ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS
as of December 31, 2002
(In thousands of U.S. dollars)

ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONTENTS

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REPORT OF INDEPENDENT AUDITORS

To the Shareholders of
Elbit Vision Systems Ltd.

We have audited the accompanying consolidated balance sheet of Elbit Vision Systems Ltd. (the "Company") and its subsidiaries as of December 31, 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the year than ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements as of December 31, 2001 and for the years ended December 31, 2001 and 2000 were audited by other auditors who have ceased operations as a foreign associated firm of the Securities and Exchange Commission Practice Section of the American Institute of Certified Public Accountants and whose report dated March 18, 2002, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2002, and the consolidated results of their operations, and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

Luboshitz Kasierer
An affiliate member of Ernst & Young International

Haifa, Israel
June 25, 2003

This is a copy of the previously issued Independent Public Accountants' report of Arthur Andersen.
The report has not been reissued by Arthur Andersen.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholders of

ELBIT VISION SYSTEMS LTD.

We have audited the accompanying consolidated balance sheets of Elbit Vision Systems Ltd. (the "Company") as of December 31, 2001 and 2000, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States and in Israel, including those prescribed under the Auditors' Regulations (Auditor's Mode of Performance), 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2001 and 2000, and the consolidated results of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

LUBOSHITZ KASIERER
Arthur Andersen

Haifa, Israel
March 18, 2002

ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands of U.S. Dollars, except share data)

	Note	December 31, 2002	December 31, 2001
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents		$1,485	$1,614
Marketable securities	(3)	-	812
Trade receivables, net of allowance for doubtful accounts of $1,225 and $618 as of December 31, 2002 and December 31, 2001, respectively		652	1,168
Other receivables and prepaid expenses	(4)	413	251
Inventories	(5)	3,211	4,151
Total current assets		5,761	7,996
LONG-TERM INVESTMENTS			
Long-term trade receivables, net of allowance for doubtful accounts of $302 and $280 as of December 31, 2002 and December 31, 2001, respectively	(6)	27	78
Deposits and loans	(7)	76	94
Severance pay funds	(10)	431	426
Total long-term investments		534	598
PROPERTY AND EQUIPMENT, NET	(8)	533	745
Total assets		$6,828	$9,339
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT LIABILITIES			
Related party	(18)	$438	$276
Trade payables		612	273
Other payables and accrued expenses	(9)	2,544	3,017
Advances from customers		1,216	1,917
Total current liabilities		4,810	5,483
LONG-TERM LIABILITIES			
Related party	(18)	-	150
Accrued severance pay	(10)	592	596
Total long-term liabilities		592	746
CONTINGENT LIABILITIES AND COMMITMENTS	(11)		
SHAREHOLDERS' EQUITY			
Share capital	(12)		
Ordinary shares, NIS 1 par value; Authorized - 20,000,000 as of December 31, 2002 and 2001; issued and outstanding - 10,166,667 as of December 31, 2002 and 2001		1,208	1,208
Additional paid in capital		17,785	17,785
Accumulated deficit		(17,567)	(15,883)
Total shareholders' equity		1,426	3,110
Total liabilities and shareholders' equity		$6,828	$9,339

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

ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Note	Year ended December 31, 2002	2001	2000
Revenues	(13)	$7,178	$9,373	$8,875
Cost of revenues	(14)	4,668	6,930	9,562
Gross profit (loss)		2,510	2,443	(687)
Research and development costs, net	(15)	1,340	1,405	1,620
Marketing and selling expenses		1,487	1,568	1,699
General and administrative expenses		1,404	886	1,411
		4,231	3,859	4,730
Operating loss		(1,721)	(1,416)	(5,417)
Financing income, net	(16)	34	89	50
Other income (expenses), net		9	20	(310)
Loss before taxes on income		(1,678)	(1,307)	(5,677)
Taxes on income	(17)	6	6	38
Loss from continuing operations		(1,684)	(1,313)	(5,715)
Cumulative effect of change in accounting principle, net	(2U)	-	-	(2,625)
Net loss		$(1,684)	$(1,313)	$(8,340)
BASIC AND DILUTED NET LOSS PER SHARE:				
Loss from continuing operations		$ (0.17)	$(0.13)	$(0.66)
Cumulative effect of change in accounting principle		-	-	(0.30)
Basic and diluted net loss per share		$ (0.17)	$(0.13)	$(0.96)
Weighted average number of shares used in computing basic and diluted net loss per share (in thousands)		10,167	9,817	8,667

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

ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(In thousands of U.S. Dollars, except share data)

	Number of shares	Share capital	Additional paid in capital	Accumulated deficit	Total Shareholders' equity
Balance as of January 1, 2000	8,666,667	$852	$16,728	$(6,230)	$11,350
Net loss	-	-	-	(8,340)	(8,340)
Balance as of December 31, 2000	8,666,667	852	16,728	(14,570)	3,010
Shares issued (1) (2)	1,500,000	356	1,057	-	1,413
Net loss	-	-	-	(1,313)	(1,313)
Balance as of December 31, 2001	10,166,667	1,208	17,785	(15,883)	3,110
Net loss	-	-	-	(1,684)	(1,684)
Balance as of December 31, 2002	10,166,667	$1,20	$17,785	$(17,567)	$1,426

(1) Net of issuance expenses of $87.

(2) See note 12A.

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

ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of U.S. Dollars)

	Year ended December 31,		
	2002	**2001**	**2000**
CASH FLOWS FROM OPERATING ACTIVITIES			
Net loss	$(1,684)	$(1,313)	$(8,340)
Adjustments required to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation	256	312	381
Currency exchange differences on deposits	2	15	-
Impairment of assets	-	-	308
Accrued interest on liability	12	-	-
Loss (gain) from sale of property and equipment	4	(13)	-
Decrease (increase) in marketable securities	812	(812)	-
Accrued severance pay, net	150	(23)	22
Decrease in trade and other receivables	405	612	5,363
Decrease (increase) in inventories	940	854	(746)
Increase (decrease) in advances from customers	(701)	(504)	3,069
Increase (decrease) in trade and other payables	(293)	(411)	147
Net cash provided by (used in) operating activities	(97)	(1,283)	204
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of equipment	(49)	(56)	(75)
Proceeds from sale of equipment	1	63	71
Investment in long-term deposits	(8)	(13)	(53)
Collection of long-term deposits	24	-	-
Net cash used in investing activities	(32)	(6)	(57)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from issuance of shares, net of issuance expenses	-	1,413	-
Short-term bank credit, net	-	(73)	(185)
Increase (decrease) in related party	-	(100)	-
Net cash provided by (used in) financing activities	-	1,240	(185)
DECREASE IN CASH AND CASH EQUIVALENTS	(129)	(49)	(38)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	1,614	1,663	1,701
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	$1,485	$1,614	$1,663
SUPPLEMANTAL CASH FLOW ACTIVITIES:			
Cash paid during the year for:			
Interest	$ -	$ 1	$ 2
Income taxes	$ 15	$ 23	$ 10
NON - CASH TRASACTION:			
Short-term liability to related party converted to long-term liability	$ -	$ 300	$ -

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

ELBIT VISION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - GENERAL

A. BUSINESS

Elbit Vision Systems Ltd. ("EVS" or the "Company") designs, develops, manufactures, markets and supports automatic vision inspection and quality monitoring systems. The Company markets and sells to the textile manufacturing industry.

Elbit Vision Systems Inc. ("EVS Inc") incorporated in Delawere U.S.A and Elbit Vision Systems B.V. ("EVS BV") incorporated in Netherlands are wholly-owned subsidiaries, engaged in the selling and marketing of the Company's products worldwide.

B. RELATIONSHIP WITH SHAREHOLDERS

The Company is 34.42% owned by Altro Warenhandelsgesmbh ("Altro") an Austrian wholly owned Company by Mr. Nir Alon's familiy and to which Mr. Alon had transferred all of his shareholdings in the Company and 26% owned (2000 - 54%) by Elbit Ltd. ("Elbit"), Elbit is a wholly owned subsidiary of Elron Electronic Industries Ltd., an Israeli public company traded on both the Tel-Aviv Stock Exchange and the Nasdaq National Market. Through December 2000, Elbit provided certain production, installation, marketing and selling services, at cost or agreed upon terms.

Through July 2001, the Company has incurred royalty expenses through Elbit for the payment of royalties to the original developer of certain elements of the technology licensed to the Company from Elbit. See Note 11D.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES

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

A. USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management 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.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

B. FINANCIAL STATEMENTS IN U.S. DOLLARS

The financial statements of the Company and its subsidiaries have been prepared in U.S. dollars, as the currency of the primary economic environment in which the operations of the Company and its subsidiaries are conducted is the U.S. dollar. The majority of the Company's sales are made in U.S. dollars, as are the majority of purchases of materials and components and marketing costs. Therefore, the functional currency and reporting currency of the Company and its subsidiaries is the U.S. dollar.

Transactions and balances denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into U.S. dollars in accordance with the principles set forth in Statement of the Financial Accounting Standards Board (“SFAS No. 52”), “Foreign Currency Translation”. Accordingly, items have been remeasured as follows:

- Monetary items - at exchange rate in effect on the balance sheet date.
- Nonmonetary items - at historical exchange rates;
- Revenue and expense items - at exchange rates in effect as of date of recognition of those items (excluding depreciation and other items deriving from nonmonetary items).

All exchange gains and losses from the abovementioned remeasurment are reflected in the consolidated statements of operations. The representative rate of exchange as of December 31, 2000, 2001, 2002 was U.S. $1.00 to NIS 4.04, NIS 4.42 and NIS 4.74 respectively.

C. PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries in the U.S. and the Netherlands. Intercompany balances and transactions including profit from intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

D. CASH AND CASH EQUIVALENTS

All highly liquid investments that are not restricted with an original maturity of three months or less are considered as cash equivalents.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

E. MARKETABLE SECURITIES

The Company accounts for investments in debt securities in accordance with SFAS No. 115, "Accounting for certain investments in debt and equity securities".

Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. The Company has classified its marketable debt securities as trading securities. Under SFAS 115, marketable securities classified as trading securities are stated at the quoted market prices at each balance sheet date. Gains and losses (realized and unrealized) related to trading securities as well as interest on such securities are included as financing income, or expenses as appropriate.

F. ALLOWANCE FOR DOUBTFUL ACCOUNTS

Allowance for doubtful accounts is computed for specific debts, the collectibility of which is doubtful based upon the Company's experience.

G. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined using the weighted average method. Inventory write-offs are provided to cover risks arising from slow moving items or technological obsolescence. Such write-offs are recorded in cost of revenues.

H. LONG-TERM TRADE RECEIVABLES

Long-term receivables from extended payment agreements are recorded at estimated present values determined based on the market rates of interest on the transaction dates. Imputed interest is recognized, using the effective interest method, as a component of interest income in the accompanying statements.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

I. PROPERTY AND EQUIPMENT

Property and equipment are stated at cost, net of accumulated depreciation. Repairs and maintenance expenses are charged to operations as incurred. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the shorter of the remaining estimated useful life or the remaining term of the lease.

Principal annual rates of depreciation:	
Computers and equipment	10-33%
Office furniture and equipment	6-10%
Leasehold improvements	10%
Vehicles	15%

J. IMPAIRMENT OF LONG-LIVED ASSETS

The Company’s long-lived assets are reviewed for impairment in accordance with Statements of Financial Accounting Standard No. 144 “Accounting for the Impairment or Disposal of Long-Lived Assets”(“SFAS No. 144”) whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If such an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value.

K. REVENUE RECOGNITION

The Company and its subsidiaries generate revenues from product sales, including systems, and from sales of spare parts, customer services and technical support.

Revenues from the sale of products and services are recognized in accordance with Staff Accounting Bulletin No. 101 “Revenue Recognition in Financial Statements” (SAB No. 101”), when delivery has occurred or services have been rendered, persuasive evidence of an arrangement exists, the fee is fixed or determinable, no further obligation exists and collectability is probable.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

K. REVENUE RECOGNITION (CONT.)

In respect of systems, the Company and its subsidiaries recognize revenue upon the installation of systems when they require no evaluation or acceptance period. For systems sold subject to an evaluation period, revenue is recognized upon customer acceptance.

Revenues relating to customer services and technical support are recognized ratably over the period of the related contract.

The Company generally does not grant a right of return to its customers. When a right of return exists, the Company defers revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria are met.

L. RESEARCH AND DEVELOPMENT COSTS

Research and development costs are charged to operations as incurred. These expenses are presented net of royalty bearing grants provided by the Office of the Chief Scientist of the Ministry of Industry and Commerce of the State of Israel ("OCS").

M. WARRANTY COSTS

The Company provides a warranty for certain parts of the systems sold for up to one year. The Company estimates the costs that may be incurred under its warranty and records a liability for such costs at the time product revenue is recognized. Factors that affect the amount of the liability include the number of installed systems, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the amount as necessary. Accrued for warranty obligation amounted to $94 and $144 as of December 31, 2002 and 2001, respectively.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

N. INCOME TAXES

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standards ("SFAS") 109, "Accounting for Income Taxes" ("SFAS No 109". This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax 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 and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

O. CONCENTRATION OF CREDIT RISK

Financial instruments which potentially subject the Company to a concentration of credit risk consist principally of cash and cash equivalents and trade receivables and marketable securities.

The majority of the Company's cash and cash equivalents and short-term deposits are invested in dollar instruments with major banks in Israel and the U.S.. Managements believes that the financial institutions that hold the Company's investments are financially sound and accordingly, minimal credit risk exists with respect to these investments.

The Company's trade receivables are derived from sales to customers located mainly in the United States and Europe. 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. In certain circumstances, the Company may require letters of credit.

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

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

P. STOCK-BASED COMPENSATION

The Company has elected to follow Accounting Principles Board Opinion No. 25 ("APB 25") "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44 ("FIN 44") "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. Under APB 25, compensation expense is recognized based on the intrinsic value method where by compensation expense equals to the excess, if any, of the quoted market price of the share at the grant date of the award or other measurement date, over the amount an employee must pay to acquire the share.

Under SFAS No. 123, "Accounting for Stock-Based Compensation" as amended by SFAS No. 148, the Company is required to disclose pro forma information regarding stock based employee compensation cost, net loss and basic and diluted net loss per share, as if the Company had accounted for its employee share options under the fair value method of SFAS 123. The fair value for these options was estimated at the grant date using a Black-Scholes option pricing model with the following weighted average assumptions for grants in 2002, 2001 and 2000: (1) expected life of 2.3 years for all periods; (2) dividend yield of 0% for all periods; (3) expected volatility of 132% in 2002, 143% in 2001, and 156% in 2000 (4) risk-free interest rate of 1.5% in 2002, 2% in 2001 and 6% in 2000.

Pro forma information under SFAS 123 is as follows:

	Year ended December 31,		
	2002	2001	2000
Net loss as reported	$(1,684)	$(1,313)	$(8,090)
Stock based compensation cost as reported	-	-	-
Stock based compensation cost under SFAS 123	(270)	(130)	-
Net loss pro forma	$(1,954)	$(1,443)	$(8,090)
Basic and diluted net loss per share as reported	$(0.17)	$(0.13)	$(0.93)
Pro forma basic and diluted net loss per share	$(0.19)	$(0.15)	$(0.93)

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Q. GOVERNMENT GRANTS

Royalty-bearing grants from the Government of Israel for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred and included as a deduction of research and development costs.

R. BASIC AND DILUTED NET LOSS PER SHARE

The Company computes net loss per share in accordance with Statement of Financial Accounting Standards No. 128 “Earning Per Share” (“SFAS No. 128”). Under the provision of SFAS No. 128, basic net loss per share is computed by dividing the net loss for the period by the weighted-average number of Ordinary shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss for the period by the weighted-average number of Ordinary shares and dilutive Ordinary share equivalents outstanding during the period. All stock options, are not reflected in diluted net loss per share for all periods presented because the effect of such options is antidilutive.

S. SEVERANCE PAY

The Company’s liability for severance pay to its Israeli employees including for the period of their employment with Elbit Ltd., is calculated pursuant to the Israeli 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. Employees are entitled to one month’s salary for each year of employment or a portion thereof.

The Company’s liability for all of its Israeli employees is partly provided by monthly deposits for insurance policies and pension funds and by an accrual. The value of these policies and funds is recorded as an asset in the Company’s balance sheet.

The deposited funds of the Company’s employees include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies, and includes immaterial profits.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

T. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of cash and cash equivalents, trade and other receivables, trade and other payables approximate their fair value due to the short term maturities of such instruments.

Fair value of long-term loans and deposits is estimated by discounting the future cash flows using current interest rates for loans of similar terms and maturities. As of December 31, 2002 the fair value of long term deposits and loans amounted to approximately $68.

U. ACCOUNTING CHANGE

Effective January 1, 2000, the Company changed its revenue recognition policy to be consistent with the guidance of the United States Securities and Exchange Commission ("the SEC"), Staff Accounting Bulletin No. 101 ("SAB 101"). SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosure related to revenue recognition policies. Prior to the issuance of SAB 101, the Company recognized revenue upon the shipment of product to the customer. The guidance in SAB 101 the established, among other items, more definitive criteria related to the installation aspect of a contract. The impact of adopting this guidance has resulted in the Company deferring revenue recognition on certain contracts until installation has been completed. The initial application of the accounting change in the first quarter of 2000 resulted in a non cash charge of $2,600, which has been recorded as a cumulative effect of change in accounting principle.

The revenues relating to the cumulative adjustment that were recognized in previous years amounted to $4,900.

Note 2 - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

V. IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses significant issue regarding the recognition, measurement and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 also requires liabilities accrued in respect of such cost to be measured at fair value.

SFAS No. 146 is effective for all exit or disposal activities initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on its results of operations or financial position.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34 ("FIN No.45"). FIN No. 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN No. 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FASB Interpretation No.34, "Disclosure of Indirect Guarantees of Indebtedness of Others", which is being superseded. The disclosure provisions of FIN No. 45 are effective for financial statements of interim or annual periods that end after December 15, 2002, and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year-end. The Company does not expect the adoption of FIN No. 45 to have a material impact on its results of operations or financial position.

(In thousand of U.S. dollars)

Note 3 - MARKETABLE SECURITIES

Marketable securities, classified as trading securities comprised debentures bearing annual interest rate of 7.125%. The fair value as of December 31, 2001 amounted to $812. In September 2002, the Company sold the marketable debentures for a total consideration of $810. As a result, the Company recorded a realized loss of $2 in financing income in the statement of operations.

Note 4 - OTHER RECEIVABLES

	December 31,	
	2002	**2001**
Government agencies	$230	$44
Prepaid expenses	68	79
Other	115	128
	$413	$251

Note 5 - INVENTORIES

	December 31,	
	2002	**2001**
Raw materials	$ 591	$ 658
Spare parts	741	772
Work-in-process	865	1,245
Finished goods	1,014	1,476
	$ 3,211	$ 4,151

The Group periodically assesses its inventory valuation in accordance with its revenues forecasts, technological obsolescence, and the market conditions.

For the years ended December 31, 2002, 2001 and 2000 inventory write-offs amounted to approximately $0, $220 and $900, respectively.

Note 6 - LONG-TERM TRADE RECEIVABLES

The Company extends long-term credit to certain customers. These receivebles mature over periods ranging primarily through the year 2004.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)

(In thousand of U.S. dollars)

Note 7 - DEPOSITS AND LOANS

	December 31,	
	2002	2001
Deposits on leased vehicle	$21	$52
Loans to employees (*)	55	42
	$76	$94

(*) Loans to employees are linked to the Israeli Consumer Price Index and are repayable over five years through 2005.

Note 8 - PROPERTY AND EQUIPMENT, NET

	December 31,	
	2002	2001
Computers and equipment	$1,729	$1,710
Office furniture and equipment	416	401
Leasehold improvements	440	431
Vehicles	37	37
	2,622	2,579
Less - accumulated depreciation	(2,089)	(1,834)
	$533	$745

Depreciation expenses amounted to $256, $312 and $381 for the years ended 2002, 2001 and 2000, respectively.

In 2000, the Company recognized an impairment loss of $308 in respect of leasehold improvements which the Company ceased to use.

Note 9 - OTHER PAYABLES AND ACCRUED EXPENSES

	December 31,	
	2002	2001
Payroll and related expenses	$770	$678
Government agencies	1,175	1,067
Accrued warranty obligation	94	144
Commissions to agents	150	334
Accrued expenses and others	355	794
	$2,544	$3,017

Note 10 - ACCRUED SEVERANCE PAY

Severance pay expense amounted to $176, $195 and $284 in 2002, 2001 and 2000, respectively.

(In thousand of U.S. dollars)

Note 11 - CONTINGENT LIABILITIES AND COMMITMENTS

A. In connection with its research and development activities, the Company has received royalty bearing grants from the OCS of the State of Israel in the aggregate amount of $5,950. In return for the Government’s grants, the Company is committed to pay royalties at a rate of 3%-5% of sales of the developed products of approved projects, up to the amount of the grants received plus interest at a Libor. 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. At December 31, 2002 the aggregate contingent liability to the OCS, amounted to approximately $669. Total royalties accrued or paid amounted to $108, $264, and $316 in 2002, 2001 and 2000, respectively and were recorded in cost of revenues.

B. The Company's principal facilities are located in a building in Yoqneam, Israel under an operating lease agreement which expires on December 31, 2005. The Company's future minimum annual rental payments, which are in NIS linked to the Israeli Consumer Price Index are as follows:

	U.S.$
2003	119
2004	119
2005	119
	357

EVS Inc. leases office space in Greenville, South Carolina under an operating lease agreement which expires on October 1, 2005. The future minimum annual rental payments are as follows:

	U.S.$
2003	27
2004	27
2005	20
	74

Rental expense for the years 2002, 2001 and 2000 amounted to $247, $248, and $305, respectively.

(In thousand of U.S. dollars)

Note 11 - CONTINGENT LIABILITIES AND COMMITMENTS (CONT.)

C. The Company leases motor vehicles under long-term operating lease agreements. The lease agreements expire on various dates ending in 2003 - 2005 (with prior notice of cancellation clauses).

The following is a schedule of future minimum lease payments under these agreements which are linked to the U.S. dollars :

	U.S. $
2003	226
2004	73
2005	31
	330

D. Effective upon its initial public offering on July 3, 1997, the Company agreed to pay Elbit Ltd. (“Elbit”) royalties in an amount dependent upon the sales of the Company’s vision system products in the textile, automotive and food industries. The royalties will in turn be paid in full by Elbit to the original developer of certain elements of the technology licensed by the Company from Elbit. Such royalties will be in an amount not less than $300 and not more than $500 per year. In addition, the Company is to pay Elbit royalties of up to 4.5% with respect to sales of products by the Company not in the textile, food and automotive industries if Elbit is required to pay such amounts to the developer.

In 2002, the Company and Elbit amended the abovementioned agreement, effective as of July 1, 2001, pursuant to which the royalties will be paid directly to the developer, twice a year, at a rate of 1.5% of sales of I-TEX products in the immediately preceding six months.

As a result of the amendment of the agreement, the Company recorded net royalty income of $64 in the year ended December 31, 2002. The royalty expense was $300 for the years ended December 31, 2001 and 2000, and was recorded as cost of revenues in the statements of operations.

Note 11 - CONTINGENT LIABILITIES AND COMMITMENTS (Cont.)

E. LEGAL PROCEEDINGS

1. U.S. Patent Infringement

On June 30, 2000, a U.S. limited partnership (the "Claimant"), presented a lawsuit before the U.S District Court for the District of Arizona against 76 defendants (several of these defendants are the Company's customers) claiming that each of the defendants has willfully and deliberately infringed on its patents.

The Claimant requested, among other things, for an order enjoining each of the defendants from further acts of infringement of said patents, and for an award of damages against each of them.

In a letter dated September 14, 2000, a customer of EVS requested that EVS Inc., defend and indemnify the customer in connection with the aforementioned patent lawsuit, claiming that the equipment infringing the Claimant's patents was purchased from EVS Inc. The Company immediately sought full indemnification from Elbit for any and all claims, demands or actions, and any losses, expenses and damages suffered by the Company resulting from the customer's claim, pursuant to section 8.1 of the License Agreement between Elbit and the Company dated December 6, 1996 (the "License Agreement").

2. Other legal proceedings

The Company has received several letters that indicate that some of the Company's customers, may be sued on the basis of allegedly infringing third party patents.

Management is presently unable to predict the ultimate outcome of the above legal proceedings, including whether they will eventually result in a law suit against the Company.

Note 11 - CONTINGENT LIABILITIES AND COMMITMENTS (Cont.)

F. In November 2002, the Company filed in the Haifa District Court an application for a permanent injunction against Panoptes Ltd. ("Panoptes") to cease all production and marketing of its current products. The Company also claimed damages from Panoptes in the amount of at least NIS 2,600 ($550). The claim was also brought against the CEO of Panoptes and former founder of EVS. The claim states that Panoptes, which was established by the CEO of Panoptes and former founder of EVS recruited several former EVS employees, and currently markets products which are unlawfully based on EVS technology.

Panoptes filed a counter claim in December 2002, alleging that EVS had conducted negotiations with Panoptes in bad-faith and had failed to execute an agreement regarding Panoptes products as a result of bad faith. The claim was for a minimum of NIS 3,000 ($600). Panoptes also filed a defence to the statement of claim of EVS.

Note 12 - SHAREHOLDER`S EQUITY

A. ORDINARY SHARES

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

In March 2001, Mr. Nir Alon, the Company's chairman, purchased 1.5 million Ordinary shares of the Company at a price of $1.00 per share. At that time, Mr. Alon also agreed to complete a second investment to purchase by no later than March 15, 2002, an additional 1.5 million shares of the Company at a price of $1.00 per share; provided that the Company's financial results for 2001 met certain minimum thresholds.

The Company's Board of Directors has agreed to enter into an agreement with Altro, whereby the previous commitment to purchase additional shares of the Company would be canceled upon the consummation of new investment terms and a warrant distribution (collectively, the "Arrangement"). Pursuant to the Arrangement, Altro has agreed to purchase 2 million Ordinary shares of the Company at a price of $0.35 per share, payable in quarterly installments commencing immediately following the approval of the Arrangement by the Company's shareholders and the Haifa District Court, pursuant to Section 350 of the Companies Law, 1999.

Note 12 - SHAREHOLDER`S EQUITY (CONT.)

A. ORDINARY SHARES (Cont.)

The final installment will be paid not later than August 25, 2004. The shares are to be held by a trustee and will be released, pro rata, as the payments are received by the Company. Following the payment of all of the installments, Altro is expected to hold approximately 45.21% of the outstanding share capital of the Company. The parties are currently negotiating the exact amount of each installment to be paid.

As of the date of issuance of the financial statements the Company's shareholders and the Haifa District Court have not yet approved the Arrangement.

Pursuant to the Arrangement, the Company will also, for no consideration, distribute warrants to purchase approximately 4 million of its Ordinary shares to all of its shareholders (other than Altro) on an agreed distribution date, on a pro rata basis. Each warrant will be exercisable for a period of four years following the grant date, at a price of $0.35 per share.

B. SHARE OPTIONS

In February 1996, the Board of Directors of the Company adopted a share option plan (the "1996 Share Option Plan") pursuant to which 554,780 options can be granted to directors, officers, employees and consultants of the Company and its subsidiaries. The last date on which the options may be granted is February 2006. As of December 31, 2002, 256,833 options were available for future grants under the above plan. Most of the options vest over a period of four years. All of the outstanding options expire no later than ten years following the date of grant. The grantee is responsible for all personal tax consequences of the grant and the exercise thereof.

In April 2000, the board of directors of the Company adopted a new option plan. The total number of ordinary shares available to be issued under the plan amounted to 4,500,000 shares and the last date on which the options may be granted is April 2010. As of December 31, 2002, 2,384,461 options were available for future grants under the above plan. Most of the options vest over a period of four years from the date of grant and expire no later than ten years following the date of grant.

(In thousand of U.S dollars except for per share data)

Note 12 - SHAREHOLDER`S EQUITY (CONT.)

B. SHARE OPTIONS (Cont.)

The option exercise price is determined by the Board of Directors of the Company and equals the market price of the Company's share at the date of grant.

Any options which are canceled or forfeited before expiration, become available for future grants.

Transactions regarding employee share options during the three years in the period ended December 31, 2002 are summarized as follows:

	Number of shares	**Weighted average exercise price**
Outstanding at January 1, 2000	455,280	$2.12
Granted	721,139	$1.17
Forfeited	(197,334)	$1.58
Outstanding at December 31, 2000	979,085	$1.54
Granted	708,000	$0.36
Forfeited	(239,250)	$0.64
Outstanding at December 31, 2001	1,447,835	$1.11
Granted	1,291,400	$0.44
Forfeited	(325,749)	$1.04
Outstanding at December 31, 2002	2,413,486	$0.76

The weighted average fair value of options granted in 2002, 2001 and 2000 was $0.22, $0.32 and $1.11, respectively.

1,050,074, 577,494 and 150,447 of the outstanding options were exercisable at December 31, 2002, 2001, and 2000 respectively.

The weighted average exercise price of the exercisable options in 2002, 2001 and 2000 was $1.03, $1.54 and $3 respectively.

(In thousand of U.S dollars except for per share data)

Note 12 - SHAREHOLDER`S EQUITY (CONT.)

B. SHARE OPTIONS (Cont.)

The following table summarizes information about options outstanding and exercisable as of December 31, 2002:

	Options outstanding			Options exercisable	
Exercise prices	**Number Outstanding at December 31, 2002**	**Weighted average remaining contractual life (years)**	**Weighted average exercise prices**	**Number outstanding at December 31, 2002**	**Weighted average exercise prices**
$3.00	99,447	4.5	$ 3.00	99,447	$ 3.00
$1.68	110,000	6.0	$ 1.68	110,000	$ 1.68
$1.17	561,389	7.5	$ 1.17	357,668	$ 1.17
$1.00	200,000	9.5	$ 1.00	27,500	$ 1.00
$0.48	516,400	9.0	$ 0.48	102,204	$ 0.48
$0.36	437,750	8.0	$ 0.36	209,755	$ 0.36
$0.20	88,500	9.5	$ 0.20	88,500	$ 0.20
$0.15	400,000	9.5	$ 0.15	55,000	$ 0.15
	2,413,486	8.3	$ 0.76	1,050,074	$ 1.03

No compensation cost was recorded for the years ended December 31, 2002, 2001 and 2000.

C. DIVIDENDS

The Company has never paid cash dividends to shareholders. The Company intends to retain future earnings for use in its business and does not anticipate paying cash dividends on its ordinary shares in the foreseeable future. Any future dividend policy will be determined by the Board of Directors and will be based upon conditions then existing, including results of operations, financial condition, current and anticipated cash needs, contractual restrictions and other conditions as the Board of Directors may deem relevant.

(In thousand of U.S dollars)

Note 13 - REVENUES

A. Composition:

	Year ended December 31,		
	2002	2001	2000
Products	$4,925	$ 7,073	$ 6,637
Services	2,253	2,300	2,238
	$ 7,178	$ 9,373	$ 8,875

B. The Company's revenues by geographic areas are as follows:

	Year ended December 31,		
	2002	2001	2000
U.S.A.	$3,250	$ 5,317	$ 5,339
Europe	3,231	2,914	3,431
Far East	697	1,142	105
	$ 7,178	$ 9,373	$ 8,875

C. The following customers accounted for 10% or more of the Company's sales:

	Year ended December 31,		
	2002	2001	2000
Customer A	-	21%	15%

Note 14 - COST OF REVENUES

	Year ended December 31,		
	2002	2001	2000
Materials	$ 1,025	$ 913	$ 5,623
Labor and related expenses	1,427	1,727	2,844
Subcontractors	70	90	278
Royalties to OCS	108	264	316
Royalties paid through Elbit (*)	(64)	300	300
Other expenses	1,260	1,773	2,152
	3,826	5,067	11,513
Decrease (increase) in work-in-process and finished goods inventories	842	1,863	(1,951)
	$4,668	$ 6,930	$ 9,562

(*) See Note 11D.

(In thousand of U.S dollars)

Note 15 - RESEARCH AND DEVELOPMENT EXPENSES, NET

	Year ended December 31,		
	2002	**2001**	**2000**
Total costs	$ 1,490	$ 1,531	$ 1,715
Less - grants from the Government of Israel	(150)	(126)	(95)
	$ 1,340	$ 1,405	$ 1,620

Note 16 - FINANCING INCOME, NET

	Year ended December 31,		
	2002	**2001**	**2000**
Income			
Foreign currency exchange differences	$ -	$ 5	$ 17
Interest on deposits	59	50	29
Interest and gain on marketable securities (*)	44	10	-
Other	2	53	26
	105	118	72
Expenses			
Foreign currency exchange differences	46	-	-
Interest on liability to related party	12	13	-
Other	13	16	22
	71	29	22
	$ 34	$ 89	$ 50

(*) Includes realized loss amounting to $2 (2001-unrealized gain of $2)

Note 17 - TAXES ON INCOME

A. Measurement of taxable income under the Income tax (inflationary adjustments) law, 1985.

Results for tax purposes are measured and reflected in real terms in accordance with the change in the Israeli Consumer Price Index ("CPI"). As explained in Note 2B the consolidated financial statements are presented in U.S dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(F) of SFAS No. 109, the Company has not provided deferred income taxes on this difference between the financial reporting basis and the tax basis of assets and liabilities.

B. Tax benefits under Israeli's Law for the Encouragement of Industry (Taxation), 1969:

The Company is an "industrial company", as defined by the Law for the Encouragement of Industry (Taxes), 1969, and as such, is entitled to certain tax benefits, mainly amortization of costs relating to know-how and patents over eight years, the right to claim public issuance expenses, and accelerated depreciation.

C. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the law"):

The Company's production facilities in Israel have been granted "Approved Enterprise" status under the law. The main benefit arising from such status is a full tax exemption on income derived from the "Approved Enterprise". The period of tax exemption commenced in 1994.

An expansion program of the Company has also been granted an "Approved Enterprise" status in 2000, under the law. For this expansion program, the Company has elected alternative benefits, waiving grants in return for a full tax exemption. Pursuant thereto, the income of the Company derived from the expansion program is tax-exempt for a period of ten years.

The Company completed a material portion of the above expansion program in 2002. The benefits period will commence in the first year in which the Company has taxable income.

Note 17 - TAXES ON INCOME (CONT.)

C. Tax benefits under the law for the Encouragement of Capital Investments, 1959 ("the-law") (Cont.):

The period of tax benefits, detailed above, is limited to the earlier of 12 years from the commencement of production, or 14 years from the approval date. For the above expansion program, the period of benefits for the production facilities, which has not yet commenced, will terminate in the year 2014.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the Company, they would be taxed at the corporate tax rate applicable to such profits (25%) as if the Company had not elected the alternative system of benefits.

The entitlement to the above benefits is conditional upon the Company's fulfilling the conditions stipulated by the above law, regulations published thereunder and the instruments of approval for the specific investments in "Approved enterprises". In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2002, management believes that the Company is meeting all of the aforementioned conditions.

As the Company is exempt from tax, the Israeli statutory tax rate for the purposes of the reconciliation of the reported tax expense is zero. Income tax expense in the financial statements relates primarily to current income taxes of subsidiaries.

(In thousands of U.S. dollars)

Note 18 - RELATED PARTY

A. BALANCE

The balance as of December 31, 2002 and 2001 represents a liability to Elbit. The liability bears interest at a rate of libor plus 0.5% per annum.

B. TRANSACTIONS WITH RELATED PARTIES

	For the year ended December 31		
	2002	**2001**	**2000**
Transactions with Elbit (see Note 1B):			
Expenses			
Production and installation services	-	-	138
Royalties (*)	-	300	300
Marketing and selling expenses	-	-	181
General and administrative expenses	-	-	2
Financing expenses	12	13	-

(*) See note 11D.

Note 19 - ALLOWANCE FOR DOUBTFUL ACCOUNTS

	For the year ended December 31	
	2002	**2001**
Balance at beginning of year	898	1,117
Charged to general and administrative expenses	629	-
Reductions in respect of bad debts	-	(219)
Balance at the end of the year	1,527	898

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