedings will not have a material adverse effect on our financial position or results of operations.

Dividend Distribution Policy

We currently intend to retain future earnings for use in our business and do not anticipate paying cash dividends on our ordinary shares in the foreseeable future. Future dividend distributions are subject to the discretion of our board of directors and will depend on a number of factors, including our operating results, future capital resources available for distribution, capital requirements, financial condition, the tax implications of dividend distributions on our income, future prospects and any other factors our board of directors may deem relevant.

The distribution of dividends also may be limited by Israeli law, which permits the distribution of dividends only out of profits (as defined by the Israeli Companies Law) or otherwise upon the permission of the court, and only if the Board of Directors determines that such distribution will not jeopardize the ability of the company to repay its debts on the due date thereof. "Profits'' are defined in the Israeli Companies Law as the balance of surpluses, or the surpluses accumulated over the past two years, whichever is the greater, in accordance with the latest adjusted financial statements, audited or reviewed, prepared by the company, provided that the date in respect of which the statements were prepared is no earlier than six months prior to the date of distribution. ''Surplus'' means sums included in a company's shareholders' equity originating from the net profit of the company, as determined according to generally accepted accounting principles, and sums other than share capital or premiums that are included in shareholders' equity under generally accepted accounting principles and that the Minister of Justice has prescribed to be considered surplus.

B. Significant Changes.

Since the date of the annual consolidated financial statements included in this annual report, no significant changes have occurred.

ITEM 9. The Offer and Listing

A. Offer and Listing Details.

Our ordinary shares are traded on the NASDAQ Global Market. Our ticker symbol is “MAGS.”

B. Plan of Distribution.

Not applicable.

C. Markets.

Our ordinary shares have traded on the NASDAQ Global Market under the symbol “MAGS” since our initial public offering in 1993.

D. Selling Shareholders.

Not applicable.

E. Dilution.

Not applicable.

F. Expenses of the Issue.

Not applicable.

ITEM 10. Additional Information

A. Share Capital.

Not applicable.

B. Memorandum and Articles of Association.

Purposes and Objects of the Company

We are a public company registered with the Israeli Companies Registrar and have been assigned company number 52 003892 8. Under our memorandum of association, we were established for the purposes of acquiring a plant from Israel Aircraft Industries known as the Magal Plant, which was engaged in the development, manufacture, sale and support of alarm devices and dealing in the development, manufacturing and support of security alarm devices and other similar products. In addition, the purpose of our Company is to be eligible to perform and act in connection with any right or obligation of whatever kind or nature permissible under Israeli law.

Board of Directors

The strategic management of our business (as distinguished from the daily management of our business affairs) is vested in our board of directors, which may exercise all such powers and do all such acts as our company is authorized to exercise and do, and which are not required to be exercised by a resolution of the general meeting of our shareholders. The board of directors may, subject to the provisions of the Israeli Companies Law, delegate some of its powers to committees, each consisting of one or more directors, provided that at least one member of such committee is an external director.

According to the Israeli Companies Law, we may stipulate in our articles of association that the general meeting of shareholders is authorized to assume the responsibilities of the board of directors. In the event the board of directors is unable to act or exercise its powers, the general meeting of shareholders is authorized to exercise the powers of the board of directors, even if the articles of association do not stipulate so. Our board of directors has the power to assume the responsibilities of our chief executive officer if he is unable to act or exercise his powers or if he fails to fulfill the instructions of the board of directors with respect to a specific matter.

Our articles of association do not impose any mandatory retirement or age limit requirements on our directors and our directors are not required to own shares in our company in order to qualify to serve as directors.

The authority of our directors to enter into borrowing arrangements on our behalf is not limited, except in the same manner as any other transaction by us.

For a discussion of Israeli law concerning a director's fiduciary duties and the approval of transactions with office holders, see Item 6.C. "Directors, Senior Management and Employees – Board Practices – Approval of Related Party Transactions under Israeli Law."

Rights Attached to Shares

Our authorized share capital consists of NIS 39,748,000 ordinary shares, par value NIS 1.00 each. All our ordinary shares have the same rights, preferences and restrictions, some of which are detailed below. At the general meeting of shareholders, our shareholders may, subject to certain provisions detailed below, create different classes of shares, each class bearing different rights, preferences and restrictions.

The rights attached to the ordinary shares are as follows:

Dividend Rights. Holders of ordinary shares are entitled to participate in the payment of dividends in accordance with the amounts paid up or credited as paid up on the nominal value of such ordinary shares at the time of payment (without taking into account any premium paid thereon). However, under Article 13 of our articles of association no shareholder will be entitled to receive any dividends until the shareholder has paid all calls then currently due and payable on each ordinary share held by such shareholder.

The board of directors may declare interim dividends and propose the final dividend with respect to any fiscal year only out of the retained earnings, in accordance with the provisions of the Israeli Companies Law. Declaration of a final dividend requires the approval by ordinary resolution of our shareholders at a general meeting of shareholders. Such resolution may reduce but not increase the dividend amount recommended by the board of directors. Dividends may be paid, in whole or in part, by way of distribution of dividends in kind. See "Item 8A. Financial Information – Consolidated Statements and Other Financial Information – Dividend Distributions Policy."

Voting Rights. Holders of ordinary shares are entitled to one vote for each share held of record on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

Generally, resolutions are adopted at the general meeting of shareholders by an ordinary resolution, unless the Israeli Companies Law or our articles of association require an extraordinary resolution. An ordinary resolution, such as a resolution approving the declaration of dividends or the appointment of auditors, requires approval by the holders of a simple majority of the shares represented at the meeting, in person or by proxy, and voting on the matter. An extraordinary resolution requires approval by the holders of at least 75% of the shares represented at the meeting, in person or by proxy, and voting on the matter. The primary resolutions required to be adopted by an extraordinary resolution of the general meeting of shareholders are resolutions to:

- amend the memorandum of association or articles of association;
- change the share capital, for example by increasing or canceling the authorized share capital or modifying the rights attached to shares; and
- approve mergers, consolidations or winding up of our company.

Our articles of association do not contain any provisions regarding a classified board of directors or cumulative voting for the election of directors. Pursuant to our articles of association, our directors (except the external directors) are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting and hold office until the next annual general meeting of shareholders and until their successors have been elected. All the members of our board of directors (except the external directors) may be reelected upon completion of their term of office. For information regarding the election of external directors, see "Item 6C. Directors, Senior Management and Employees – Directors and Senior Management – Board Practices – External and Independent Directors – External Directors."

Rights to Share in the Company's Profits. Our shareholders have the right to share in our profits distributed as a dividend or any other permitted distributions. See this Item 10B. "Additional Information – Memorandum and Articles of Association – Rights Attached to Shares – Dividend Rights."

Liquidation Rights. Article 111 of our articles of association provides that upon any liquidation, dissolution or winding-up of our company, our remaining assets shall be distributed pro-rata to our ordinary shareholders.

Redemption. Under Article 38 of our articles of association, we may issue redeemable stock and redeem the same.

Capital Calls. Under our memorandum of association and the Israeli Companies Law, the liability of our shareholders is limited to the par value of the shares held by them.

Substantial limitations on shareholders. See Item 6.C. "Directors, Senior Management and Employees Board Practices–Approval of Related Party Transactions."

Modifications of Share Rights

The rights attached to a class of shares may be altered by an extraordinary resolution of the general meeting of shareholders, provided the holders of 75% of the issued shares of that class approve such change by the adoption of an extraordinary resolution at a separate meeting of such class, subject to the terms of such class. The provisions of the articles of association pertaining to general meetings of shareholders also apply to a separate meeting of a class of shareholders. Shares which confer preferential or subordinate rights relating to, among other things, dividends, voting, and payment of capital may be created only by an extraordinary resolution of the general meeting of shareholders.

General Meetings of Shareholders

Under the Israeli Companies Law, a company must convene an annual meeting of shareholders at least once every calendar year and within 15 months of the last annual meeting. Depending on the matter to be voted upon, notice of at least 21 days or 35 days prior to the date of the meeting is required. Our board of directors may, in its discretion, convene additional meetings as "special general meetings." In addition, the board must convene a special general meeting upon the demand of two of the directors, 25% of the nominated directors, one or more shareholders having at least 5% of the outstanding share capital and at least 1% of the voting power in the company, or one or more shareholders having at least 5% of the voting power in the company. See this Item 10B. "Additional Information – Memorandum and Articles of Association – Rights Attached to Shares – Voting Rights."

A shareholder present, in person or by proxy, at the commencement of a general meeting of shareholders may not seek the cancellation of any proceedings or resolutions adopted at such general meeting of shareholders on account of any defect in the notice of such meeting relating to the time or the place thereof. Shareholders who are registered in our register of shareholders at the record date may vote at the general meeting of shareholders. The record date is set in the resolution to convene the general meeting of shareholders, provided, however, that such record date must be between 14 to 21 days or, in the event of a vote by ballots, between 28 to 40 days prior the date the general meeting of shareholders is held.

The quorum required for a general meeting of shareholders consists of at least two record shareholders, present in person or by proxy, who hold, in the aggregate, at least one third of the voting power of our outstanding shares. A general meeting of shareholders will be adjourned for lack of a quorum after half an hour from the time appointed for such meeting to the same day in the following week at the same time and place or any other time and place as the board of directors designates in a notice to the shareholders. At such reconvened meeting, if a quorum is not present within half an hour from the time appointed for such meeting, two or more shareholders, present in person or by proxy, will constitute a quorum. The only business that may be considered at an adjourned general meeting of shareholders is the business that might have been lawfully considered at the general meeting of shareholders originally convened and the only resolutions that may be adopted are the resolutions that could have been adopted at the general meeting of shareholders originally convened.

Limitations on the Right to Own Our Securities

Neither our memorandum or articles of association nor the laws of the State of Israel restrict in any way the ownership or voting of our ordinary shares by non-residents, except that the laws of the State of Israel may restrict the ownership of ordinary shares by residents of countries that are in a state of war with Israel.

Provisions Restricting a Change in Control of Our Company

The Israeli Companies Law requires that mergers between Israeli companies be approved by the board of directors and general meeting of shareholders of both parties to the transaction. The approval of the board of directors of both companies is subject to such boards' confirmation that there is no reasonable doubt that after the merger the surviving company will be able to fulfill its obligations towards its creditors. Each company must notify its creditors about the contemplated merger. Under our articles of association, such merger must be approved by a resolution of the shareholders, as explained above. The approval of the merger by the general meetings of shareholders of the companies is also subject to additional approval requirements as specified in the Israeli Companies Law and regulations promulgated thereunder. For purposes of the shareholders' approval, the merger shall not be deemed as granted unless the court determines otherwise, if it is not supported by the 75% of the shares represented and voting at the general meeting, provided that such majority includes a simple majority of the non-interested shareholders. See also Item 6C. "Directors, Senior Management and Employees – Board Practices – Approval of Related Party Transactions under Israeli Law."

The Israeli Companies Law also provides that an acquisition of shares of a public company must be made by means of a special tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company and there is no existing 25% or greater shareholder in the company. An acquisition of shares of a public company must also be made by means of a tender offer if as a result of the acquisition the purchaser would become a 45% or greater shareholder of the company and there is no existing 45% or greater shareholder in the company. These requirements do not apply if the acquisition (i) was made through a private placement that received shareholder approval, (ii) was from a 25% shareholder of the company and resulted in the acquirer becoming a 25% shareholder of the company or (iii) was from a 45% shareholder of the company and resulted in the acquirer becoming a 45% shareholder of the company. The special tender offer must be extended to all shareholders but the offer may include explicit limitations allowing the offeror not to purchase shares representing more than 5% of the voting power attached to the company's outstanding shares, regardless of how many shares are tendered by shareholders. The special tender offer may be effected only if (i) at least 5% of the voting power attached to the company's outstanding shares will be acquired by the offeror and (ii) the number of shares tendered in the offer exceeds the number of shares whose holders objected to the offer.

If, as a result of an acquisition of shares, the acquirer will hold more than 90% of the outstanding shares, the acquisition must be made by means of a tender offer for the entire outstanding shares. In such event, if less than 5% of the outstanding shares are not tendered in the tender offer, all the shares of the company will be deemed as tendered and sold. However, if more than 5% of the outstanding shares are not tendered in the tender offer, then the acquirer may not acquire any shares at all. The law provides for appraisal allowing any shareholder to file a motion to the court within six months following the consummation of a full tender offer. However, in the event of a full tender offer, the offer or may determine that any shareholder who accepts the offer will not be entitled to appraisal rights. Such determination shall be effective only if the offeror or the company has timely published all the information that is required to be published in connection with such full tender offer pursuant to all applicable laws.

In addition, the purchase of 25% or more of the outstanding share capital of a company or the purchase of substantial assets of a company requires, under certain conditions, the approval of the Restrictive Practices Authority. Furthermore, if the target company has received tax incentives of grants from the Office of the Chief Scientist, changes in ownership may require also the approval of the tax authorities or the Office of the Chief Scientist, as applicable.

Finally, in general, Israeli tax law treats stock-for-stock acquisitions less favorably than does U.S. tax law. Israeli tax law has been amended to provide for tax deferral in specified acquisitions, including transactions where the consideration for the sale of shares is the receipt of shares of the acquiring company. Nevertheless, Israeli tax law may subject a shareholder who exchanges his ordinary shares for shares in a foreign corporation to immediate taxation or to taxation before his investment in the foreign corporation becomes liquid, although in the case of shares of a foreign corporation that are traded on a stock exchange, the tax may be postponed subject to certain conditions.

C. Material Contracts.

On April 2, 2018, we acquired 55% controlling interests in ESC BAZ Ltd. ("BAZ"). BAZ is an Israeli-based company focused on the development and manufacturing of military-grade smart Security Video Observation and Surveillance systems. The BAZ product portfolio includes a wide range of modular and customizable medium and long range surveillance systems for distances from 500m up to 25km.

D. Exchange Controls.

Israeli law and regulations do not impose any material foreign exchange restrictions on non Israeli holders of our ordinary shares. Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

E. Taxation.

The following is a discussion of Israeli and United States tax consequences material to us and to our shareholders. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations.

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

Israeli Tax Considerations

The following is a summary of the material Israeli tax laws applicable to us, and some Israeli Government programs benefiting us. This section also contains a discussion of material Israeli tax consequences concerning the ownership of and disposition of our ordinary shares. This summary does not discuss all the acts of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law. Examples of this kind of investor include residents of Israel or traders in securities who are subject to special tax regimes not covered in this discussion. Since some parts of this discussion are based on new tax legislation that has not yet been subject to judicial or administrative interpretation, we cannot assure you that the appropriate tax authorities or the courts will accept the views expressed in this discussion.

The discussion below should not be construed as legal or professional tax advice and does not cover all possible tax considerations. Potential investors are urged to consult their own tax advisors as to the Israeli or other tax consequences of the purchase, ownership and disposition of our ordinary shares, including in particular, the effect of any foreign, state or local taxes.

General Corporate Tax Structure

Generally, Israeli companies are subject to corporate tax on their taxable income. Since January 2018, the corporate tax rate is 23%. However, the effective tax rate payable by a company that generates income from an Approved Enterprise or a Preferred Enterprise, as further discussed below, may be considerably lower. In addition, Israeli companies are currently subject to regular corporate tax rate on their capital gains.

Israeli Transfer Pricing Regulations

On November 29, 2006, Income Tax Regulations (Determination of Market Terms), 2006, promulgated under Section 85A of the Israeli Tax Ordinance, came into effect, or the TP Regs. Section 85A of the Tax Ordinance and the TP Regs generally require that all cross-border transactions carried out between related parties be conducted on an arm's length principle basis and will be taxed accordingly. The TP Regs are not expected to have a material effect on us.

Tax Benefits for Research and Development

Israeli tax law allows, under specified conditions, a tax deduction for expenditures, including capital expenditures, in the year incurred relating to scientific research and development projects, if the expenditures are approved by the relevant Israeli Government ministry, determined by the field of research, and the research and development is for the promotion of the company and is carried out by or on behalf of the company seeking such deduction. However, the amount of such deductible expenses shall be reduced by the sum of any funds received through government grants for the finance of such scientific research and development projects. Expenditures that were not approved (as described above) are deductible over a three-year period.

Encouragement of Capital Investments Law, 1959

2005 Amendment to the Investments Law

An amendment to the Investments Law, which was published on April 1, 2005, or the Amendment, has changed certain provisions of the Investments Law. As a result of the Amendment, a company is no longer obliged to acquire approved enterprise status in order to receive the tax benefits previously available under the alternative benefits provisions, and therefore generally there is no need to apply to the Investment Center for this purpose (approved enterprise status remains mandatory for companies seeking grants). Rather, a company may claim the tax benefits offered by the Investments Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the Amendment. A company is also granted a right to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the Amendment.

Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export, referred to as a "Benefited Enterprise." In order to receive the tax benefits, the Amendment states that the company must make an investment in the Benefited Enterprise exceeding a certain percentage or a minimum amount specified in the Investments Law. Such investment may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the Benefited Enterprise, referred to as the Year of Election. Where the company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and the company's effective tax rate will be the result of a weighted combination of the applicable rates. In this case, the minimum investment required in order to qualify as a Benefited Enterprise is required to exceed a certain percentage or a minimum amount of the company's production assets before the expansion.

The duration of tax benefits is subject to a limitation of the earlier of seven to ten years from the commencement year, or 12 years from the first day of the Year of Election. The tax benefits granted to a Benefited Enterprise are determined, as applicable to its geographic location within Israel, according to one of the following new tax routes, which may be applicable to us:

- Similar to the currently available alternative route, exemption from corporate tax on undistributed income for a period of two to ten years, depending on the geographic location of the Benefited Enterprise within Israel, and a reduced corporate tax rate of 10% to 25% for the remainder of the benefits period, depending on the level of foreign investment in each year. Benefits may be granted for a term of seven to ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Benefited Enterprise during the tax exemption period, such income will be subject to corporate tax at the applicable rate (10%-25%) with respect to the gross amount of dividend distributed. The company is required to withhold tax at the source at a rate of 15% from any dividends distributed from income derived from the Benefited Enterprise; and

- A special tax route, which enables companies owning facilities in certain geographical locations in Israel to pay corporate tax at the rate of 11.5% on income of the Benefited Enterprise. The benefits period is ten years. Upon payment of dividends, the company is required to withhold tax at source at a rate of 15% for Israeli residents and at a rate of 4% for foreign residents.

Generally, a company that is "Abundant in Foreign Investment," as defined in the Investments Law, is entitled to an extension of the benefits period by an additional five years, depending on the rate of its income that is derived in foreign currency.

The Amendment changes the definition of "foreign investment" in the Investments Law so that the definition now requires a minimal investment of NIS 5 million by foreign investors. Furthermore, such definition now also includes the purchase of shares of a company from another shareholder, provided that the company's outstanding and paid-up share capital exceeds NIS 5 million. Such changes to the aforementioned definition are retroactive from 2003.

The Amendment applies to approved enterprise programs in which the year of election under the Investments Law is 2004 or later, unless such programs received "Approved Enterprise" approval from the Investment Center on or prior to December 31, 2004, in which case the Amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investments Law as they were on the date of such approval.

Should we elect to utilize tax benefits under the Amendment to the Investments Law, any such tax exempt profits might be subject to future taxation on the corporate level upon distribution to shareholders by a way of dividend or liquidation. Accordingly, we may be required to recognize deferred tax liability with respect to such tax exempt profits.

In March 2007, we received a pre-ruling from the Israeli Tax Authority for our request for a Beneficiary Enterprise for the elected tax year 2005 ("the 2005 program"), regarding eligibility for benefits under the Amendment. We have not obtained any tax benefits from this program. The benefit period of this program terminated on December 31, 2016.

Amendment to the Law for the Encouragement of Capital Investments, 1959 (Amendment 68):

An additional amendment to the Investment Law became effective in January 2011, or the 2011 Amendment. Under the 2011 Amendment, income derived by ‘Preferred Companies’ from ‘Preferred Enterprises’ (both as defined in the 2011 Amendment) would be subject to a uniform rate of corporate tax as opposed to the incentives prior to the 2011 Amendment that were limited to income from Approved or Benefiting Enterprises during their benefits period. According to the 2011 Amendment, the uniform tax rate on such income, referred to as ‘Preferred Income’, would be 10% in areas in Israel that are designated as Development Zone A and 15% elsewhere in Israel during 2011-2012, 7% and 12.5%, respectively, in 2013-2014, and 6% and 12%, respectively, thereafter. Income derived by a Preferred Company from a ‘Special Preferred Enterprise’ (as defined in the Investment Law) would enjoy further reduced tax rates for a period of ten years of 5% in Zone A and 8% elsewhere. As with dividends distributed from taxable income derived from an Approved Enterprise or Benefiting Enterprise during the applicable benefits period, dividends distributed from Preferred Income would be subject to a 15% tax (or lower, if so provided under an applicable tax treaty), which would generally be withheld by the distributing company, provided however that dividends distributed from ‘Preferred Income’ from one Israeli corporation to another, would not be subject to tax. While a company may incur additional tax liability in the event of distribution of dividends from tax exempt income generated from its Approved and Benefiting Enterprises, no additional tax liability will be incurred by in the event of distribution of dividends from income taxed in accordance with the 2011 Amendment. Under the transitional provisions of the 2011 Amendment, we could have elected whether to irrevocably implement the 2011 Amendment with respect to our existing Approved and Benefiting Enterprises while waiving benefits provided under the legislation prior to the 2011 Amendment or keep implementing the legislation prior to the 2011 Amendment during the next years. The 2011 Amendment had no material effect on the tax payable in respect of our operations and therefore, we did not elect to implement the 2011 Amendment.

In November 2012, the Knesset passed Amendment No. 69 to the Investment Law, or the Trapped Earnings Law, which provides a temporary, partial, relief from taxation on a distribution from exempt income for companies which elect the relief through November 2013. The Trapped Earnings Law allows companies to qualify a portion of its exempt income, or Elected Earnings, for a reduced tax rate ranging between 17.5% and 6%. While the reduced tax is payable within 30 days of election, an electing company is not required to actually distribute the Elected Earnings within a certain period of time. The applicable rate is based on a linear formula involving the portion of Elected Earnings to exempt income and the applicable tax rate prescribed in the Investment Law. A company electing to qualify its exempt income must undertake to make designated investments in productive fixed assets, research and development, or wages of new employees. The amount of such designated investments is defined by a formula which considers the portion of Elected Earnings to the exempt income and the applicable tax rate prescribed by the Investment Law.

In addition to the reduced tax rate a distribution of Elected Earnings would be subject to a 15% withholding tax. The Trapped Earnings Law provides an exemption from the 15% withholding tax for a distribution to an Israeli resident company from companies which have elected the Privileged Enterprise status and waived their Approved Enterprise and privileged Enterprise Status through June 2015.

We are currently evaluating the implications that the Trapped Earnings Law will have on the tax payable in respect of our operations.

Amendment to the Law for the Encouragement of Capital Investments, 1959 (Amendment 71):

On August 5, 2013, the “Knesset” issued the Law for Changing National Priorities (Legislative Amendments for Achieving Budget Targets for 2013 and 2014), 2013 which consists of Amendment 71 to the Law for the Encouragement of Capital Investments (“the Amendment”). According to the Amendment, the tax rate on preferred income from a preferred enterprise in 2014 and thereafter is 16% (in development area A - 9%). As for changes in tax rates resulting from the enactment of Amendment 73 to the Law, see below.

The Amendment also prescribes that any dividends distributed to individuals or foreign residents from the preferred enterprise's earnings as above will be subject to tax at a rate of 20%.
Amendment to the Law for the Encouragement of Capital Investments, 1959 (Amendment 73):

In December 2016, the Economic Efficiency Law (Legislative Amendments for Applying the Economic Policy for the 2017 and 2018 Budget Years), 2016 which includes Amendment 73 to the Law for the Encouragement of Capital Investments ("the Amendment") was published. According to the Amendment, a preferred enterprise located in development area A will be subject to a tax rate of 7.5% instead of 9% effective from January 1, 2017 and thereafter (the tax rate applicable to preferred enterprises located in other areas remains at 16%).

The Amendment also prescribes special tax tracks for technological enterprises, which are subject to rules that are to be issued by the Minister of Finance by March 31, 2017.

The new tax tracks under the Amendment are as follows:

Technological preferred enterprise - an enterprise for which total consolidated revenues of its parent company and all subsidiaries are less than NIS 10 billion. A technological preferred enterprise, as defined in the Law, which is located in the center of Israel will be subject to tax at a rate of 12% on profits deriving from intellectual property (in development area A - a tax rate of 7.5%).

Any dividends distributed to "foreign companies", as defined in the Law, deriving from income from the technological enterprises will be subject to tax at a rate of 4%.

Since definitive criteria to determine the tax benefits had not yet been established as of December 31, 2018, it cannot be concluded that the legislation in respect of technological enterprises had been enacted or substantively enacted as of that date. Accordingly, the above changes in the tax rates relating to technological enterprises were not taken into account in the computation of deferred taxes as of December 31, 2018.

Encouragement of Industry (Taxes) Law, 5729-1969

Under the Encouragement of Industry (Taxes) Law, 5729-1969, or the Industry Encouragement Law, "Industrial Companies" are entitled to certain corporate tax benefits, including, among others:

- Amortization, under certain conditions, of purchases of know how and patents and of rights to use a patent and know how which are used for the development or advancement of the company, over an eight year period for tax purposes;

- Right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies; and

- Accelerated depreciation rates on equipment and buildings; and

- Deductions over a three-year period of expenses in connection with the issuance and listing of shares on a recognized stock market.

Eligibility for benefits under the Industry Encouragement Law is not subject to the prior approval of any governmental authority. Under the Industry Encouragement Law, an "Industrial Company" is a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, capital gains, interest and dividends, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is an enterprise owned by an Industrial Company, whose major activity in a given tax year is industrial production activity.

We believe that we currently qualify as an industrial company as defined by the Industry Encouragement Law. We cannot assure you that we will continue to qualify as an industrial company or that the benefits described above will be available to us in the future.

Encouragement of Industrial Research and Development Law, 5744-1984

Under the Encouragement of Industrial Research and Development Law, 5744-1984, or the Research Law, research and development programs that meet specified criteria and are approved by a governmental committee of the Innovation Authority (formerly the Office of the Chief Scientist), are eligible for grants between 20%-50% of certain of the project's expenditures, as determined by the research committee of the Innovation Authority. In exchange, the recipient of such grants is required to pay the Innovation Authority royalties from the revenues derived from products incorporating technology developed within the framework of the approved research and development program or derived from such program (including ancillary services in connection with such program), usually up to 100% of the U.S. dollar-linked value of the total grants received in respect of such program, plus LIBOR interest.

The terms of the Israeli government participation also require a declaration regarding the location of manufacturing of supported products by the recipients of the grants. Under regulations promulgated under the Research Law, upon the approval of the Innovation Authority, some of the manufacturing volume may be transferred outside of Israel, beyond the aforementioned declared rate of production abroad, provided that the grant recipient pays royalties at an increased rate and in addition may incur an increased payment cap of up to 300% of the received grant, depending on the percentage of manufacturing being transferred abroad. The Research Law also provides that know-how developed under an approved research and development program and any derivatives of this know-how may not be transferred to third parties in Israel without the prior approval of the research committee of the Innovation Authority. The Research Law further provides that the know-how developed under an approved research and development program may not be transferred to any third parties outside Israel. No approval is required for the sale or export of any products resulting from such research and development.

In June 2005, an amendment to the Research Law became effective, which amendment was intended to make the Research Law more compatible with the global business environment by, among other things, relaxing restrictions on the transfer of manufacturing rights outside Israel and on the transfer of Innovation Authority funded know-how outside of Israel. The amendment permits the Innovation Authority, among other things, to approve the transfer of manufacturing rights outside Israel in exchange for an import of different manufacturing into Israel as a substitute, in lieu of demanding the recipient to pay increased royalties as described above. The amendment further permits, under certain circumstances and subject to the Innovation Authority's prior approval, the transfer outside Israel of know-how that has been funded by Innovation Authority, generally in the following cases: (a) the grant recipient pays to the Innovation Authority a portion of the consideration paid for such funded know-how (according to certain formulas), (b) the grant recipient receives know-how from a third party in exchange for its funded know-how, or (c) such transfer of funded know-how arises in connection with certain types of cooperation in research and development activities under agreements of cooperation programs between Israel and an additional country.

The Research Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient. The law requires the grant recipient and its controlling shareholders and interested parties to notify the Innovation Authority on any change in control of the recipient or a change in the holdings of the means of control of the recipient and obtaining the approval of the Innovation Authority in case such a change results in a foreign resident becoming an interested party directly in the recipient and requires the new interested party to undertake to the Innovation Authority to comply with the Research Law. In addition, the rules of the Innovation Authority may require prior approval of the Innovation Authority or additional information or representations in respect of certain of such events. For this purpose, "control" is defined as the ability to direct the activities of a company other than any ability arising solely from serving as an officer or director of the company. A person is presumed to have control if such person holds 50% or more of the means of control of a company. "Means of control" refers to voting rights or the right to appoint directors or the chief executive officer. An "interested party" of a company includes a holder of 5% or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director, and a company with respect to which any of the foregoing interested parties owns 25% or more of the outstanding share capital or voting rights or has the right to appoint 25% or more of the directors. Accordingly, any foreign resident who acquires 5% or more of our ordinary shares will be required to notify the Innovation Authority that it has become an interested party and to sign an undertaking to comply with the Research Law.

The Israeli authorities have indicated that the government may reduce or abolish grants from the Innovation Authority in the future. Even if these grants are maintained, we cannot assure you that we will receive Innovation Authority grants in the future. In addition, each application to the Innovation Authority is reviewed separately, and grants are based on the program approved by the research committee. Generally, expenditures supported under other incentive programs of the State of Israel are not eligible for grants from the Innovation Authority.

Taxation under Inflationary Conditions

In February 2008, the “Knesset” (Israeli parliament) passed an amendment to the Income Tax (Inflationary Adjustments) Law, 1985, which limits the scope of the law starting 2008 and thereafter. Since 2008, the results for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Israeli CPI carried out in the period up to December 31, 2007. Adjustments relating to capital gains such as for sale of property (betterment) and securities continue to apply until disposal. Since 2008, the amendment to the law includes, among others, the cancellation of the inflationary additions and deductions and the additional deduction for depreciation (in respect of depreciable assets purchased after the 2007 tax year).

Capital Gains Tax on Sales of Our Ordinary Shares by Foreign Holders

Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares in Israeli companies, by non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder’s country of residence provides otherwise. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset’s purchase price which is attributable to the increase in the CPI or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

Generally, as of January 1, 2012, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 25% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 30%. Additionally, if such shareholder is considered a “significant shareholder” at any time during the 12-month period preceding such sale, i.e., such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company, the tax rate shall be 30%. However, the foregoing tax rates do not apply to: (i) dealers in securities; and (ii) shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement). Israeli companies are subject to the Corporate Tax rate on capital gains derived from the sale of listed shares.

The tax basis of our ordinary shares acquired prior to January 1, 2003 will generally be determined in accordance with the average closing share price in the three trading days preceding January 1, 2003. However, a request may be made to the tax authorities to consider the actual adjusted cost of the shares as the tax basis if it is higher than such average price.

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange or regulated market outside of Israel, provided however that such capital gains are not derived from a permanent establishment in Israel and such shareholders did not acquire their shares prior to an initial public offering. However, non-Israeli corporations will not be entitled to such exemption if Israeli residents (i) have a controlling interest of 25% or more in such non-Israeli corporation, or (ii) are the beneficiaries or are entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In some instances, where our shareholders may be liable to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

Pursuant to the Convention Between the government of the United States of America and the government of Israel with Respect to Taxes on Income, as amended, or the U.S.-Israel Tax Treaty, the sale, exchange or disposition of ordinary shares by a person who (i) holds the ordinary shares as a capital asset, (ii) qualifies as a resident of the United

States within the meaning of the U.S.-Israel Tax Treaty, or a Treaty U.S. Resident, and (iii) is entitled to claim the benefits afforded to such person by the U.S.-Israel Tax Treaty, generally, will not be subject to the Israeli capital gains tax. Such exemption will not apply if (i) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding such sale, exchange or disposition, subject to certain conditions, or (ii) the capital gains from such sale, exchange or disposition can be allocated to a permanent establishment in Israel. In such case, the sale, exchange or disposition of ordinary shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, such Treaty U.S. Resident would be permitted to claim a credit for such taxes against the U.S. federal income tax imposed with respect to such sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

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Taxation of Dividends paid to Non-Resident Holders of Shares

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends. On distributions of dividends other than bonus shares or stock dividends, income tax is applicable at the rate of 25%, or 30% for a shareholder that is considered a “significant shareholder” at any time during the 12-month period preceding such distribution, unless a different rate is provided in a treaty between Israel and the shareholder’s country of residence. However, under the Investments Law, dividends generated by an Approved Enterprise (or Benefited Enterprise) are taxed at the rate of 15%.

Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident is 25%. However, if the income out of which the dividend is paid is not generated by an Approved Enterprise (or Benefited Enterprise), and not more than 25% of our gross income consists of interest or dividends, dividends paid to a U.S. corporation holding at least 10% of our issued voting power during the part of the tax year which precedes the date of payment of the dividend and during the whole of its prior tax year, are generally taxed at a rate of 12.5%. Dividends generated by an Approved Enterprise (or Benefited Enterprise) are taxed at the rate of 15% under the U.S.-Israel Tax Treaty.

United States Federal Income Tax Considerations

The following is a description of the material U.S. federal income tax consequences of the acquisition, ownership and disposition of our ordinary shares. This description addresses only the U.S. federal income tax considerations that are relevant to U.S. Holders (as defined below) who hold our ordinary shares as capital assets. This summary is based on the U.S. Internal Revenue Code of 1986, as amended, or the Code, Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, or the Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively.

There can be no assurance that the U.S. Internal Revenue Service, or the IRS, will not take a different position concerning the tax consequences of the acquisition, ownership and disposition of our ordinary shares or that such a position would not be sustained. This description does not address all tax considerations that may be relevant with respect to an investment in our ordinary shares. In addition, this description does not account for the specific circumstances of any particular investor, such as:

- broker-dealers;
- financial institutions;
- certain insurance companies;
- investors liable for alternative minimum tax;
- regulated investment companies, real estate investment trusts, or grantor trusts;
- dealers or traders in securities, commodities or currencies;
- tax-exempt organizations;
- non-resident aliens of the United States or taxpayers whose functional currency is not the U.S. dollar;
- persons who hold the ordinary shares through partnerships or other pass-through entities;
- persons who acquire their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services;
- direct, indirect or constructive owners of investors that actually or constructively own 10% or more of our shares by vote or value; or
- investors holding ordinary shares as part of a straddle, appreciated financial position, a hedging transaction or conversion transaction.

If a partnership or an entity treated as a partnership for U.S. federal income tax purposes owns our ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns our ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of ordinary shares.

This summary does not address the effect of any U.S. federal taxation (such as estate and gift tax) other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or non-U.S. taxation. You are urged to consult your tax advisors regarding the non-U.S. and U.S. federal, state and local tax consequences of an investment in ordinary shares.

For purposes of this summary, as used herein, the term “U.S. Holder” means a person that is eligible for the benefits of the Treaty and is a beneficial owner of an ordinary share who is, for U.S. federal income tax purposes:

- an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;
- a corporation or other entity taxable as a corporation created or organized in or under the laws of the United States or any political subdivision thereof;
- an estate the income of which is subject to U.S. federal income taxation regardless of its source; or
- a trust if such trust has validly elected to be treated as a U.S. person for U.S. federal income tax purposes or if (1) a court within the United States is able to exercise primary supervision over its administration and (2) one or more U.S. persons have the authority to control all of the substantial decisions of such trust.

Unless otherwise indicated, this discussion assumes that the Company is not, and will not become, a “passive foreign investment company,” or a PFIC, for U.S. federal income tax purposes. See “—Passive Foreign Investment Companies” below.

Taxation of Distributions

Subject to the discussion below under the heading “—Passive Foreign Investment Companies,” the gross amount of any distributions received with respect to our ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes to the extent of our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. Because we do not expect to maintain calculations of our earnings and profits under U.S. federal income tax principles, it is expected that the entire amount of any distribution will generally be reported as dividend income to you. Dividends are included in gross income as ordinary income. Distributions in excess of our current and accumulated earnings and profits would be treated as a non-taxable return of capital to the extent of your tax basis in our ordinary shares and any amount in excess of your tax basis will be treated as gain from the sale of ordinary shares. See “—Disposition of Ordinary Shares” below for a discussion of the taxation of capital gains. Our dividends would not qualify for the dividends-received deduction generally available to corporations under section 243 of the Code.

Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received, regardless of whether the payment is in fact converted into U.S. dollars. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on such day may have a foreign currency exchange gain or loss that would be treated as U.S.-source ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Subject to complex limitations, some of which vary depending upon the U.S. Holder’s circumstances, any Israeli withholding tax imposed on dividends paid with respect to our ordinary shares, at a rate not exceeding the applicable rate provided by the Treaty, will be a foreign income tax eligible for credit against a U.S. Holder’s U.S. federal income tax liability (or, alternatively, for deduction against income in determining such tax liability). Israeli taxes withheld in excess of the applicable rate allowed by the Treaty (if any) will not be eligible for credit against a U.S. Holder’s federal income tax liability. The limitation on foreign income taxes eligible for credit is calculated separately with respect to specific classes of income. Dividends generally will be treated as foreign-source passive category income or, in the case of certain U.S. Holders, general category income for U.S. foreign tax credit purposes. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate (see discussion below). A U.S. Holder may be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on our ordinary shares if such U.S. Holder fails to satisfy certain minimum holding period requirements or to the extent such U.S. Holder’s position in ordinary shares is hedged. An election to deduct foreign taxes instead of claiming foreign tax credit applies to all foreign taxes paid or accrued in the taxable year. The rules relating to the determination of the foreign tax credit are complex, and you should consult with your own tax advisors to determine whether and to what extent you would be entitled to this credit.

Subject to certain limitations (including the PFIC rules discussed below), “qualified dividend income” received by a non-corporate U.S. Holder will be subject to tax at the lower long-term capital gain rates (currently at 20%). Distributions taxable as dividends paid on our ordinary shares should qualify for a reduced rate provided that either: (i) we are entitled to benefits under the Treaty, or (ii) our ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that our ordinary shares currently are readily tradable on an established securities market in the United States (see discussion below). However, no assurance can be given that our ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied, nor does it apply to dividends received from a PFIC (see discussion below), in respect of certain risk-reduction transactions, or in certain other situations. The legislation enacting the reduced tax rate on qualified dividend income contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of our ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

Sale or Disposition of Ordinary Shares

Subject to the discussion of PFIC rules below, if you sell or otherwise dispose of our ordinary shares, you will generally recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amount realized on the sale or other disposition and your adjusted tax basis in our ordinary shares, in each case determined in U.S. dollars. Such gain or loss will generally be capital gain or loss and will be long-term capital gain or loss if you have held the ordinary shares for more than one year at the time of the sale or other disposition. Long-term capital gain realized by a non-corporate U.S. Holder is generally eligible for a preferential tax rate (currently 20%). In general, any gain that you recognize on the sale or other disposition of ordinary shares will be U.S.-source for purposes of the foreign tax credit limitation; losses will generally be allocated against U.S. source income. Deduction of capital losses is subject to certain limitations under the Code.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of our ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A cash basis U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss, which would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of our ordinary shares that are traded on an established securities market, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the IRS. In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as U.S.- source ordinary income or loss and would be in addition to the gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

Passive Foreign Investment Companies

We believe that we were not a PFIC for U.S. federal income tax purposes for the taxable year of 2018. However, since PFIC status depends upon the composition of our income and assets and the market value of our assets from time to time, there can be no assurance that we will not be considered a PFIC for any future taxable year. If we were a PFIC for any taxable year during which a U.S. Holder owned an ordinary share, certain adverse consequences could apply to the U.S. Holder. Specifically, gain recognized by a U.S. Holder on a sale or other disposition of such ordinary share would be allocated ratably over the U.S. Holder’s holding period for the ordinary share. The amounts allocated to the taxable year of the sale or other disposition and to any year before we became a PFIC would be taxed as ordinary income. The amount allocated to each other taxable year would be subject to tax at the highest rate in effect for individuals or corporations, as appropriate, for that taxable year, and an interest charge would be imposed on the resulting tax liability. Further, any distribution in excess of 125% of the average of the annual distributions received by the U.S. Holder on our ordinary shares during the preceding three years or the U.S. Holder’s holding period, whichever is shorter, would be subject to taxation as described immediately above. Certain elections (such as a mark-to-market election) may be available to U.S. Holders and may result in alternative tax treatment. In addition, if we were a PFIC for a taxable year in which we pay a dividend or the prior taxable year, the favorable dividend rates discussed above with respect to dividends paid to certain non-corporate U.S. Holders would not apply. If we were a PFIC for any taxable year in which a U.S. Holder owned our shares, the U.S. Holder would generally be required to file annual returns with the IRS on IRS Form 8621.

Additional Tax on Investment Income

In addition to the income taxes described above, U.S. Holders that are individuals, estates or trusts and whose income exceeds certain thresholds will be subject to a 3.8% Medicare contribution tax on net investment income, which includes dividends and capital gains from the sale or exchange of our ordinary shares.

Backup Withholding and Information Reporting

Payments in respect of our ordinary shares may be subject to information reporting to the IRS and to U.S. backup withholding tax at the rate (currently) of 24%. Backup withholding will not apply, however, if you (i) are a corporation, or fall within certain exempt categories, and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder's U.S. tax liability. A U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

U.S. citizens and individuals taxable as resident aliens of the United States that own "specified foreign financial assets" with an aggregate value in a taxable year in excess of certain thresholds (as determined under rules in Treasury regulations) and that are required to file a U.S. federal income tax return generally will be required to file an information report with respect to those assets with their tax returns. IRS Form 8938 has been issued for that purpose. "Specified foreign financial assets" include any financial accounts maintained by foreign financial institutions, foreign stocks held directly, and interests in foreign estates, foreign pension plans or foreign deferred compensation plans. Under those rules, our ordinary shares, whether owned directly or through a financial institution, estate or pension or deferred compensation plan, would be "specified foreign financial assets." Under Treasury regulations, the reporting obligation applies to certain U.S. entities that hold, directly or indirectly, specified foreign financial assets. Penalties can apply if there is a failure to satisfy this reporting obligation. A U.S. Holder is urged to consult the U.S. Holder's tax advisor regarding the reporting obligation.

Any U.S. Holder who acquires more than $100,000 of our ordinary shares or holds 10% or more in vote or value of our ordinary shares may be subject to certain additional U.S. information reporting requirements.

The above description is not intended to constitute a complete analysis of all tax consequences relating to acquisition, ownership and disposition of our ordinary shares. You should consult your tax advisor concerning the tax consequences of your particular situation.

F. Dividends and Paying Agents.

Not applicable.

G. Statements by Experts.

Not applicable.

H. Documents on Display.

We are subject to certain of the reporting requirements of the Securities and Exchange Act of 1934, as amended, or the Exchange Act, as applicable to "foreign private issuers" as defined in Rule 3b-4 under the Exchange Act. As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, and transactions in our equity securities by our officers and directors are exempt from reporting and the "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required to file quarterly reports including financial statements. We file with the SEC an annual report on Form 20-F containing financial statements audited by an independent accounting firm. We also submit to the SEC reports on Form 6-K containing, among other things, press releases and unaudited financial information. We post our annual report on Form 20-F on our website (www.magalsecurity.com) promptly following the filing of our annual report with the SEC. The information on our website is not incorporated by reference into this annual report.

The SEC maintains an Internet website that contains reports and other information about issuers, like us, that file electronically with the SEC. The address of that website is www.sec.gov. We make our reports available on our internet website, free of charge, as soon as reasonably practicable after such material is electronically filed with the SEC. The documents concerning our company that are referred to in this annual report may also be inspected at our executive offices in Israel.

I. Subsidiary Information.

Not applicable.

ITEM 11. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to a variety of risks, including changes in interest rates and foreign currency fluctuations.

Foreign Currency Exchange Risk

We sell most of our products in North America, Europe, Africa, Latin America and Israel. Our revenues are primarily denominated in U.S. dollars, Canadian dollars, Mexican pesos, Euros and NIS, while a portion of our expenses, primarily labor expenses, is incurred in NIS and Canadian Dollars. Additionally, certain assets, especially trade receivables, as well as part of our liabilities are denominated in NIS and CAD. As a result, fluctuations in rates of exchange between the U.S. dollar and non-U.S. dollar currencies may affect our operating results and financial condition. The dollar cost of our operations in Israel may be adversely affected by the appreciation of the NIS against the U.S. dollar. The U.S. dollar cost of our operations in Canada may be adversely affected by the appreciation of the Canadian dollars against the U.S. dollar. The U.S. dollar cost of our operations in Mexico may be adversely affected by the appreciation of the Mexican peso against the U.S. dollar. In addition, the value of our non-U.S. dollar revenues could be adversely affected by the depreciation of the U.S. dollar against such currencies.

The U.S. dollar cost of our operations in Canada is influenced by the exchange rate between the U.S. dollar and the CAD. In 2016 and 2017 the CAD appreciated against the U.S. dollar by 2.7% and 7%, respectively. In 2018 the CAD depreciated against the U.S. dollar by 8.6%. In addition, the U.S. dollar cost of our operations in Mexico is influenced by the exchange rate between the U.S. dollar and the Mexican Peso. In 2016, the Peso depreciated against the U.S. dollar by 19.2%. In 2017 and 2018 the Mexican Peso appreciated against the U.S. dollar by 4.5% and 0.4% respectively.

During the years ended December 31, 2016 and 2017, foreign currency fluctuations had a negative impact on our results of operations and we recorded a foreign exchange loss, net of $0.6 million and $4 million, respectively. During the year ended December 31, 2018, foreign currency fluctuations had a positive impact on our results of operations and we recorded a foreign exchange gain, net of $1.1 million. We cannot assure you that in the future our results of operations may not be materially affected by currency fluctuations.

ITEM 12. Description of Securities Other Than Equity Securities

Not applicable.

PART II

ITEM 13. Defaults, Dividend Arrearages and Delinquencies

Not applicable.

ITEM 14. Material Modifications to the Rights of Security Holders and Use of Proceeds

Not applicable.

ITEM 15. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our chief executive officer and chief financial officer to allow timely decisions regarding required disclosure. Our management, including our chief executive officer and chief financial officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e), as of the end of the period covered by this Annual Report on Form 20-F. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective.

Management's Report on Internal Control over Financial Reporting

Our management, including our chief executive officer and chief financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined under Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets, (ii) 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 appropriate authorizations; and (iii) 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 assessed the effectiveness of our internal control over financial reporting as of December 31, 2018. 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, or the COSO, of the Treadway Commission. Based on that assessment, our management has concluded that our internal control over financial reporting was effective as of December 31, 2018.

Changes in Internal Control over Financial Reporting

During the period covered by this Annual Report on Form 20-F, no changes in our internal control over financial reporting have occurred that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 16. [Reserved]

ITEM 16A. Audit Committee Financial Expert

Our board of directors has determined that Ms. Liza Singer, an external and independent director, meets the definition of an audit committee financial expert, as defined by rules of the SEC. For a brief description of Ms. Singer's relevant experience, see Item 6.A. "Directors, Senior Management and Employees – Directors and Senior Management."

ITEM 16B. Code of Ethics

Our amended and restated code of ethics, which was adopted in April 2010, applies to our chief executive officer and all senior financial officers of our company, including our chief financial officer, chief accounting officer or controller, and persons performing similar functions. The amended and restated code of ethics reflects our growing emphasis on international operations and better addresses issues related with such activities by providing clear instructions in connection with commercial international activities. The code of ethics is publicly available on our website at www.magalsecurity.com. Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the code of ethics, we will disclose the nature of such amendment or waiver on our website.

ITEM 16C. Principal Accountant Fees and Services

Independent Public Accountant Fees and Services

The following table sets forth, for each of the years indicated, the fees billed by our principal independent registered public accounting firm, Kost Forer Gabbay & Kasierer, a member of Ernst & Young global. All of such fees were pre-approved by our Audit Committee.

	Year Ended December 31,	
Services Rendered	2017	2018
Audit [(1)]	262,000	243,000
Tax [(2)]	86,000	99,000
Other [(3)]	12,000	12,000
Total	360,000	354,000

(1) Audit fees are for audit services for each of the years shown in the table, including fees associated with the annual audit (including audit of our internal control over financial reporting), consultations on various accounting issues and audit services provided in connection with other statutory or regulatory filings.

(2) Tax fees are for professional services rendered by our auditors for tax compliance, tax planning and tax advice on actual or contemplated transactions, tax consulting associated to international taxation, tax assessment deliberation, transfer pricing and withholding tax assessments.

(3) Other fees primarily relate to out of pocket reimbursement of expenses and primarily traveling expenses of our auditors. These fees also relate to fees associated with the conflict Minerals work plan and the Risk Assessment Service.

Pre-Approval Policies and Procedures

Our audit committee has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent public accounting firm, Kost Forer Gabbay & Kasierer and their affiliates. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the scope of the engagement of our independent auditor, or on an individual basis. Any proposed services exceeding general pre-approved levels also require specific pre-approval by our audit committee. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the SEC, and also requires the audit committee to consider whether proposed services are compatible with the independence of the public accountants.

ITEM 16D. Exemptions from the Listing Standards for Audit Committees

Not applicable.

ITEM 16E. Purchase of Equity Securities by the Issuer and Affiliated Purchasers

We did not purchase any ordinary shares of our company nor did an affiliated purchaser purchase any shares of our company on our behalf during 2018.

ITEM 16F. Changes in Registrant's Certifying Accountant

None.

ITEM 16G. Corporate Governance

Under NASDAQ Stock Market Rule 5615(a)(3), foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of NASDAQ Stock Market Rules. A foreign private issuer that elects to follow a home country practice instead of any of such NASDAQ requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws.

We have notified NASDAQ that we do not comply with the following NASDAQ requirements, and instead follow Israeli law and practice in respect of such requirements:

- the requirement regarding the process of nominating directors. Instead, we follow Israeli law and practice in accordance with which our directors are recommended by our board of directors for election by our shareholders. See Item 6.C. "Directors, Senior Management and Employees – Board Practices – Election of Directors."

- the requirement regarding the compensation of our chief executive officer and all other executive officers. Instead, we follow Israeli law and practice in accordance with which our board of directors must approve all compensation arrangements for our chief executive officer and all compensation arrangements for officers are subject to the chief executive officer's approval. See Item 6.C. "Directors, Senior Management and Employees – Compensation."

- the requirement that our independent directors have regularly scheduled meetings at which only independent directors are present. Under Israeli law, independent directors are not required to hold executive sessions.

- the requirement that we maintain a majority of independent directors, as defined under NASDAQ Stock Market Rules. Under Israeli law and practice we are required to appoint at least two external directors, within the meaning of the Israeli Companies Law, to our board of directors.

ITEM 16H. MINE SAFETY DISCLOSURE

Not applicable.

PART III

ITEM 17. Financial Statements

We have elected to furnish financial statements and related information specified in Item 18.

ITEM 18. Financial Statements

The financial statements required by this item are found at the end of this annual report, beginning on page F-1.

Consolidated Financial Statements

ITEM 19. Exhibits

Exhibit No.	Description
1.1	Memorandum of Association of the Registrant [1]
1.2	Articles of Association of the Registrant [2]
2.1	Specimen Share Certificate for Ordinary Share [3]
2.2	Registrant's 2010 Israeli Share Option Plan[4]
2.4	Amendment to Registrant's 2010 Israeli Share Option Plan[5]
4.1	Share Purchase Agreement, dated as of April 1, 2016, by and among Senstar Corporation, Aimetis Corp., the persons listed in Annex A thereto, and Marc Holtenhoff in his capacity as the Holder Agent[6]
4.2	Compensation Policy of Office Holders (August 8, 2016) [7
4.3	Warrant Purchase Agreement, dated October 2018, by and among the Company and the Sellers listed in Exhibit 1 thereto
8.1	List of Subsidiaries of the Registrant
12.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act, as amended
12.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act, as amended
13.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
13.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
15.1	Consent of Kost Forer Gabbay & Kasierer
15.2	Consent of Sallas, Sainz – Grant Thornton, S.C.
101.INS	XBRL Instance Document.*
101.SCH	XBRL Taxonomy Extension Schema Document.*
101.PRE	XBRL Taxonomy Presentation Linkbase Document.*
101.CAL	XBRL Taxonomy Calculation Linkbase Document.*
101.LAB	XBRL Taxonomy Label Linkbase Document.*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.*

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* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for the purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

(1) Filed as an exhibit to our Registration Statement on Form F-1 (File No. 33 57438), filed with the Securities and Exchange Commission on January 26, 1993, as amended, and incorporated herein by reference.

(2) Filed as an exhibit to our Registration Statement on Form F-1 (No. 33 57438), filed with the Securities and Exchange Commission on January 26, 1993, as amended, and incorporated herein by reference, as amended by an amendment filed as an exhibit to our Registration Statement on Form S-8 (File No. 333-6246), filed with the Commission on January 7, 1997 and incorporated herein by reference, as further amended by an amendment filed as an exhibit to our Annual Report on Form 20-F for the fiscal year ended December 31, 2000, filed with the Securities and Exchange Commission on June 29, 2001 and incorporated herein by reference, as further amended by the company's shareholders on July 17, 2002, as described under Form 6-K furnished to the SEC on June 19, 2002, as further amended by the company's shareholders on August 20, 2008, as described under Form 6-K furnished to the SEC on July 17, 2008, and as further amended by the company's shareholders on August 31, 2011,

as described under Form 6-K furnished to the SEC on July 27, 2011.

(3) Filed as an exhibit to our Registration Statement on Form 8-A, filed with the Securities and Exchange Commission on March 18, 1993, as amended, and incorporated herein by reference.

(4) Filed as Exhibit 2.3 to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2010, and incorporated herein by reference.

(5) Filed as Exhibit 2.4 to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2013, and incorporated herein by reference.

(6) Filed as Exhibit 10.1 to the Registrant's Registration Statement on Form F-1 (No. 333-213020), filed with the Securities and Exchange Commission on August 9, 2016, as amended, and incorporated herein by reference.

(7) Filed as Exhibit A to Exhibit 99.1 to the Registrant's Proxy Statement on Form 6-K furnished with the Securities and Exchange Commission on July 8, 2016 and incorporated herein by reference.

MAGAL SECURITY SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2018

IN U.S. DOLLARS

INDEX

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

MAGAL SECURITY SYSTEMS LTD.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Magal Security Systems Ltd. and subsidiaries (the Company) as of December 31, 2018 and 2017, the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, based on our audit and the report of other auditors, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We did not audit the financial statements of Senstar Latin America SA DE CV., a wholly-owned subsidiary, which reflect total assets constituting 11% and 10% at December 31, 2018 and 2017, respectively and total revenues constituting 27% and 20% in 2018 and 2017, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Senstar Latin America SA DE CV., is based solely on the report of the other auditors.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

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

We have served as the Company's auditor since 1984.

Tel-Aviv, Israel
April 15, 2019
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To the shareholders of
Senstar Latin America, S. A. de C.V.:

Opinion on Financial Statements

We have audited the accompanying balance sheets of Senstar Latin America, S. A. de C.V. (the Company) as of December 31, 2018 and 2017,the related statements of comprehensive income, changes in shareholders' equity and cash flows for the years ended December 31, 2018 and 2017, and the related notes (collectively referred to as the "financial statements") not presented herein. In our opinion, based on our audits, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years ended December 31, 2018 and 2017, in conformity with U.S. generally accepted accounting principles.

Basis for opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/Salles, Sainz – Grant Thornton, S.C.

C.P.C. Guillermo Segura Herrera
We have served as the Company's auditor since 2017.
Mexico City, Mexico
April 15, 2019

Contadores y Consultores de Negocios
Miembro de Grant Thornton International Ltd

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$38,665	$22,463
Short-term bank deposits	13,150	27,025
Restricted deposits	3,135	2,842
Trade receivables (net of allowance for doubtful accounts of $ 2,751 and $ 1,557 at December 31, 2018 and 2017, respectively)	14,176	14,489
Unbilled accounts receivable	6,050	6,309
Other accounts receivable and prepaid expenses (Note 3)	4,126	2,850
Inventories (Note 4)	13,863	9,596
Total current assets	93,165	85,574
LONG-TERM INVESTMENTS AND RECEIVABLES:		
Long-term deposits and restricted bank deposits	146	155
Severance pay fund	1,289	1,524
Deferred tax assets (Note 12)	3,459	2,579
Total long-term investments and receivables	4,894	4,258
PROPERTY AND EQUIPMENT, NET (Note 5)	6,347	5,718
INTANGIBLE ASSETS, NET (Note 6)	3,645	4,303
GOODWILL (Note 7)	11,120	12,692
Total assets	$119,171	$112,545

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

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

	December 31, 2018	December 31, 2017
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	$6,359	$5,198
Customer advances	10,170	7,191
Deferred revenues	2,387	2,163
Other accounts payable and accrued expenses (Note 8)	13,226	11,621
Total current liabilities	32,142	26,173
LONG-TERM LIABILITIES:		
Deferred revenues	1,344	891
Deferred tax liabilities	182	190
Accrued severance pay	2,181	2,328
Other long-term liabilities	351	14
Total long-term liabilities	4,058	3,423
COMMITMENTS AND CONTINGENT LIABILITIES (Note 9)		
REDEEMABLE NON-CONTROLLING INTEREST	1,755	-
SHAREHOLDERS' EQUITY:		
Share capital -		
Ordinary shares of NIS 1 par value -		
Authorized: 39,748,000 shares at December 31, 2018 and December 31, 2017; Issued and outstanding: 23,049,639 shares at December 31, 2018 and 23,032,448 shares at December 31, 2017	6,721	6,716
Additional paid-in capital	94,205	93,975
Accumulated other comprehensive loss	(1,827)	(87)
Foreign currency translation adjustments (Company's standalone financial statements)	2,795	5,859
Accumulated deficit	(20,678)	(23,514)
Total shareholders' equity (Note 10)	81,216	82,949
Total liabilities and shareholders' equity	$119,171	$112,545

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands (except per share data)

	Year ended December 31, 2018	2017	2016
Revenues	$92,602	$64,292	$67,825
Cost of revenues	52,299	32,967	34,570
Gross profit	40,303	31,325	33,255
Operating expenses:			
Research and development, net	6,852	6,558	6,779
Selling and marketing	18,557	18,158	17,536
General and administrative	11,139	7,853	7,445
Total operating expenses	36,548	32,569	31,760
Operating income (loss)	3,755	(1,244)	1,495
Financial income (expenses), net (Note 15)	1,361	(3,961)	(591)
Income (loss) before income taxes	5,116	(5,205)	904
Taxes on income (tax benefit) (Note 12)	2,072	1,695	(122)
Net income (loss)	3,044	(6,900)	1,026
Less - loss (income) attributable to non-controlling interests	(95)	(14)	3
Net income (loss) attributable to Magal shareholders'	$2,949	$(6,914)	$1,029
Basic income (loss) per share	$0.12	$(0.30)	$0.06
Diluted income (loss) per share	$0.12	$(0.30)	$0.06

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

U.S. dollars in thousands (except per share data)

	Year ended December 31,		
	2018	2017	2016
Net income (loss)	$3,044	$(6,900)	$1,026
Realized foreign currency translation adjustments	-	64	-
Foreign currency translation adjustments	(1,740)	1,772	(73)
Total comprehensive income (loss)	$1,304	$(5,064)	$953
Net income (loss) attributable to:			
Non-controlling interests	$-	$14	$(3)
Redeemable non-controlling interests	95	-	-
Magal shareholders'	2,949	(6,914)	1,029
Net income (loss)	$3,044	$(6,900)	$1,026
Total comprehensive income (loss) attributable to:			
Non-controlling interests	$-	$14	$(3)
Redeemable non-controlling interests	(5)	-	-
Magal shareholders'	1,309	(5,078)	956
Total comprehensive income (loss)	$1,304	$(5,064)	$953

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

MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands (except share data)

	Number of shares	Ordinary shares	Additional paid-in capital	Accumulated other comprehensive income (loss)	Foreign currency translation adjustment - the Company	Retained earnings (accumulated deficit)	Non-controlling interests	Total shareholders' equity
Balance as of January 1, 2016	16,398,872	$ 4,968	$ 69,888	$ (1,850)	$ 406	$ (17,629)	$ (88)	$ 55,695
Issuance of share capital, net (Note 10b)	6,170,386	1,626	21,991	-	-	-	-	23,617
Issuance of shares upon exercise of employee stock options	325,090	85	1,304	-	-	-	-	1,389
Stock-based compensation	-	-	258	-	-	-	-	258
Foreign currency translation adjustments- the Company	-	-	-	-	6	-	-	6
Comprehensive income (loss):								
Net income (loss)	-	-	-	-	-	1,029	(3)	1,026
Foreign currency translation adjustments	-	-	-	(73)	-	-	-	(73)
Balance as of December 31, 2016	22,894,348	6,679	93,441	(1,923)	412	(16,600)	(91)	81,918
Issuance of shares upon exercise of warrants	60,000	16	238	-	-	-	-	254
Issuance of shares upon exercise of employee stock options	78,100	21	306	-	-	-	-	327
Stock-based compensation	-	-	144	-	-	-	-	144
Foreign currency translation adjustments- the Company	-	-	-	-	5,447	-	-	5,447
Purchase of non-controlling interests	-	-	(154)	-	-	-	77	(77)
Comprehensive income (loss):								
Loss	-	-	-	-	-	(6,914)	14	(6,900)
Realized foreign currency translation adjustments	-	-	-	64	-	-	-	64
	-	-	-	1,772	-	-	-	1,772

Foreign currency translation adjustments								
Balance as of December 31, 2017	23,032,448	6,716	93,975	(87)	5,859	(23,514)	-	82,949
Cumulative effect adjustment resulting from adoption of ASC606	-	-	-	-	-	114	-	114
Issuance of shares upon exercise of employee stock options	17,191	5	72	-	-	-	-	77
Stock-based compensation	-	-	158	-	-	-	-	158
Foreign currency translation adjustments- the Company	-	-	-	-	(3,064)	-	-	(3,064)
Comprehensive income (loss):								
Net income	-	-	-	-	-	2,949	-	2,949
Adjustment to the redemption value of redeemable non-controlling interests	-	-	-	-	-	(227)	-	(227)
Foreign currency translation adjustments	-	-	-	(1,740)	-	-	-	(1,740)
Balance as of December 31, 2018	23,049,639	6,721	94,205	(1,827)	2,795	(20,678)	-	81,216

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31, 2018	2017	2016
Cash flows from operating activities:			
Net income (loss)	$3,044	$(6,900)	$1,026
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	2,245	1,876	1,740
Impairment of goodwill	979	-	-
Loss (gain) on sale of property and equipment	(47)	(4)	5
Increase (decrease) in accrued interest and exchange differences on short-term and other long-term liabilities	(520)	2,996	(57)
Stock based compensation	158	144	258
Decrease in trade receivables, net	555	153	1,487
Decrease (increase) in unbilled accounts receivable	(227)	(1,593)	1,395
Decrease (increase) in other accounts receivable and prepaid expenses	(1,333)	119	221
Decrease (increase) in inventories	(3,981)	(2,079)	1,200
Increase in deferred income taxes	(968)	(467)	(1,722)
Decrease in long-term trade receivables	-	329	319
Increase in trade payables	1,071	787	857
Increase (decrease) in other accounts payable and accrued expenses and deferred revenues	3,114	1,521	(1,010)
Increase in customer advances	3,214	1,207	3,351
Accrued severance pay, net	22	(41)	(137)
Net cash provided by (used in) operating activities	$7,326	$(1,952)	$8,933

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31, 2018	2017	2016
Cash flows from investing activities:			
Investment in short-term deposits	$-	$-	$(27,868)
Proceeds from sale of short-term bank deposits	12,873	4,103	-
Release of long-term bank deposits	-	(15)	13
Proceeds from sale of property and equipment	57	35	93
Purchase of property and equipment	(2,128)	(934)	(797)
Investment in technology, know-how and patents	(296)	(13)	(31)
Payments for acquisition of ESC BAZ, net of cash acquired (1)	(385)	-	-
Payments for acquisition of Aimetis, net of cash acquired (2)	-	-	(12,113)
Net cash provided by (used in) investing activities	10,121	3,176	(40,703)
Cash flows from financing activities:			
Proceeds from issuance of shares, net of issuance costs of $ 201	-	-	23,617
Proceeds from issuance of shares upon exercise of options to employees	77	327	1,389
Proceeds from issuance of shares upon exercise of warrants	-	254	-
Purchase of shares from non-controlling interests, net	-	(77)	-
Net cash provided by financing activities	77	504	25,006
Effect of exchange rate changes on cash and cash equivalents	(1,029)	2,076	160
Increase (decrease) in cash, cash equivalents and restricted cash	16,495	3,804	(6,604)
Cash, cash equivalents and restricted cash at the beginning of the year	25,305	21,501	28,105
Cash, cash equivalents and restricted cash at the end of the year	$41,800	$25,305	$21,501
Supplemental disclosures of cash flows activities:			
Cash paid during the year for:			
Interest	$20	$148	$27
Income taxes	$2,926	$1,855	$1,677

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31, 2018	2017	2016
(1) Payments for acquisition of ESC BAZ, net of cash acquired:			
Net fair value of assets acquired and liabilities assumed of ESC BAZ at the date of acquisition (see also Note 1a):			
Net assets (excluding cash and cash equivalents)	$1,222	$ -	$-
Technology	190	-	-
Customer relationship	164	-	-
Backlog	147	-	-
Adjustment to deferred revenue	20	-	-
Deferred tax liability, net	(80)	-	-
Goodwill	255		
Redeemable non-controlling interest	(1,533)	-	-
Total payments for acquisition of ESC BAZ, net of cash acquired	$385	$ -	$-
(2) Payments for acquisition of Aimetis, net of cash acquired:			
Net fair value of assets acquired and liabilities assumed of Aimetis at the date of acquisition (see also Note 1b):			
Net assets (liabilities) (excluding cash and cash equivalents)	$-	$ -	$(293)
Technology	-	-	3,759
Customer relationship	-	-	761
Adjustment to deferred revenue	-	-	671
Contingent consideration			(82)
Deferred tax liability, net	-	-	(562)
Goodwill	-	-	7,859
Total payments for acquisition of Aimetis, net of cash acquired	$-	$ -	$12,113

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

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MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

a. General:

Magal Security Systems Ltd. ("the Parent Company" or "Magal") and its subsidiaries (together - "the Company") is a leading international provider of solutions and products for physical and video security solutions, as well as site management. Since 1969, the Company has delivered its products as well as tailor-made security solutions and turnkey projects to customers in over 100 countries under some of the most challenging conditions. The Company offers comprehensive integrated solutions for critical sites, which leverage its broad portfolio of homegrown PIDS (Perimeter Intrusion Detection Systems), advanced VMS (Video Management Software) with native IVA (Intelligent Video Analytics) security solutions, as well as a proprietary command and control platform.

On September 30, 2016, the Parent Company completed a rights offering according to which it distributed to all holders of its ordinary shares at no charge, subscription rights to purchase up to an aggregate of 6,170,386 Ordinary shares. The rights offering was fully subscribed for and the Parent Company received net proceeds of approximately $ 23,617 after deducting issuance expenses related to the rights offering of approximately $ 201.

On October 1, 2014, FIMI Opportunity Fund ("FIMI"), completed the purchase of approximately 40% of Magal's outstanding shares from Ki Corporation Limited, a Company beneficially owned by Mr. Nathan Kirsh. Following the closing of the transaction, FIMI is the largest shareholder of Magal. Following the 2016 rights offering, FIMI increased its holdings in Magal to approximately 43%.

b. 2018 Acquisition:

On April 2, 2018 (the "Closing Date"), the Company completed the acquisition of a 55% controlling interest in ESC BAZ Ltd. ("ESC BAZ" or "BAZ") by means of a capital investment in ESC BAZ against the issuance of shares. As a part of the transaction, the Company invested $ 2,846 in ESC BAZ and granted a put option to the non-controlling interest for the remaining 45% of the shares of ESC BAZ, exercisable starting 2021. Starting 2019, the Company has an exercisable call option, which enables it to acquire the non-controlling interest in ESC BAZ. The exercise price of the put and call options is based on a formula calculation, driven by an adjusted multiple on the average operating income of ESC BAZ.

ESC BAZ is an Israeli-based company, focused on the development and manufacture of military-grade smart security video observation and surveillance systems. The acquisition broadens the Company’s offerings, adding a wide range of modular and customizable medium and long range surveillance systems for distances from 500m up to 25km. ESC BAZ systems, which have been used successfully for over twenty years, are operational and field proven with customers including the Israeli Defense Forces, police and security services, as well as numerous other government and civilian customers worldwide.

MAGAL SECURITY SYSTEMS LTD.
AND ITS SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL (Cont.)

The acquisition was accounted for by the acquisition method and accordingly, the purchase price has been allocated according to the estimated fair value of the assets acquired and liabilities assumed. The entire goodwill was assigned to the BAZ reporting unit within the Company's Project segment. The results of ESC BAZ's operations have been included in the consolidated financial statements since April 2, 2018.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Net assets (including cash of $ 2,461)	$3,683
Intangible assets	501
Adjustment to deferred revenue	20
Deferred tax liabilities	(80)
Goodwill	255
Redeemable non-controlling interests	(1,533)
Total purchase price	$2,846

In performing the purchase price allocation, management considered, among other factors, analyses of historical financial performance, highest and best use of the acquired assets and estimates of future performance of the acquired company's business.

The fair value of intangible assets was based on the market participant approach using an income approach. Intangible assets that are subject to amortization are amortized over their estimated useful lives. For technology, Magal is using the straight-line method and for customer relationships and backlog, Magal is using the acceleration method.

The following table sets forth the components of intangible assets associated with the acquisition:

	Fair value
Technology	$ 190
Customer relationships	164
Backlog	147
Total intangible assets	$ 501

Redeemable non-controlling interests in the amount of $ 1,533 was recorded at acquisition date and classified as temporary equity (mezzanine account), separate from permanent equity, on the consolidated balance sheets. The redeemable non-controlling interests is measured at each reporting period at the higher of their redemption amount or the non-controlling interest book value, in accordance with the requirements of ASC 810 "Consolidation" and ASC 480-10-S99-3A, "Distinguishing Liabilities from Equity" (See note 2c).

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MAGAL SECURITY SYSTEMS LTD.
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U.S. dollars in thousands (except share and per share data)

NOTE 1:- GENERAL (Cont.)

Acquisition related costs for the year ended December 31, 2018 amounted to approximately $ 67 were included in general and administrative expenses in the statement of operations.

The amounts of revenue and net earnings of ESC BAZ since the acquisition date included in the consolidated income statement for the reporting period are:

	Year ended December 31, 2018
Revenues	$ 3,969
Net income	$ 210

Unaudited pro forma condensed results of operations:

The following represents the unaudited pro forma condensed results of operations for the years ended December 31, 2018 and 2017, assuming that the acquisition of ESC BAZ occurred on January 1, 2017. The pro forma information is not necessarily indicative of the results of operations that would have actually occurred had the acquisitions been consummated on those dates, nor does it purport to represent the results of operations for future periods.

	Year ended December 31, 2018	2017
	Unaudited	
Revenues	$94,216	$69,851
Net income (loss) attributable to Magal shareholders'	$3,198	$(6,802)
Basic and diluted net income (loss) per share	$0.14	$(0.30)

c. 2016 Acquisition:

On April 1, 2016 (the "Closing Date"), a wholly-owned subsidiary of the Parent Company, completed the acquisition of all of the outstanding ordinary shares of Aimetis Corp. ("Aimetis"), a corporation incorporated under the laws of Canada for total consideration of $ 14,469, consisting of $ 14,387 in cash and performance-based contingent payments ("Earn-out") of up to $ 844. The Earn-out payments were measured, by using the Monte Carlo Simulation of the triangular model, at fair value at the Closing Date in the amount of $ 82. Since the performance conditions have not been met, the liability of $ 82 was eliminated and such amount was included as a reduction of general and administrative expenses in the statement of operations in 2016.

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NOTE 1:- GENERAL (Cont.)

In addition, a retention payment in the amount of $ 844 was paid as a result of the continued employment of two executive employees of Aimetis during the period of 13 months following the closing date. The expense was recognized on a straight-line basis.

Aimetis specializes in advanced video analytics software and intelligent IP video management software (VMS). The acquisition added a product portfolio complementary to the Company's large portfolio of perimeter intrusion detection systems (PIDS), adding a video surveillance offering with solutions for outdoor and critical sites, and also strengthening the Company's position in the market. The value of goodwill was attributed to synergies between the Company's portfolio and the acquired company's products and services.

The acquisition was accounted for by the acquisition method and accordingly, the purchase price has been allocated according to the estimated fair value of the assets acquired and liabilities assumed of the acquired company. The entire goodwill was assigned to the Video reporting unit within the Video and Cyber security segment. The results of the operations of Aimetis have been included in the consolidated financial statements since April 1, 2016.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Net assets (including cash of $ 2,274)	$ 1,981
Intangible assets	4,520
Adjustment to deferred revenue	671
Deferred tax liabilities, net	(562)
Goodwill	7,859
Total purchase price	$ 14,469

In performing the purchase price allocation, management considered, among other factors, analyses of historical financial performance, highest and best use of the acquired assets and estimates of future performance of the acquired company's business.

The fair value of intangible assets was based on market participant approach using an income approach. Intangible assets that are subject to amortization are amortized over their estimated useful lives. For technology, the Company is using the straight-line method and for customer relationships it is using the acceleration method.

The following table sets forth the components of intangible assets associated with the acquisition:

	Fair value
Technology	$ 3,759
Customer relationships	761
Total intangible assets	$ 4,520

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

NOTE 1:- GENERAL (Cont.)

Acquisition related costs for the year ended December 31, 2016 amounted to approximately $270 and were included in general and administrative expenses in the statement of operations.

The amounts of revenue and net earnings of the Aimetis since the acquisition date included in the consolidated income statement for the reporting period are:

	Year ended December 31, 2016
Revenues	$ 5,047
Net loss	$ (2,667)

Unaudited pro forma condensed results of operations:

The following represents the unaudited pro forma condensed results of operations for the years ended December 31, 2016 and 2015, assuming that the acquisitions of Aimetis occurred on January 1, 2015. The pro forma information is not necessarily indicative of the results of operations that would have actually occurred had the acquisitions been consummated on those dates, nor does it purport to represent the results of operations for future periods.

	Year ended December 31,	
	2016	2015
	Unaudited	
Revenues	$69,956	$71,709
Net income (loss) attributable to Magal shareholders'	$(73)	$2,134
Basic and diluted income (loss) per share	$0.00	$0.13

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MAGAL SECURITY SYSTEMS LTD.
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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"), followed on a consistent basis.

a. Use of estimates:

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates, judgments and assumptions that affect the amounts reported in the financial statements and accompanying notes. The most significant assumptions are employed in estimates used in determining values of goodwill and identifiable intangible assets, revenue recognition, allowances for doubtful debts, inventory write-offs, warranty provision, tax assets and tax positions, legal contingencies, and stock-based compensation costs. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

The Company's revenues are generated mainly in NIS, U.S. dollars, Canadian dollars, Mexican Pesos and Euros. In addition, most of the Parent Company's costs are incurred in NIS. The Company's management believes that the NIS is the primary currency of the economic environment in which the Company operates.

In accordance with U.S. Securities and Exchange Commission Regulation S-X, Rule 3-20, the Company has determined its reporting currency to be the U. S. dollar. The measurement process of Rule 3-20 is conceptually consistent with that of ASC 830.

Therefore, the functional currency of the Company is the NIS and its reporting currency is the U.S. dollar. The functional currency of the Company's foreign subsidiaries is the local currency in which each subsidiary operates.

ASC 830, "Foreign Currency Matters" sets the standards for translating foreign currency financial statements of consolidated subsidiaries. The first step in the translation process is to identify the functional currency for each entity included in the financial statements. The accounts of each entity are then measured in its functional currency. All transaction gains and losses from the measurement of monetary balance sheet items are reflected in the statement of operations as financial income or expenses, as appropriate.

After the measurement process is complete the financial statements are translated into the reporting currency, which is the U.S. dollar, using the current rate method. Equity accounts are translated using historical exchange rates. All other balance sheet accounts are translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the year. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Parent Company and its subsidiaries. Intercompany transactions and balances including profits from intercompany sales not yet realized outside the Company, have been eliminated upon consolidation.

Changes in the Parent Company's ownership interest with no change of control are treated as equity transactions, rather than step acquisitions or dilution gains or losses.

Non-controlling interests in subsidiaries represent the equity in subsidiaries not attributable, directly or indirectly, to a parent. Non-controlling interests are presented in equity separately from the equity attributable to the equity holders of the Company. Profit or loss and components of other comprehensive income are attributed to the Company and to non-controlling interests. Losses are attributed to non-controlling interests even if they result in a negative balance of non-controlling interests in the consolidated statement of financial position. When the purchase price of a non-controlling interest exceeds the book value at the time of purchase, any excess or shortfall is recognized as an adjustment to additional paid-in capital.

Redeemable non-controlling interests are classified as temporary equity, separate from permanent equity, on the consolidated balance sheets and measured at each reporting period at the higher of their redemption amount or the non-controlling interest book value, in accordance with the requirements of ASC 810 “Consolidation” and ASC 480-10-S99-3A, “Distinguishing Liabilities from Equity”.

The following table provides a reconciliation of the beginning and ending amount of the redeemable non-controlling interests for the year ended December 31, 2018:

Balance as of January 1, 2018	$-
Redeemable non-controlling interests at the acquisition of ESC BAZ	1,533
Adjustment to the redemption value of redeemable non-controlling interests	227
Net income attributable to redeemable non-controlling interests	95
Foreign currency translation adjustments	(100)
Balance as of December 31, 2018	$1,755

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible into cash with original maturities of three months or less at the date acquired.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Short-term and long-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months and less than one year, and are presented at their cost.

A bank deposit with a maturity of more than one year is included in long-term bank deposits, and presented at cost.

f. Inventories:

Inventories are stated at the lower of cost or net realizable value. The Company periodically evaluates the inventory quantities on hand relative to historical and projected sales volumes, current and historical selling prices and contractual obligations to maintain certain levels of parts. Based on these evaluations, inventory write-offs are provided to cover risks arising from slow-moving items, discontinued products, excess inventories, market prices lower than cost and adjusted revenue forecasts.

Cost is determined as follows:

Raw materials, parts and supplies: using the "first-in, first-out" method.

Work in progress and finished products: on the basis of direct manufacturing costs with the addition of allocable indirect cost, representing allocable operating overhead expenses and manufacturing costs.

During the years ended December 31, 2018, 2017 and 2016, the Company recorded inventory write-offs in the amounts of $ 118, $ 128 and $ 226, respectively. Such write-offs were included in cost of revenues.

g. Long-term trade receivables:

Long-term trade and other receivables with long term payment terms are recorded at their estimated present values.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

h. Property and equipment:

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

	%
Buildings	3 - 4
Machinery and equipment	10 - 33 (mainly 10%)
Motor vehicles	15
Promotional displays	15 - 50
Office furniture and equipment	6 - 33
Leasehold improvements	By the shorter of the term of the lease or the useful life of the assets

i. Intangible assets:

Intangible assets are comprised of patents, acquired technology, customer relations and backlog.

Intangible assets are amortized over their useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with ASC 350, "Intangibles - Goodwill and Other." Intangible assets were amortized based on the straight-line method or acceleration method, at the following weighted average annual rates:

	%
Patents	10
Technology	12.5-26.7
Customer relationships	10.3-36.4
Backlog	50-100

During the years ended December 31, 2018, 2017 and 2016, the Company did not record any impairment charges relating to its intangible assets.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

j. Impairment of long-lived assets:

The Company's long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with ASC 360, "Property, Plant, and Equipment" whenever events or changes in circumstances indicate that the carrying amount of a group of assets may not be recoverable. Recoverability of a group of assets to be held and used is measured by a comparison of the carrying amount of the group to the future undiscounted cash flows expected to be generated by the group. If such group of assets is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. During the years ended December 2018, 2017 and 2016, the Company did not record any impairment charges attributable to long-lived assets.

k. Goodwill:

Goodwill has been recorded as a result of acquisitions and represents the excess of the costs over the net fair value of the assets of the businesses acquired.

Goodwill is allocated to four reporting units: PIDS reporting unit within the Products segment, BAZ reporting unit within the Project segment and the Cyber security and Video reporting units, both within the Video and Cyber security segment.

The Company follows ASC 350, "Intangibles - Goodwill and Other."

ASC 350 requires goodwill to be tested for impairment, at the reporting unit level.

ASC 350 allows an entity to first assess qualitative factors to determine whether it is necessary to perform the quantitative goodwill impairment test. If the qualitative assessment does not result in a more likely than not indication of impairment, no further impairment testing is required. If it does result in a more likely than not indication of impairment, the quantitative impairment test is performed. Alternatively, ASC 350 permits an entity to bypass the qualitative assessment for any reporting unit and proceed directly to performing the first step of the goodwill impairment test. The Company elects to perform an annual impairment test of goodwill as of December 31 of each year, or more frequently if impairment indicators are present.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-04, "Intangibles—Goodwill and Other (Topic 350): - Simplifying the Test for Goodwill Impairment", which eliminates the requirement to calculate the implied fair value of goodwill (i.e., Step 2 of the goodwill impairment test) for the purpose of measuring a goodwill impairment charge. Instead, an impairment charge will be recognized based on the excess of a reporting unit's carrying amount over its fair value. The standard will be applied prospectively and is effective for annual and interim impairment tests performed in periods beginning after December 15, 2019, for public entities. Early adoption is permitted for annual and interim goodwill impairment testing dates after January 1, 2017. The Company early adopted the new guidance on January 1, 2018 (refer also to Note 7).

Goodwill annual impairment test for the PIDS reporting unit within the Products segment:

The material assumptions used for the goodwill annual impairment test for the PIDS reporting unit within the Products segment, according to the income approach for 2018 were five years of projected net cash flows, a weighted average cost of capital rate of 13% and a long-term growth rate of 3%. The Company considered historical rates and current market conditions when determining the discount and growth rates to use in its analyses. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for its goodwill.

As required by ASC 820, "Fair Value Measurements and Disclosures," the Company applies assumptions that marketplace participants would consider in determining the fair value of its reporting unit.

During the years ended December 31, 2018, 2017 and 2016, the Company did not record any impairment charges relating to the goodwill allocated to the PIDS reporting units within the Products segment.

Goodwill annual impairment test for the Cyber security reporting unit within the Video and Cyber security segment:

The material assumptions used for the goodwill annual impairment test for the Cyber security reporting unit within the Video and Cyber security segment, according to the income approach for 2018 were five years of projected net cash flows, a weighted average cost of capital rate of 14% and a long-term growth rate of 2%. The Company considered current market conditions when determining the discount and growth rates to use in its analyses. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for its goodwill.

As required by ASC 820, "Fair Value Measurements and Disclosures," the Company applies assumptions that marketplace participants would consider in determining the fair value of its reporting unit.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In 2018, the excess of the reporting unit's carrying amount over its fair value represented an impairment loss of goodwill in the amount of $ 979 which was recorded as part of the general and administrative expenses in the statements of operations (See Note 7).

During the years ended December 31, 2017 and 2016, the Company did not record any impairment charges relating to the goodwill allocated to the Cyber security reporting unit within the Video and Cyber security segment.

Goodwill annual impairment test for the Video reporting unit within the Video and Cyber security segment:

The material assumptions used for the goodwill annual impairment test for the Video reporting unit within the Video and Cyber security segment, according to the income approach for 2018 were five years of projected net cash flows, a weighted average cost of capital rate of 16.4% and a long-term growth rate of 3%. The Company considered historical rates and current market conditions when determining the discount and growth rates to use in its analyses. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for its goodwill.

As required by ASC 820, "Fair Value Measurements and Disclosures," the Company applies assumptions that marketplace participants would consider in determining the fair value of its reporting unit.

During the years ended December 31, 2018, 2017 and 2016, the Company did not record any impairment charges relating to the goodwill allocated to the Video reporting unit within the Video and Cyber security segment.

Goodwill annual impairment test for the BAZ reporting unit within the Project segment:

The material assumptions used for the goodwill annual impairment test for the BAZ reporting unit within the Project segment, according to the income approach for 2018 were five years of projected net cash flows, a weighted average cost of capital rate of 15% and a long-term growth rate of 1.5%. The Company considered historical rates and current market conditions when determining the discount and growth rates to use in its analyses. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for its goodwill.

As required by ASC 820, "Fair Value Measurements and Disclosures," the Company applies assumptions that marketplace participants would consider in determining the fair value of its reporting unit.

During the year ended December 31, 2018, the Company did not record any impairment charges relating to the goodwill allocated to the BAZ reporting unit within the Project segment.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

l. Business combinations:

The Company accounts for business combinations in accordance with ASC No. 805, "Business Combinations". ASC No. 805 requires recognition of assets acquired, liabilities assumed, and any non-controlling interest at the acquisition date, measured at their fair values as of that date. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in consolidated statements of operations.

Acquisition related costs are expensed in the statement of operations in the period incurred.

m. Revenue recognition:

The Company generates its revenues mainly from (1) installation of comprehensive security systems for which revenues are generated from long-term fixed price contracts; (2) sales of security products; (3) services and maintenance, which are performed either on a fixed-price basis or as time-and-materials based contracts; and (4) software license fees and related services.

Revenues from the Company's contracts are recognized using the five-step model in ASC 606 - "Revenue from Contracts with Customers" ("ASC 606"). At first, the Company determines if an agreement with a customer is considered to be a contract to the extent it has a commercial substance, it is approved in writing by both parties, all rights and obligations including payment terms are identifiable, the agreement between the parties creates enforceable rights and obligations, and collectability in exchange for goods and services that will be transferred to the customer is considered as probable. The Company then assesses the transaction price for a contract in order to determine the consideration the Company expects to receive for satisfying the performance obligations called for in the contract. To the extent, the transaction price includes variable consideration (e.g., contract penalties, unpriced change orders or like measures), the Company usually estimates the most likely amount that should be included in the transaction price subject to constraints based on the specific facts and circumstances.

At the inception of a contract, the Company also evaluates and determines if a contract should be separated into more than one performance obligation. The Company's installation of comprehensive security systems contracts usually includes one-performance obligations due to a significant customization for each customer's specific needs and integrated system or solution.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

For most of the Company's installation of comprehensive security systems contracts, where the Company's performance does not create an asset with an alternative use, the Company recognizes revenue over performance time because of continuous transfer of control to the customer. For these performance obligations that are satisfied over time, the Company generally recognizes revenue using an input method with revenue amounts being recognized proportionately as costs are incurred relative to the total expected costs to satisfy the performance obligation. The Company believes that costs incurred as a portion of total estimated costs is an appropriate measure of progress towards satisfaction of the performance obligation since this measure reasonably depicts the progress of the work effort and the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged, the manner, and the terms of settlement, including in cases of termination for convenience. Project costs include materials purchased to produce the system, related labor, overhead expenses and subcontractor's costs. The performance costs are measured by monitoring costs and efforts devoted using records of actual costs incurred to date in the project compared to the total estimated project requirements, which corresponds to the costs related to earned revenues. The Company estimates the profit on a contract as the difference between the total estimated transaction price and the total expected performance costs of the contract and recognizes revenue and costs over the life of the 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 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.

For contracts that are deemed to be loss contracts, the Company establishes forward loss reserves for total estimated costs that are in excess of total estimated consideration under a contract in the period in which they become probable.

Fees are payable upon completion of agreed upon milestones and subject to customer acceptance. Amounts of revenues recognized in advance of contractual billing are recorded as unbilled accounts receivable. In most instances, the period between the advanced recognition of revenues and the customers' billing generally ranges between one to six months.

Revenues for performance obligations that are not recognized over time are recognized at the point in time when control is transferred to the customer (which is generally upon delivery) and include mainly revenues from the sales of security products and software license fees without significant installation work. The Company generally does not provide a right of return to its customers. For performance obligations that are satisfied at a point in time, the Company evaluates the point in time when the customer can direct the use of, and obtain the benefits from, the products. Shipping and handling costs are not considered performance obligations and are included in cost of sales as incurred.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Services and maintenance are performed under either fixed-price or time-and-materials based contracts. Under fixed-price contracts, the Company agrees to perform certain work for a fixed price. Under time-and-materials contracts, the Company is reimbursed for labor hours at negotiated hourly billing rates and for materials. The Company's service contracts include contracts in which the customer simultaneously receives and consumes the benefits provided as the performance obligations are satisfied, accordingly, related revenues are recognized, as those services are performed or over the term of the related agreements.

Maintenance and support agreements provide customers with rights to unspecified software product updates, if and when available. These services grant the customers on line and telephone access to technical support personnel during the term of the service. The Company recognizes maintenance and support services revenues ratably over the term of the agreement, usually one year.

The Company generates revenues from the sales of its software products user licenses as well as from maintenance, support, consulting and training services.

As required by ASC 606, following the determination of the performance obligations in the contract, the Company allocates the total transaction price to each performance obligation in an amount based on the estimated relative standalone selling prices of the promised license fees or services underlying each performance obligation. Standalone selling price is the price at which the Company would sell a promised license or service separately to a customer.

The Company capitalizes sales commission as costs of obtaining a contract when they are incremental and if they are expected to be recovered. Amortization of sales commission expense is included in selling and marketing expenses in the accompanying consolidated statements of income. For costs that the Company would have capitalized and amortized over one year or less, the Company has elected to apply the practical expedient and expense these contract costs as incurred.

Remaining performance obligations:
Remaining performance obligations represents the future revenues expected to be recognized on firm orders received by the Company and is equivalent to the Company's remaining performance obligations at the end of each period for a remaining period of more than a year. The Company's remaining performance obligations as of December 31, 2018 was $ 27.3 million, out of which the Company expects to recognize approximately 47% as revenue in 2019, with the remainder to be recognized thereafter.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Unbilled accounts receivables
Unbilled accounts receivables decreased by $0.2 million, compared to the beginning balance of $6.3 million as of January 1, 2018. The decrease was primarily as a result of $10.3 million of billings and $0.5 million of exchange rate impact. This was offset by an increase of $10.6 million due to the amounts of recognized revenues in advance of contractual billing during the year. The above resulted in and ending balance of $6.1 million as of December 31, 2018.

Customer advances and deferred revenues:
Customer advances and deferred revenues increased by $3.7 million, compared to the beginning balance of $10.2 million as of January 1, 2018. The increase was primarily as a result of $14.3 million of new unearned amounts under project contracts, as well as service and maintenance agreements during the year. This was offset by an amount of $10.2 million of recognized revenues from customer advances and deferred revenues, as well as $0.4 million of exchange rate impact. The above resulted in an ending balance of $13.9 million as of December 31, 2018.

n. Accounting for stock-based compensation:

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation-Stock Compensation".

ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statement.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting, based on the accelerated attribution method over the vesting period.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, an accounting policy election for forfeitures and classification on the statement of cash flows. For public companies, ASU 2016-09 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The Company adopted ASU 2016-09 during the first quarter of 2017, at which time it changed its accounting policy to account for forfeitures as they occur. There was no material impact of the adoption of this standard on the Company's financial statements.

During the years ended December 31, 2018, 2017 and 2016, the Company recognized stock-based compensation expenses related to employee stock options in the amounts of $ 158, $ 144 and $ 258, respectively.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company estimates the fair value of stock options granted under ASC 718 using the Binomial model. The Binomial model for option pricing requires a number of assumptions, of which the most significant are the suboptimal exercise factor and expected stock price volatility. The suboptimal exercise factor is estimated using historical option exercise information. The suboptimal exercise factor is the ratio by which the stock price must increase over the exercise price before employees are expected to exercise their stock options. Expected volatility is based upon actual historical stock price movements and was calculated as of the grant dates for different periods, since the Binomial model can be used for different expected volatilities for different periods. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term to the contractual term of the options. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding.

The following assumptions were used in the Binomial option pricing model for the years ended December 31, 2018 and 2016 (no options were granted in 2017):

	2018	2016
Dividend yield	0%	0%
Expected volatility	37.11%-43.98%	27.72%-46.02%
Risk-free interest	2.5%-2.86%	0.61%-1.59%
Contractual term	5-7 years	5-7 years
Forfeiture rate	10%	10%
Suboptimal exercise multiple	1.32-1.33	1.41

o. Research and development costs:

Research and development costs incurred in the process of developing product improvements or new products, are charged to expenses as incurred.

p. Warranty costs:

The Company provides various warranty periods up to 24 months at no extra charge. The Company estimates the costs that may be incurred under its warranty and records a liability in the amount of such costs at the time product revenue is recognized in accordance with ASC 450, "Contingencies." Factors that affect the Company's warranty liability include the number of units, historical and anticipated rates of warranty claims and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The following table provides the detail of the change in the Company's warranty accrual, which is a component of other accrued liabilities in the consolidated balance sheets for the years ended December 31, 2018 and 2017:

	December 31, 2018	December 31, 2017
Warranty provision, beginning of year	$1,281	$1,197
Charged to costs and expenses relating to new sales	569	230
Costs of warranties granted	(365)	(251)
Foreign currency translation adjustments	(125)	105
Warranty provision, end of year	$1,360	$1,281

q. Net earnings per share:

Basic net earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted net earnings per share is computed based on the weighted average number of ordinary shares outstanding during each year, plus dilutive potential ordinary shares considered outstanding during the year, in accordance with ASC 260, "Earnings Per Share." Certain of the Company's outstanding stock options have been excluded from the calculation of the diluted earnings per share because such options are anti-dilutive. The total weighted average number of the Company's ordinary shares related to the outstanding options excluded from the calculations of diluted earnings per share was 559,250 shares, 137,988 shares and 400,000 shares for the years ended December 31, 2016, 2017 and 2018, respectively.

r. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term and long-term bank deposits, trade receivables, unbilled accounts receivable, long-term trade receivables and long-term loans.

Of the Company's cash and cash equivalents and short-term and restricted bank deposits at December 31, 2018, $ 41,459 was invested in major Israeli and U.S. banks, and approximately $ 13,491 was invested in other banks, mainly with the Royal Bank of Canada, BBVA Bankcomer, Comerica Bank and Deutsche Bank. Cash and cash equivalents in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Generally, these deposits may be redeemed upon demand and therefore, bear low risk.

The short-term and long-term trade receivables of the Company, as well as the unbilled accounts receivable, are primarily derived from sales to large and solid organizations and governmental authorities located mainly in Israel, the U.S., Canada, Mexico and Europe.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company performs ongoing credit evaluations of its customers. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection and in accordance with an aging policy. In certain circumstances, the Company may require letters of credit, other collateral or additional guarantees.

Changes in the Company's allowance for doubtful accounts during the three years period ended December 31, 2018 are as follows:

	Year ended December 31,		
	2018	2017	2016
Balance at the beginning of the year	$1,557	$2,064	$2,331
Doubtful debt expenses during the year	1,453	299	429
Customers write-offs/collection during the year, net	(204)	(957)	(706)
Exchange rate	(55)	151	10
	$2,751	$1,557	$2,064

As of December 31, 2018, the Company has no significant off-balance sheet concentrations of credit risk, such as foreign exchange contracts or foreign hedging arrangements.

s. Income taxes:

The Company accounts for income taxes in accordance with ASC 740, "Income Taxes." This ASC prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

The Company establishes reserves for uncertain tax positions based on an evaluation of whether the tax position is “more likely than not” to be sustained upon examination. The Company records interest and penalties pertaining to its uncertain tax positions in the financial statements as income tax expense

In the years ended December 31, 2018, 2017 and 2016, the Company recorded tax expenses (income) in connection to uncertainties in income taxes of $ 717, $ 245 and $ (230), respectively.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

t. Severance pay:

The Company's liability for its Israeli employees severance pay is calculated pursuant to Israel's Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date (the "Shut Down Method"). Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for its employees in Israel is fully provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies and includes immaterial profits.

On December 31, 2007, the then Chairman of the Company's Board of Directors, retired from his position. Pursuant to his retirement agreement, the retired Chairman is entitled to receive certain perquisites from the Company for the rest of his life. As of December 31, 2018, the actuarial value of these perquisites is estimated at approximately $ 581. This provision was included as part of accrued severance pay.

Severance expenses for the years ended December 31, 2018, 2017 and 2016, amounted to approximately $ 804, $ 1,095 and $ 1,126, respectively.

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

u. Fair value of financial instruments:

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

(i) The carrying amounts of cash and cash equivalents, short-term bank deposits, long-term bank deposits, trade receivables, unbilled accounts receivable, short-term bank credit and trade payables approximate their fair value due to the short-term maturity of such instruments.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

(ii) The carrying amount of the Company's long-term trade receivables approximate their fair value. The fair value was estimated using discounted cash flows analysis, based on the Company's investment rates for similar type of investment arrangements.

(iii) The carrying amounts of the Company's long-term debt are estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. As of December 31, 2018, there was no material difference in the fair value of the Company's long-term borrowing compared to their carrying amount.

v. Advertising expenses:

Advertising costs are expensed as incurred. Advertising expenses for the years ended December 31, 2018, 2017 and 2016, were $ 151, $ 194 and $ 219, respectively.

w. Fair value measurements:

ASC 820, "Fair Value Measurement and Disclosure" clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, ASC 820 establishes a three tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 -	Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
Level 2-	Significant other observable inputs based on market data obtained from sources independent of the reporting entity.
Level 3 -	Unobservable inputs which are supported by little or no market activity.

As of December 31, 2018, 2017 and 2016, the Company did not have any derivative instruments, measured at fair value on a recurring or nonrecurring basis.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

x. Comprehensive income (loss):

The Company accounts for comprehensive income (loss) in accordance with ASC 220, "Comprehensive Income". ASC 220 establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income generally represents all changes in shareholders' equity (deficiency) during the period except those resulting from investments by, or distributions to, shareholders.

The Company has determined that its items of comprehensive income (loss) relate to unrealized gain (loss) from foreign currency translation adjustments.

The total accumulated other comprehensive loss, net was comprised as follows:

	December 31,		
	2018	2017	2016
Foreign currency translation adjustments	$(1,827)	$(87)	$(1,923)
Total accumulated other comprehensive loss	$(1,827)	$(87)	$(1,923)

y. Non-controlling interest:

The Company established a subsidiary in India in 2012 which was 51% owned by the Company and 49% owned by a local partner. The non-controlling interest relating to the India subsidiary was not material in 2016 and 2017. During 2017, the Company entered to a share purchase agreement with the local partner, according to which, the Company acquired the 49% interest from the local partner for total consideration of approximately $ 100. The Company owns 100% of the India subsidiary.

z. Impact of recently issued and adopted accounting standards:

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). This new standard clarifies certain aspects of the statement of cash flows and also clarifies that an entity should determine each separately identifiable source of use within the cash receipts and payments on the basis of the nature of the underlying cash flows.
The Company adopted the standard effective as of January 1, 2018, and the adoption of this standard did not have an impact on the Company's consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash ("ASU 2016-18"), which requires companies to include amounts generally described as restricted cash and restricted cash equivalents in cash and cash equivalents when reconciling beginning-of-period and end-of-period total amounts shown on the statement of cash flows. ASU 2016-18 was effective for the Company in the first quarter of 2018 and early adoption was permitted. The Company adopted the standard retrospectively to all periods presented effective as of January 1, 2018.

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. The amendments in this update provide a more robust framework to use in determining when a set of assets and activities is a business. The amendments provide more consistency in applying the guidance, reduce the costs of application, and make the definition of a business more operable. The Company adopted the standard effective as of January 1, 2018, and the adoption of this standard did not have an impact on the Company's consolidated financial statements.

On January 1, 2018, the Company adopted ASC Topic 606 using the modified retrospective method and applied the standard to those contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with the previous accounting under Topic 605. The Company recognized the cumulative effect of initially adopting Topic 606 as an adjustment to the opening balance of accumulated deficit as of January 1, 2018. In connection with adopting Topic 606, the Company recorded a cumulative-effect adjustment to accumulated deficit of $114 on January 1, 2018. This adjustment relates to incremental costs of obtaining a contract that relate to sales commission (an amount of $ 94) and allocating contract consideration by estimate the standalone selling price for each performance obligation and allocate the transaction price to each performance obligation on a relative standalone selling price basis with limited exceptions (an amount of $ 20). The results of the Company's operations for the year ended December 31, 2018 under the previous standard are not materially different compared to the results under ASC 606.

aa. New accounting pronouncements not yet effective:

In February 2016, the FASB issued Accounting Standards Update No. 2016-02 (Topic 842) "Leases." Topic 842 supersedes the lease requirements in Accounting Standards Codification (ASC) Topic 840, "Leases." Under Topic 842, lessees are required to recognize assets and liabilities on the balance sheet for most leases and provide enhanced disclosures. Leases will continue to be classified as either finance or operating. This ASU is effective for annual periods beginning after December 15, 2018. The provisions of ASU 2016-02 are to be applied using a modified retrospective approach. In July 2018, the FASB issued Accounting Standards Update 2018-11, Leases (Topic 842). This update provides entities with an additional (and optional) transition method to adopt the new leases standard. Under this method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, the prior comparative period’s financials will remain the same as those previously presented.

The Company has elected to apply the guidance at the beginning of the period of adoption and not restate comparative periods. In addition, the Company elected the available practical expedients on adoption.

The Company expects to record right-of-use leased assets and corresponding liabilities of approximately $4,000 to $ 5,000, at the beginning of first quarter 2019.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In August 2018, the FASB issued Accounting Standards Update 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract ("ASU 2018-15"). The amendments in ASU 2018-15 provide guidance to align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The new guidance is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company is still evaluating the effect that this guidance will have on the Company's consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07 to expand the scope of ASC Topic 718, Compensation - Stock Compensation, to include share-based payment transactions for acquiring goods and services from nonemployees. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. The Company is evaluating the effects of this standard on its consolidated financial statements.

In June 2016, the FASB issued Accounting Standards Update No. 2016-13 (ASU 2016-13) "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" which requires the measurement and recognition of expected credit losses for financial assets held at amortized cost.
ASU 2016-13 replaces the existing incurred loss impairment model with an expected loss methodology, which will result in more timely recognition of credit losses. ASU 2016-13 is effective for annual reporting periods, and interim periods within those years, beginning after December 15, 2019. The Company is evaluating the effect that this guidance will have on the Company's consolidated financial statements.

NOTE 3:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2018	2017
Prepaid expenses	$2,188	$1,495
Government authorities	1,222	730
Advances to suppliers	445	359
Employees	62	63
Others	209	203
	$4,126	$2,850

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NOTE 4:- INVENTORIES

	December 31, 2018	December 31, 2017
Raw materials	$4,762	$2,346
Work in progress	1,952	1,378
Finished products	7,149	5,872
	$13,863	$9,596

NOTE 5:- PROPERTY AND EQUIPMENT, NET

a. Composition:

	December 31, 2018	December 31, 2017
Cost:		
Land and buildings	$7,559	$7,311
Machinery and equipment	3,392	3,129
Motor vehicles	2,440	1,958
Promotional displays	644	600
Office furniture and equipment	4,198	4,619
Leasehold improvements	739	906
	18,972	18,523
Accumulated depreciation:		
Buildings	4,375	4,283
Machinery and equipment	2,689	2,446
Motor vehicles	1,244	1,165
Promotional displays	477	453
Office furniture and equipment	3,426	3,861
Leasehold improvements	414	597
	12,625	12,805
Property and equipment, net	$6,347	$5,718

b. Depreciation expenses amounted to $ 1,070, $ 960 and $ 954 for the years ended December 31, 2018, 2017 and 2016, respectively.

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NOTE 6:- INTANGIBLE ASSETS, NET

a. Composition:

	December 31, 2018	2017
Cost:		
Know-how and patents	$4,194	$4,525
Technology	5,873	5,766
Customer relationships	1,582	1,521
Backlog	858	746
	12,507	12,558
Accumulated amortization:		
Know-how and patents	4,162	4,478
Technology	2,774	2,154
Customer relationships	1,093	877
Backlog	833	746
	8,862	8,255
Intangible assets , net	$3,645	$4,303

b. Amortization expenses related to intangible assets amounted to $ 1,175, $ 916 and $ 786 for the years ended December 31, 2018, 2017 and 2016, respectively.

c. Estimated amortization of intangible assets for the years ended:

December 31,	
2019	$897
2020	888
2021	850
2022	673
2023	227
2024 and thereafter	110
	$3,645

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NOTE 7:- GOODWILL

Goodwill relates to the PIDS operating unit within the Products segment, BAZ reporting unit within the Project segment and the Cyber security and Video reporting units, both within the Video and Cyber security segment.

Changes in the carrying amount of goodwill for the years ended December 31, 2018 and 2017 are as follows:

	Products	Video and Cyber security	Projects	Total
As of January 1, 2017	$ 3,305	$ 8,545	$ -	$ 11,850
Foreign currency translation adjustments	165	677	-	842
As of December 31, 2017	3,470	9,222	-	12,692
Acquisition of ESC BAZ	-	-	255	255
Impairment of goodwill (See Note 2k.)	-	(979)	-	(979)
Foreign currency translation adjustments	(105)	(727)	(16)	(848)
As of December 31, 2018	$ 3,365	$ 7,516	$ 239	$ 11,120

NOTE 8:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31, 2018	December 31, 2017
Employees and payroll accruals	$ 4,250	$ 3,082
Accrued expenses	7,190	6,100
Government authorities	156	1,427
Income tax payable and tax provision	1,457	951
Others	173	61
	$ 13,226	$ 11,621

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NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalty commitments to the Innovation Authority (formerly the Office of the Chief Scientist) of the Israeli Ministry of Economy, or Innovation Authority:

Under the research and development agreements between the Company and the Innovation Authority and the Company's Israeli subsidiary and the Innovation Authority and pursuant to applicable laws, the Company and its Israeli subsidiary are required to pay royalties at the rate of 3.5% of revenues derived from sales of products developed with funds provided by the Innovation Authority and ancillary services, up to an amount equal to 100% of the Innovation Authority research and development grants received, linked to the U.S. dollars plus interest on the unpaid amount received based on the 12-month LIBOR rate applicable to U.S. dollar deposits. The obligation to pay these royalties is contingent on actual sales of the products and in the absence of such sales no payment is required. During 2014 and 2015, the Company's Israeli subsidiary received grants amounted to $ 118 and $ 134, respectively, from the Innovation Authority. Following the cancelation of the 2015 project, the Company's Israeli subsidiary returned the $ 134 advance grant received in 2015. The Company did not receive any grants from the Innovation Authority in 2016, 2017 and 2018.

Royalties paid to the Innovation Authority amounted to $ 6, $ 33 and $ 17 for the years ended December 31, 2018, 2017 and 2016, respectively, which were recorded in cost of revenues. As of December 31, 2018, the Company and its Israeli subsidiary had remaining contingent obligations to pay royalties in the amount of approximately $ 1,725.

b. Royalty commitments to a third party:

During 2002, the Company entered into a development agreement for planning, developing and manufacturing a security system with a third party. Under the agreement, the Company agreed to pay the third party royalty fees based on a defined formula. As of December 31, 2018, royalty commitments under the agreement amounted to $ 55.

c. Lease commitments:

The Company rents certain of its facilities and some of its motor vehicles under various operating lease agreements, which expire on various dates, the latest of which is in 2028.

Future minimum lease payments under non-cancelable operating lease agreements are as follows:

2019	$1,119
2020	720
2021	599
2022	517
2023	465
2024 and there after	1,473
	$4,893

Total rent expenses for the years ended December 31, 2018, 2017 and 2016 were approximately $ 1,228, $ 1,055 $ 1,121, respectively.

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

NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

d. Guarantees:

As of December 31, 2018 and 2017, the Company had credit lines of approximately $ 16,468 and $ 17,442, out of which $ 9,345 and $ 6,364 were utilized for bank performance guarantees, advance payment guarantees and bid bond guarantees from several banks, mainly in Israel and Canada.

e. The Company's Canadian subsidiary has undertaken to maintain a general covenant and the following financial ratio and term in respect of its outstanding credit lines: a ratio of total liabilities to tangible net worth of not greater than 0.75:1. As of December 31, 2018, the Canadian subsidiary was in a default of its covenant. After the balance sheet date, the bank acknowledged the default and agreed to the Company's plan to remedy such default until May 31, 2019. Such default has no impact on the Company's financial statements as of December 31, 2018.

f. Restricted deposits:

As of December 31, 2018 the Company's restricted deposits relate mainly to a project for the protection of critical energy infrastructure in the Americas and to several other projects, in order to guarantee the Company's performance under those projects. In connection with a project for the protection of critical energy infrastructure in the Americas, the Company was required to maintain restricted deposits in order to guarantee the Company's performance under that project of $2,941. The deposits for the project bear an average annual interest at rate of approximately 7% and will be released to the Company after meeting predetermined milestones.

g. Legal proceedings:

The Company is subject to legal proceedings arising in the normal course of business. Based on the advice of legal counsel, management believes that these proceedings will not have a material adverse effect on the Company's financial position or results of operations.

NOTE 10:- SHAREHOLDERS' EQUITY

a. Pertinent rights and privileges conferred by Ordinary shares:

The Ordinary shares of the Company are listed on the NASDAQ Global Market. The Ordinary shares confer upon their holders the right to receive notice to participate and vote in the general meetings of the Company and the right to receive dividends, if declared.

b. Issued and outstanding share capital: 23,049,639 Ordinary shares at December 31, 2018 and 23,032,448 Ordinary shares at December 31, 2017.

On September 30, 2016, the Parent Company completed a rights offering of 6,170,386 of the Company's Ordinary shares at a price per share of $ 3.86 and received approximately $ 23,617, net in consideration of the sale. Total expenses related to the rights offering were approximately $201.

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NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

c. Stock Option Plan:

On October 27, 2003, the Company's Board of Directors approved the Company's 2003 Israeli Share Option Plan ("the 2003 Plan"). Under the 2003 Plan, stock options may be periodically granted to employees, directors, officers and consultants of the Company or its subsidiaries in accordance with the decision of the Board of Directors of the Company (or a committee appointed by it). The Board of Directors also has the authority to determine the vesting schedule and exercise price of options granted under the 2003 Plan.

In May 2008, the Board of Directors approved an amendment to the 2003 Plan, which was approved by the shareholders in August 2008, which increased the number of Ordinary shares available for issuance under the 2003 Plan by an additional 1,000,000 shares and the termination of the 2003 Plan was extended from October 2013 to October 2018. Any options that are cancelled or forfeited before expiration become available for future grant.

On June 23, 2010, the Company's Annual General Meeting approved the Company's 2010 Israeli Share Option Plan, or the 2010 Plan, which authorizes the grant of options to employees, officers, directors and consultants of the Company and its subsidiaries. The ordinary shares that remain available for futures option grants under the 2003 Plan as of the date of the adoption of the 2010 Plan and any ordinary shares that become available in the future under the 2003 Plan as a result of expiration, cancellation or relinquishment of any option currently outstanding under the 2003 Plan will be rolled over to the 2010 Plan. No additional options will be granted under the 2003 Plan. In June 2013, the Company's shareholders approved an increase to the number of ordinary shares available for issuance under the 2010 Plan by an additional 500,000 shares. The 2010 Plan has a term of ten years.

As of December 31, 2018, 230,026 Ordinary shares were available for future option grants.

A summary of employee option activity under the Company's stock option plans as of December 31, 2018 and changes during the year ended December 31, 2018 are as follows:

	Number of options	Weighted-average exercise price	Weighted-average remaining contractual life (in months)	Aggregate intrinsic value (in thousands)
Outstanding at January 1, 2018	412,976	4.616	44.21	183
Granted	555,000	5.032		
Exercised	(17,191)	4.507		
Forfeited	(61,667)	4.807		
Outstanding at December 31, 2018	889,118	4.865	51.25	-
Exercisable at December 31, 2018	223,620	4.57	0.003	-

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NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

The weighted-average grant-date fair value of options granted during the years ended December 31, 2018 and 2016 were $ 1.73 and $ 1.53, respectively. No options were granted in 2017. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of the fourth quarter of fiscal 2018 and the exercise price, multiplied by the number of in-the-money options). This amount changes, based on the fair market value of the Company's stock. The total intrinsic value of options exercised for the years ended December 31, 2018, 2017 and 2016 were approximately $17, $ 174 and $ 300. As of December 31, 2018, there was approximately $ 843 of unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Company's stock option plans. This cost is expected to be recognized over a period of up to 4 years.

The options outstanding as of December 31, 2018 are follows:

Number of options outstanding as of December 31, 2018	Exercise price	Weighted average remaining contractual life (In months)	Number of options exercisable as of December 31, 2018
54,000	5.01	38.89	18,000
81,906	4.96	3.25	81,906
24,000	4.40	29.23	16,000
135,212	4.15	28.33	94,713
39,000	4.86	43.94	13,001
24,000	5.61	61.23	-
440,000	5.15	65.78	-
91,000	4.31	71.92	-
889,118		51.25	223,620

d. Warrants:

On January 2013, as part of the acquisition of CyberSeal, the Company issued to CyberSeal's former owners warrants to purchase 898,203 of the Company's Ordinary shares at an exercise price of $ 4.16 per share. 50% of the warrants became exercisable on December 31, 2013 and expired on December 30, 2018. The remaining 50% became exercisable on December 31, 2014 and were to expire on December 30, 2019. The $ 1,500 fair value of the warrants was calculated using the Binominal model. The Company recognized the $ 1,500 as part of its additional paid-in capital. The Company granted registration rights to the recipients of the warrants. During 2017, 60,000 warrants were exercised. No warrants were exercised during 2018.

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NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

In October 2018, the Company agreed to purchase the remaining 838,203 warrants from the warrant holders for an aggregate consideration of $ 375. Under Israeli law, the consummation of such transaction was subject to court approval, which was granted on January 16, 2019. The closing of the purchase of the warrants occurred in the first quarter of 2019.

e. Dividends:

Dividends, if any, will be declared and paid in U.S. dollars. Dividends paid to shareholders in Israel will be converted into NIS on the basis of the exchange rate prevailing at the date of payment. The Company has determined that it will not distribute dividends out of tax-exempt profits.

NOTE 11:- BASIC AND DILUTED NET EARNINGS PER SHARE

	Year ended December 31,		
	2018	2017	2016
Numerator:			
Income (loss) attributable to Magal shareholders'	$2,722	$(6,914)	$1,029
Denominator:			
Denominator for basic net earnings (loss) per share weighted-average number of shares outstanding	23,040,436	22,989,009	17,999,779
Effect of diluting securities:			
Employee stock options	247,315	-	31,654
Denominator for diluted net earnings (loss) per share - adjusted weighted average shares and assumed exercises	23,287,751	22,989,009	18,031,433

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NOTE 12:- TAXES ON INCOME

a. Tax laws applicable to the Group companies:

Income Tax (Inflationary Adjustments) Law, 1985:

According to the law, until 2007, the results for tax purposes were adjusted for the changes in the Israeli CPI.

In February 2008, the "Knesset" (Israeli parliament) passed an amendment to the Income Tax (Inflationary Adjustments) Law, 1985, which limits the scope of the law starting 2008 and thereafter. Since 2008, the results for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Israeli CPI carried out in the period up to December 31, 2007. Adjustments relating to capital gains such as for sale of property (betterment) and securities continue to apply until disposal. Since 2008, the amendment to the law includes, among others, the cancellation of the inflationary additions and deductions and the additional deduction for depreciation (in respect of depreciable assets purchased after the 2007 tax year).

The Law for the Encouragement of Capital Investments, 1959:

According to the Law, the companies are entitled to various tax benefits by virtue of the "approved enterprise" and/or "beneficiary enterprise" status granted to part of their enterprises, as implied by this Law. The principal benefits by virtue of the Law are:

Tax benefits and reduced tax rates:

Following the enactment of Amendment No. 60 to the Law, subsequent to April 1, 2005, the income qualifying for tax benefits under the tax benefits track is the taxable income of a company that has met certain conditions as determined by the Law ("a beneficiary company"), and which is derived from an industrial enterprise. In respect of plant expansions executed following Amendment No. 60 to the Law, the benefit period starts at the later of the year elected and the first year the Company earns taxable income provided that 12 years have not passed since the beginning of the year of election.

In March 2007, the Company received a pre-ruling from the Israeli Tax Authority for its request for a Beneficiary Enterprise for the elected tax year 2005 ("the 2005 program"), regarding eligibility for benefits under the Amendment. The Company did not obtain any tax benefits from this program. The benefit period of this program expired on December 31, 2016.

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

NOTE 12:- TAXES ON INCOME (Cont.)

Amendment to the Law for the Encouragement of Capital Investments, 1959 (Amendment 68):

In December 2010, the "Knesset" (Israeli Parliament) passed the Law for Economic Policy for 2011 and 2012 (Amended Legislation), 2011 ("the Amendment"), which prescribes, among others, amendments in the Law for the Encouragement of Capital Investments, 1959 ("the Law"). The Amendment became effective as of January 1, 2011. According to the Amendment, the benefit tracks in the Law were modified and a flat tax rate applies to the Company's entire preferred income under its status as a privileged company with a preferred enterprise. Commencing from the 2011 tax year, the Company can elect (without possibility of reversal) to apply the Amendment in a certain tax year and from that year and thereafter, it will be subject to the amended tax rates. The tax rates under the Amendment are: 2011 and 2012 - 15% (in development area A - 10%) and in 2013 - 12.5% (in development area A - 7%).

After the termination of the benefit period of the 2005 program, the Company applies the Amendment effective from the 2017 tax year.

The Company's Israeli subsidiaries applied the Amendment effective from the 2011 tax year.

Amendment to the Law for the Encouragement of Capital Investments, 1959 (Amendment 71):

On August 5, 2013, the "Knesset" issued the Law for Changing National Priorities (Legislative Amendments for Achieving Budget Targets for 2013 and 2014), 2013 which consists of Amendment 71 to the Law for the Encouragement of Capital Investments ("the Amendment"). According to the Amendment, the tax rate on preferred income form a preferred enterprise in 2014 and thereafter will be 16% (in development area A - 9%). As for changes in tax rates resulting from the enactment of Amendment 73 to the Law, see below.

The Amendment also prescribes that any dividends distributed to individuals or foreign residents from the preferred enterprise's earnings as above will be subject to tax at a rate of 20%.

Amendment to the Law for the Encouragement of Capital Investments, 1959 (Amendment 73):

In December 2016, the Economic Efficiency Law (Legislative Amendments for Applying the Economic Policy for the 2017 and 2018 Budget Years), 2016 which includes Amendment 73 to the Law for the Encouragement of Capital Investments ("the Amendment") was published. According to the Amendment, a preferred enterprise located in development area A will be subject to a tax rate of 7.5% instead of 9% effective from January 1, 2017 and thereafter (the tax rate applicable to preferred enterprises located in other areas remains at 16%).

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

NOTE 12:- TAXES ON INCOME (Cont.)

Accelerated depreciation:

By virtue of the Law, the Company is eligible for deduction of accelerated depreciation on equipment used by the approved enterprise / beneficiary enterprise from the first year of the asset's operation.

The Law for the Encouragement of Industry (Taxation), 1969:

The Company has the status of an "industrial company", as defined by this law. According to this status and by virtue of regulations published thereunder, the Company is entitled to claim a deduction of accelerated depreciation on equipment used in industrial activities, as determined in the regulations issued under the Inflationary Law. The Company is also entitled to amortize a patent or rights to use a patent or intellectual property that are used in the enterprise's development or advancement, to deduct issuance expenses for shares listed for trading, and to file consolidated financial statements under certain conditions.

b. Tax rates applicable to the Group:

1. The Israeli regular corporate tax rate for Israeli companies was 25% in 2016, 24% in 2017 and 23% in 2018.

In December 2016, the Israeli Parliament approved the Economic Efficiency Law (Legislative Amendments for Applying the Economic Policy for the 2017 and 2018 Budget Years), 2016 which reduces the corporate income tax rate to 24% (instead of 25%) effective from January 1, 2017 and to 23% effective from January 1, 2018.

In August 2013, the Law for Changing National Priorities (Legislative Amendments for Achieving Budget Targets for 2013 and 2014), 2013 ("the Budget Law") was enacted. The Law includes, among others, provisions for the taxation of revaluation gains effective from August 1, 2013. The provisions regarding revaluation gains will become effective only after the publication of regulations defining what should be considered as "retained earnings not subject to corporate tax" and regulations that set forth provisions for avoiding double taxation of foreign assets. As of the date of approval of these financial statements, these regulations have not been published.

These changes include, among others, increasing the corporate tax rate from 25% to 26.5%, cancelling the reduction in the tax rates applicable to privileged enterprises (9% in development area A and 16% elsewhere) and, in certain cases, increasing the rate of dividend withholding tax within the scope of the Law for the Encouragement of Capital Investments to 20% effective from January 1, 2014.

2. The tax rates of the Company's non-Israeli subsidiaries range between 16%-35%.

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NOTE 12:- TAXES ON INCOME (Cont.)

3. Tax Reform in U.S.:

On December 22, 2017, the U.S. enacted the Tax Cuts and Jobs Act (the "Act"), which among other provisions, reduced the U.S. corporate tax rate from 35% to 21%, effective January 1, 2018.

At December 31, 2017, the Company has made reasonable estimates of the effects on the existing deferred tax balances for which provisional amounts have been recorded in 2017 and finalized in 2018. The Company re-measured certain of its U.S. deferred tax assets and liabilities, based on the rates at which they are expected to reverse in the future. The estimated tax expense recorded related to the re-measurement of the deferred tax balance was $ 377, mainly due to reduction in the U.S. corporate tax rate.

c. Income taxes on non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed according to the tax laws in their respective country of domicile.

Israeli income taxes and foreign withholding taxes were not provided for undistributed earnings of the Company's foreign subsidiaries. The Company's board of directors has determined that the Company will not distribute any amounts of its undistributed earnings as dividends. The Company intends to reinvest these earnings indefinitely in its foreign subsidiaries. Accordingly, no deferred income taxes have been provided. If these earnings were distributed to Israel in the form of dividends or otherwise, the Company would be subject to additional Israeli income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes.

d. Tax assessments:

Final tax assessments:

The Company received final tax assessments through the 2014 tax year. The Company's Israeli subsidiary received final tax assessments through the 2012 tax year. The subsidiary in Latin America received final tax assessments for the 2010 and 2011 tax years.

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NOTE 12:- TAXES ON INCOME (Cont.)

The remaining subsidiaries have not received final tax assessments since their incorporation, however, the assessments of these subsidiaries are deemed final through the range between 2007-2011 tax years.

e. Reconciliation between the theoretical tax expense, assuming all income is taxed at the Israeli statutory rate, and the actual tax expense, is as follows:

	Year ended December 31,		
	2018	2017	2016
Income (loss) before taxes as reported in the statements of operations	$5,116	$(5,205)	$904
Tax rate	23 %	24 %	25 %
Theoretical tax	$1,177	$(1,249)	$226
Increase (decrease) in taxes:			
Non-deductible items	32	185	249
Losses and other items for which a valuation allowance was provided	972	1,769	977
Realization of carryforward tax losses for which valuation allowance was provided	(1,293)	(28)	(541)
Changes in valuation allowance	(377)	-	(1,602)
Tax rate differences in subsidiaries	223	(71)	236
Adjustment of deferred tax balances following a changes in tax rates	-	410	
Provision for uncertain tax positions	717	245	(230)
Taxes in respect of prior years	(2)	21	79
Tax withheld against which valuation allowance was provided this year	755	638	602
Investment tax credit	(180)	(178)	(220)
Other	48	(47)	102
Taxes on income (tax benefit) in the statements of operations	$2,072	$1,695	$(122)

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NOTE 12:- TAXES ON INCOME (Cont.)

f. Taxes on income (tax benefit) included in the statements of operations:

	Year ended December 31, 2018	2017	2016
Current	$3,003	$2,162	$1,485
Deferred	(931)	(467)	(1,607)
	$2,072	$1,695	$(122)
Domestic	$1,460	$893	$407
Foreign	612	802	(529)
	$2,072	$1,695	$(122)

g. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows:

	December 31, 2018	2017
Deferred tax assets:		
Operating loss carry forwards	$4,123	$5,158
Reserves and tax allowances	3,875	4,052
Total deferred taxes before valuation allowance	7,998	9,210
Valuation allowance	(4,539)	(6,631)
Deferred tax assets, net:	3,459	2,579
Deferred tax liabilities:	182	190
Net deferred tax assets	$3,277	$2,389
Foreign	$3,277	$2,389

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NOTE 12:- TAXES ON INCOME (Cont.)

h. The domestic and foreign components of income (loss) before taxes are as follows:

	Year ended December 31, 2018	2017	2016
Domestic	$1,705	$(1,605)	$(1,482)
Foreign	3,411	(3,600)	2,386
	$5,116	$(5,205)	$904

i. Net operating carry forward tax losses:

The Company has estimated total available carry forward tax losses of $ 3,473 to offset against future taxable income. As of December 31, 2018, the Company recorded a full valuation allowance on these carry forward tax losses due to the uncertainty of their future realization. There is no time limitation for the realization of such tax losses. The Parent Company's subsidiaries have estimated total available carry forward tax losses of $ 14,122, which may be used to offset against future taxable income, for periods ranging between 1 to 20 years. As of December 31, 2018, the Parent Company recorded a partial valuation allowance for its subsidiaries' carry forward tax losses due to the uncertainty of their future realization.

Utilization of U.S. net operating losses may be subject to a substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

j. Uncertain tax positions:

As of December 31, 2018 and 2017, balances in respect to ASC 740, "Income Taxes" amounted to $ 1,611 and $ 908, respectively.

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

	December 31, 2018	2017
Balance at the beginning of the year	$908	$663
Additions based on tax positions taken related to the current year	717	245
Foreign currency translation adjustments	(14)	-
Balance at the end of the year	$1,611	$908

Substantially all the balance of unrecognized tax benefits, if recognized, would reduce the Company's annual effective tax rate.

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NOTE 13:- BALANCES AND TRANSACTIONS WITH RELATED PARTIES

The Company compensates its Executive Chairman of the Board for services provided to the Company commencing October 1, 2014.

The Company pays for his services in addition to the directors' fees paid by the Company to all of its directors: (i) a monthly payment of approximately $4 for time devoted to such position; and (ii) an annual cash bonus of $30 that will be paid only if the Company's net profit pursuant to its annual audited and consolidated financial statement exceeds $5,000. The annual cash bonus is payable commencing as of the fiscal year 2015 and will be paid, if earned, as set forth in the Compensation Policy.

NOTE 14:- SEGMENT INFORMATION

The Company adopted ASC 280, "Segment Reporting." As of December 31, 2017, the Company operates in three operational segments, as follows:

· Perimeter Products segment (Products) - sales of perimeter products, including services and maintenance that are performed either on a fixed-price basis or pursuant to time-and-materials based contracts, and

· Turnkey Projects segment (Projects) - installation of comprehensive turnkey solutions for which revenues are generated from long-term fixed price contracts and modular and customizable medium and long range surveillance systems, and

· Video and Cyber security segment - provides software and hardware products, in the field of Video management and Cyber security, for monitoring, securing, and the active management of network video systems, video analytics, as well as wired, wireless, and fiber optic communication networks.

a. The following data present the revenues, expenditures, assets and other operating data of the Company's operating segments:

	Year ended December 31, 2018				
	Products	Projects	Video and Cyber security	Eliminations	Total
Revenues	$27,626	$57,072	$9,461	$ (1,557)	$92,602
Depreciation, amortization and impairment of goodwill	$586	$879	$1,759	$ -	$3,224
Operating income (loss), before financial expenses and taxes on income	$2,863	$2,782	$(1,298)	$ (592)	$3,755
Financial income, net					1,361
Taxes on income					(2,072)

Net income	$3,044

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NOTE 14:- SEGMENT INFORMATION (Cont.)

	Year ended December 31, 2017				
	Products	Projects	Video and Cyber security	Eliminations	Total
Revenues	$22,301	$34,742	$8,350	$ (1,101)	$64,292
Depreciation and amortization	$614	$498	$764	$ -	$1,876
Operating income (loss), before financial expenses and taxes on income	$242	$1,762	$(2,830)	$ (418)	$(1,244)
Financial expenses, net					(3,961)
Taxes on income					(1,695)
Net loss					$(6,900)

	Year ended December 31, 2016				
	Products	Projects	Video and Cyber security	Eliminations	Total
Revenues	$32,372	$31,823	$5,626	$ (1,996)	$67,825
Depreciation and amortization	$632	$512	$596	$ -	$1,740
Operating income (loss), before financial expenses and taxes on income	$5,799	$(163)	$(3,383)	$ (758)	$1,495
Financial expenses, net					(591)
Tax benefits, net					122
Net income					$1,026

	Year ended December 31, 2018			
	Products	Projects	Video and Cyber security	Total

Total long-lived assets	$5,847	$4,267	$10,998	$21,112

	Year ended December 31, 2017			
	Products	Projects	Video and Cyber security	Total
Total long-lived assets	$6,374	$3,460	$12,879	$22,713

Long-lived assets include property and equipment, net, intangible assets, net and goodwill.

b. Major customer data (percentage of total revenues):

	Year ended December 31,		
	2018	2017	2016
Customer A	25.3%	14.6%	11.9%
Customer B	10.9%	10.2%	8.6 %

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

NOTE 14:- SEGMENT INFORMATION (Cont.)

c. Geographical information:

The following is a summary of revenues within geographic areas based on end customer's location and long-lived assets:

1. Revenues:

	Year ended December 31,		
	2018	2017	2016
Israel	$13,577	$9,599	$8,727
Europe	14,021	11,232	8,330
North America	24,324	15,547	23,467
South and Latin America	25,471	13,152	10,364
Africa	7,126	9,370	7,585
Others	8,083	5,392	9,352
	$92,602	$64,292	$67,825

2. Long-lived assets:

	December 31,	
	2018	2017
Israel	$3,720	$3,996
Europe	970	1,030
USA	2,377	2,612
Canada	13,337	14,404
Others	708	671
	$21,112	$22,713

Long-lived assets include property and equipment, net, intangible assets, net and goodwill.

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NOTE 15:- SELECTED STATEMENTS OF INCOME DATA

Financial expenses:

	Year ended December 31,		
	2018	2017	2016
Financial expenses:			
Interest on short-term and long-term bank credit and bank charges and long-term debt	$(412)	$(349)	$(299)
Realization of foreign currency translation adjustments	-	(64)	-
Foreign exchange loss, net	-	(4,010)	(595)
	(412)	(4,423)	(894)
Financial income:			
Interest on short-term and long-term bank deposits	670	462	303
Foreign exchange gains, net	1,103	-	-
	1,773	462	303
Financial income (expenses), net	$1,361	$(3,961)	$(591)

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SIGNATURE

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

MAGAL SECURITY SYSTEMS LTD.

By:/s/ Dror Sharon
Name: Dror Sharon
Title: Chief Executive Officer

Date: April 15, 2019

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