

# Enabling technologies for improved medical care



**Oridion Systems Ltd.**  
**Annual Report 2004**



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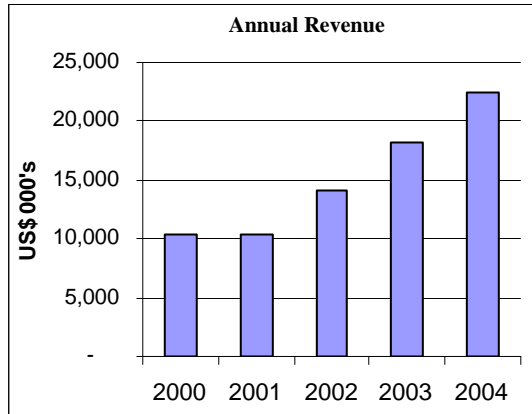
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# CEO Letter to Shareholders

## Dear Oridion Shareholders,

The year 2004 has been a landmark year for Oridion. For the first time in its history, the Company was able to report a consolidated operating profit in both the third and fourth quarters, excluding non-recurring, non-cash expenses. In addition, our core business, Capnography, which is the non-invasive monitoring of CO<sub>2</sub> in the breath of patients, and represents over 99% of sales, also experienced an historic first as it generated an operating profit for the entire year. As a consequence, the Company's cash balance, after years of constant decline, has now stabilized and our balance sheet has been strengthened.

The year was also a landmark strategically. Oridion's global leadership position in the CO<sub>2</sub> monitoring market was further solidified - as evidenced by: the rapid acceleration in the number of patient procedures being monitored by Microstream® capnography products; the new leading medical device companies that have become Oridion OEM partners; and the important patient-safety needs that can be reliably met only now because of enabling Microstream® technologies introduced this past year into new environments for capnography. These environments include gastroenterology, cardiac catheterization laboratories ("cath labs") and pain management.



During 2004, we also made the strategic decision that as a result of the potential for growth and innovation in the capnography business, Oridion will focus its resources and management attention on fully exploiting our leadership position in the CO<sub>2</sub> monitoring market. Accordingly, we have decided to seek partners, strategic and/or financial, to help build Oridion's early-stage, breath testing business ("BreathID") - which will itself require substantial resources and management commitment - so that the potential inherent in BreathID can be fully realized without diverting corporate management's focus from capnography. Our target is to bring partners into the BreathID business in 2005. In the interim, we will continue current pre-commercialization programs.

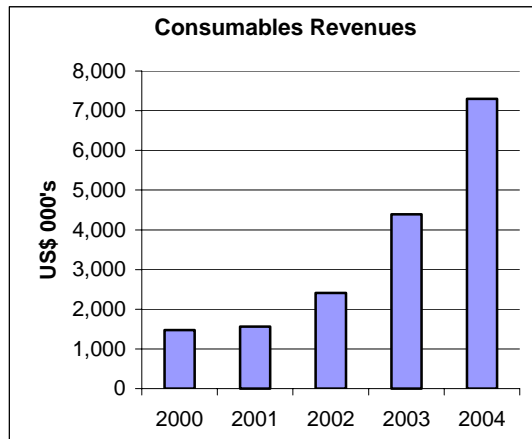
## Capnography

The strong growth in consolidated revenues for 2004 has been driven entirely by sales of Oridion's Microstream® capnography product line, which has become the CO<sub>2</sub> monitoring solution of choice for many of the world's leading patient monitoring and medical device companies. These include Philips Medical Systems, Medtronic-PhysioControl, Tyco-Nellcor, Datascope, Siemens Medical Solutions, Alaris and Fukuda Denshi.

These market leaders have selected Oridion as their CO<sub>2</sub> monitoring supplier because of the versatility and reliability of our Microstream® products. Based on innovative and proprietary technologies, Microstream® capnography is unique in being able to accurately and reliably monitor CO<sub>2</sub> in all types of patients across the broadest variety of clinical environments.

Oridion is now benefiting from the years of investment in market development devoted to raising the medical community's level of awareness of the importance of capnography to patient safety and, in particular, to the fact that capnography provides the earliest available indication that a patient is in respiratory distress. The constant flow of new medical standards during recent years that recommend the use of CO<sub>2</sub> monitoring in more and more clinical settings is a strong indication that capnography's importance has gained increasing recognition. The result has been a strong acceleration in demand by the medical community for capnography monitoring and, specifically, for Oridion's Microstream® capnography.

Accordingly, we are pleased to report that during 2004, Microstream® capnography was used in approximately 1.2 million clinical procedures, resulting in a 66% increase in sales of our proprietary consumable products over the previous year. After several years of similar growth rates, sales of consumable products have now reached 32% of total Oridion sales. This is a major milestone for the Company and, more than any other performance metric, indicates that the business strategy that Oridion has actively pursued in recent years has gained real traction and that the potential we envisioned for our capnography business is beginning to be realized.



To further increase the use of capnography and to advance Oridion’s consumables strategy, the Company undertook an important new initiative during 2004 by establishing the Oridion Distribution Network (“ODN”). Our intention with the ODN is to complement our OEM partners’ sales forces with specialty, consumables-oriented distributors who will be dedicated to the sales and support of Oridion’s consumable products. Thus far, we have distributors covering about two-thirds of the US market as well as the UK. During 2005, we intend to complete coverage of the US market and broaden our global coverage considerably. These distributors are chosen for their potential to increase usage rates of our proprietary consumables in the large existing installed base of Microstream® monitors and to sell into our new target clinical environments. This is to be achieved through the ODN distributors’ special selling skills and, equally importantly, through their support and training of clinical personnel in the benefits and application of, Microstream® capnography consumables, which are tailored to the specific needs of the different clinical environments.

This has also been an active product development year, with the launch of a number of important new products. A new generation of modules was introduced that both features significantly improved operating performance and also meets the important need of our OEM customers for further miniaturization. In addition, we launched capnography products into a number of new clinical environments, such as in cardiac cath labs through our OEM partner Siemens, and in pain management, an emerging application that will save lives as patients are protected from drug overdoses. In addition, we introduced our new Smart BiteBloc™ consumable product into the GI setting, which for the first time enables capnography to be conveniently and accurately monitored during upper endoscopies.

## Breath Testing

Oridion’s breath testing business is based on one of the clear future directions for medical care: point-of-care diagnostic testing. The BreathID® multi-test platform enables physicians to conveniently and non-invasively test and diagnose, in real time, patients suffering from various gastrointestinal and digestive system disorders, with just one device and in an office setting – in many cases replacing unpleasant, expensive and potentially harmful invasive procedures. Our vision is that the BreathID® platform has the potential to become an indispensable feature in GI (and internal medicine) clinics and hospital departments.

Oridion has already developed three BreathID® clinical applications: a breath test to measure liver function, a breath test to measure gastric emptying rate, and a breath test to diagnose the presence of the ulcer- and cancer-causing H.pylori bacteria. Additional applications are currently under development.

Having completed development of these first tests, this year Oridion focused its efforts on pre-commercialization activities such as further clinical validation and market assessment. In current and past clinical studies, the BreathID® tests have compared favorably with alternative tests and have demonstrated substantial promise for use in clinical practice. Nevertheless, further studies and regulatory approvals are still needed before full commercialization is feasible.

# CEO Letter to Shareholders

## Looking Ahead

An aging world population combined with increasingly severe global pollution and breathing-related ailments, such as asthma, together with a heightened awareness in the medical community of the need for improved patient safety, makes the need for CO<sub>2</sub> monitoring solutions greater than ever.

As the technology leader in CO<sub>2</sub> monitoring, Oridion will continue to innovate and bring new products to market that further improve patient safety. We plan to actively follow up the innovations we introduced in 2004 to pain management, to the cardiac cath labs and to the GI sector, in order to ensure that our products are fully meeting the needs of the clinicians and patients in these environments. In addition, we have high-priority programs underway to update our solutions for critical care units in order to fully meet new demands created by changes in these environments in patient-care procedures and technologies. in these environments.

We also plan to devote our energies to further enhancing the important cooperation we have with our leading OEM partners through a range of support programs. In parallel, we plan to further strengthen the coverage and abilities of the new ODN network in order to ensure the ongoing success of our consumables business.

For these reasons, we expect to see a continuation in the coming years of the current positive momentum in sales growth coupled with increasing profitability. Superb execution in dealing with our strong growth prospects in capnography represents the greatest challenge facing the Company. Our top priorities, therefore, are to ensure that we execute our growth plans effectively and that we consistently not only meet but exceed our customers' expectations. To meet this challenge, our management invested great effort during 2004 in strengthening our professional marketing team, improving our sales management and implementing a wide range of new management processes for effective strategic and tactical planning. While this effort is by no means complete, we are confident that we have a highly motivated team that is more skilled and utilizes better management tools than at any time in our history. In 2005, we have an ambitious program to further improve key internal processes and skills.

In our breath testing business, we plan to continue our program of clinical studies and to expand the platform abilities of the BreathID® by developing additional breath tests, with our newest application expected to be completed this year. We will also work actively in 2005 to identify suitable partners, both in terms of resources and sector skills, in order to be able to move forward towards commercialization and the building of the BreathID® business.

The year 2004 has been one of the most significant periods since Oridion was founded. We are happy to see our achievements transformed into increased shareholder value, and are grateful for your support which, together with the ongoing dedication of Oridion's employees, has enabled us to report these improved results. Allow me also to express, on behalf of the entire Company and Board of Directors, our gratitude to George Yariv, the Founder of Oridion, who stepped down as CEO last March and who retired at the end of the year. George's vision, leadership and drive have been instrumental to Oridion's many achievements and the promising position Oridion is in today. Fortunately, since he remains an active Board member, we will continue to benefit from his wisdom and experience.

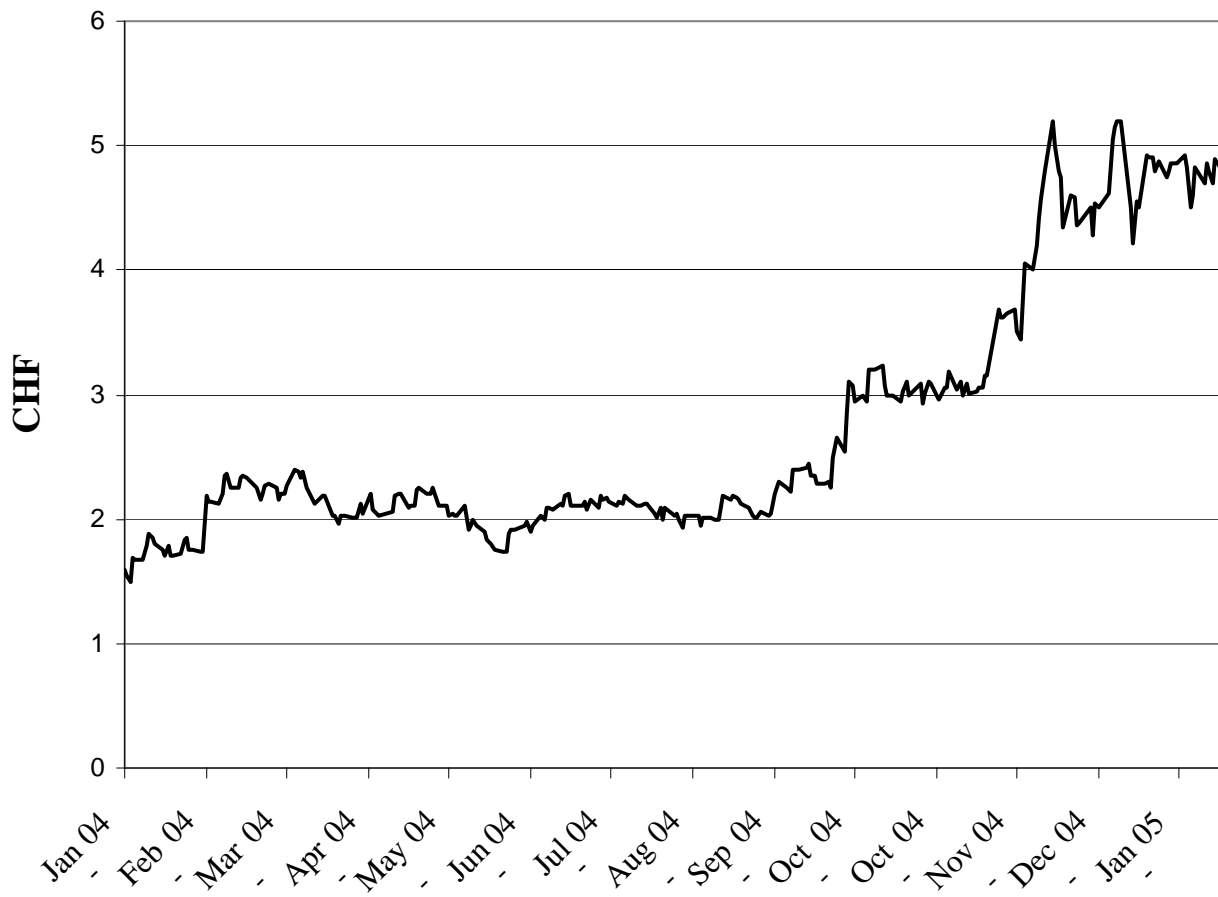
We at Oridion look forward to continuing to make an important contribution to improving the standard of medical care worldwide and to helping save lives.

Sincerely,



Alan Adler  
Chairman of the Board and CEO  
February 21st 2005

## Oridion Stock Price



# Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements of Oridion together with the Notes thereto included elsewhere in the 2004 Annual Report. The Annual Report contains certain forward-looking statements that involve risks and uncertainties. Oridion's actual performance, results and the timing of certain events could differ materially from those discussed in the forward-looking statements contained in this document as a result of certain factors as well as those included in the Annual Report.

## Results of Operations

Year ended December 31	2004	2003*	Percent increase (decrease)	Capnography 2004	BreathID 2004
Net Sales	22,450	18,117	24%	22,279	171
Cost of Goods Sold	(11,547)	(9,792)	18%	(11,176)	(371)
Inventory write-off	(1,206)	(350)	N/A	-	(1,206)
<b>Gross Profit</b>	<b>9,697</b>	<b>7,975</b>	<b>22%</b>	<b>11,103</b>	<b>(1,406)</b>
Gross margin %	43.2%	44.0%	-	49.8%	N/A
Gross Margin % (pro-forma) **	48.6%	46.0%	-	49.8%	N/A
Research and Development	2,895	3,328	(13%)	2,350	545
Sales and Marketing	7,093	8,102	(12%)	6,207	886
General and Administration	2,114	2,592	(18%)	1,900	214
Pension and Retirement benefit	863	-	N/A	345	518
Impairment of long-lived Assets	328	-	N/A	-	328
Operating Expenses	13,293	14,022	(5%)	10,802	2,491
<b>Operating Profit/(Loss)</b>	<b>(3,596)</b>	<b>(6,047)</b>	<b>(41%)</b>	<b>301</b>	<b>(3,897)</b>
<b>Operating Profit/(Loss) (pro-forma)***</b>	<b>(1,199)</b>	<b>(5,697)</b>	<b>(79%)</b>	<b>646</b>	<b>(1,845)</b>
<b>Net Profit/(Loss)</b>	<b>(3,903)</b>	<b>(6,161)</b>	<b>(37%)</b>		
<b>Net Profit/(Loss) (pro-forma) ***</b>	<b>(1,506)</b>	<b>(5,811)</b>	<b>(74%)</b>		
Earnings per share (in actual dollars)	(0.36)	(0.59)			
Weighted average number of shares used in computing basic and diluted net loss per share	10,712,874	10,501,421			
<b>Operating Profit/(Loss)</b>	<b>(3,596)</b>	<b>(6,047)</b>	<b>(41%)</b>	<b>301</b>	<b>(3,897)</b>
Depreciation and amortization	935	963	(3%)	778	157
<b>EBITDA</b>	<b>(2,661)</b>	<b>(5,084)</b>	<b>(48%)</b>	<b>1,079</b>	<b>(3,740)</b>
Inventory write-off	1,206	350	-	-	1,206
Retirement benefit	863	-	-	345	518
Impairment of assets	328	-	-	-	328
<b>EBITDA adjusted</b>	<b>(264)</b>	<b>(4,734)</b>	<b>(91%)</b>	<b>1,424</b>	<b>(1,688)</b>

\* Reclassified – in 2003 inventory write-off was presented in Other expenses

\*\* Excluding BreathID inventory write-off

\*\*\* In 2004, excluding BreathID inventory write-off, BreathID impairment of long-lived assets and one-time pension and retirement benefits. In 2003, excluding BreathID inventory write-off.

## Overview

Oridion Systems Ltd. is a medical technology company based in Jerusalem, Israel and Needham, Massachusetts, U.S.A. Oridion employs its patented Microstream<sup>®</sup> technology in the development, manufacturing and marketing of products used in two distinct businesses:

- 1) The current core business, capnography – the non-invasive measurement of carbon dioxide contained in the exhaled breath to determine the status of adequacy of respiration;
- 2) Oridion's early-stage business, breath testing (BreathID<sup>®</sup>) – the non-invasive analysis of gases in the breath to diagnose the adequacy of organ function and the presence of infectious diseases.

### Capnography

Oridion designs, manufactures and markets proprietary medical devices and consumables that are used to enable the measurement of exhaled CO<sub>2</sub> in patients, either as part of larger, multi-parameter patient safety monitoring systems, or as stand-alone, single parameter monitors. The performance of these devices are further enhanced by Oridion's patented family of consumable FilterLine<sup>®</sup> products, which enable CO<sub>2</sub> monitoring of every patient – including non-intubated patients and premature newborns – in every clinical environment, including transport monitoring, procedural sedation, pain management and emergency medical services.

Oridion markets and distributes its capnography products primarily through long-term supplier agreements with OEM partners, typically medical equipment leaders in the patient monitoring market and other patient care segments, and also through specialty consumable products distributors. In the year ended December 31, 2004, approximately 72 percent of Oridion's sales consisted of products sold to its four largest OEM customers, intended for integration into their medical devices. These devices are then shipped for sale worldwide. Demand for Oridion's capnography products has often been affected by seasonal trends in hospital purchases, with sales of Oridion's products generally peaking in November and December, while consistently being lower in the first quarter of the year.

### Breath Testing

Oridion also has developed a proprietary diagnostic breath testing system – the BreathID – designed to non-invasively diagnose, in real time, certain diseases and physiological conditions in just one visit to the physician's office. Oridion has already completed development of the first three BreathID applications – the liver function breath test, the gastric emptying rate breath test, and the H. pylori breath test - and is currently developing additional breath tests for use with this system.

This is an early-stage business, which will require substantial resources to fully exploit. Oridion has decided to search for strategic and possibly financial partners to participate in the commercialization of this business.

Oridion's Consolidated Financial Statements have been prepared in U.S. Dollars in accordance with U.S. GAAP. As almost all of Oridion's sales are made in U.S. Dollars, Oridion uses the U.S. Dollar as its functional and reporting currency.

### Year ended December 31, 2004 compared to year ended December 31, 2003

*Revenues.* For the year ended December 31, 2004, revenues increased by 24 percent to \$22.5 million compared to \$18.1 million for the year ended December 31, 2003. The increase in the sales is primary a result of a 66 percent growth in Capnography consumables, sold both through the Oridion Distribution Network (ODN) and OEM partners. For the year ended December 31, 2004, 72 percent of revenues were derived from four of Oridion's customers, as compared to 71 percent in 2003. Although Oridion sells consumables through its OEMs, the end user is free to purchase their consumable products from any OEM vendor, or from Oridion directly or from Oridion's appointed distributors, therefore Oridion believes that its dependency on key OEMs is being reduced as the percentage of consumables sales increase. For the year ended December 31, 2004, consumables sales accounted for 33 percent of total sales compared to 24 percent in 2003. Sales of Oridion's four leading OEM customers excluding consumables sales, account for 52% of sales. For the year ended December 31, 2004, sales to

## Management's Discussion and Analysis of Financial Condition and Results of Operations

customers in the United States accounted for 66 percent compared to 70 percent in 2003, and sales to customers in Europe accounted for 30 percent in 2004 compared to 25 percent in 2003. This, however, does not necessarily fully reflect the true geographic distribution of Oridion's products, since major OEM customers in the U.S. sell Oridion capnography products on to their other markets around the world.

*Cost of revenues.* Cost of revenues for the year ended December 31, 2004 increased to \$12.8 million compared to \$10.1 million for the year ended December 31, 2003. The cost of revenues includes a write-off of inventory for the breath testing business of \$1.2 million and \$0.4 million for the fiscal years 2004 and 2003 respectively. It is management's position to take a conservative view of the potential to realize this inventory going forward. This is due to the dependence of the successful commercialization of the BreathID business on concluding agreements with strategic and/or financial investors in 2005.

*Gross margin.* Decreased to 43.2 percent for the year ended December 31, 2004, from 44.0 percent for the year ended December 31, 2003. The pro-forma gross margin percentage without the inventory write down would have increased to 48.6% compared to 46.0% for the year ended December 31, 2003. The increase in the pro-forma gross margin resulted from a number of factors, including continued rapid growth in sales of consumables, which generally provide higher margins, stable transfer prices for Oridion's products, and improvements of efficiency in production and product costs.

*Research and Development expenses, net.* Research and development expenses, net, decreased to \$2.9 million for the year ended December 31, 2004, compared to \$3.3 million for the year ended December 31, 2003. The Company continues to invest in the development of many new Capnography products – both devices and consumables. In late 2004, it delivered the first units of the new generation of OEM boards – MiniMedico2. In the Breath Testing business, Oridion is currently completing development of its fourth Breath Test – Gastric Accommodation. Research and development expenses, net, represented 13 percent of revenues for the year ended December 31, 2004, compared to 18 percent for the year ended December 31, 2003.

*Selling and marketing expenses.* Selling and marketing expenses, for the year ended December 31, 2004, decreased to \$7.1 million compared to \$8.1 million for the year ended December 31, 2003. The main reason for the decrease was the decision not to extend the trial sales and marketing activities of the BreathID system in the U.S., which occurred in 2003, into a full-scale launch but rather to postpone entering the U.S. market until a platform of tests is available. As a consequence, in 2004, there were no BreathID sales and marketing expenses in the U.S. Current BreathID sales and marketing costs are devoted to the pre-commercialization programs for the three current tests and are primarily focused on supporting pilot sites in Europe, Israel and Japan. These, for the most part, are operated by opinion leaders who are carrying out clinical studies of the clinical efficacy of these tests. Selling and marketing expenses for Capnography include the newly established activities of Oridion's Distribution Network (ODN). The ODN includes a number of specialty consumable distributors, both in the U.S. and the UK, who work together with Oridion's Sales and Marketing department to educate, train and increase the usage of Microstream® capnography products in current and new medical environments. Selling and marketing expenses, represented 32 percent of revenues for the year ended December 31, 2004, compared to 45 percent for the year ended December 31, 2003.

*General and administrative expenses.* For the year ended December 31, 2004, general and administrative expenses decreased to \$2.1 million compared to \$2.6 million for the year ended December 31, 2003. General and administrative expenses represented 9 percent of revenues for the year ended December 31, 2004 compared to 14 percent for the year ended December 31, 2003.

*Pension and retirement benefit.* In April 2004 Oridion announced the retirement of its founder and CEO. In July 2004, the annual general meeting of the shareholders resolved to grant the former CEO a package of ordinary shares and options to purchase ordinary shares of Oridion. The result being pension and retirement benefit expenses, which were expensed in the third quarter, 2004, in the amount of \$0.9 million, of which \$0.7 million are non-cash.

*Impairment of long-lived assets.* In line with management's decision to take a conservative view regarding the possibility of identify potential strategic/financial partners to commercialize its BreathID business, manufacturing equipment in the value of \$0.3 million has been written off as of December 31, 2004.

*Financial expenses, net.* For the year ended December 31, 2004, financial expenses, net, were \$0.3 million compared to financial expenses of \$0.2 million for the year ended December 31, 2003. The increase in expense resulted mainly from a lower average cash balance and receipt of a long-term loan.

*Net Loss.* The net loss decreased to \$3.9 million compared to \$6.2 million for 2003. On a pro-forma basis, without the write-off of BreathID inventory, the impairment of manufacturing equipment of BreathID and the one-time non-recurring charge for pension and retirement benefit, the Company would have made a net loss of \$1.5 million.

#### **Year ended December 31, 2003 compared to year ended December 31, 2002**

*Revenues.* For the year ended December 31, 2003, revenues increased by 29 percent to \$18.1 million compared to \$14.1 million for the year ended December 31, 2002. The increase in the sales is primary a result of growth in OEM capnography customer sales, new Capnography products launched and a significant increase in Capnography consumables. For the year ended December 31, 2003, 71 percent of revenues were derived from four of Oridion's customers, basically stable as compared to 72 percent in 2002. For the year ended December 31, 2003, sales to customers in the United States accounted for 70 percent, the same as in 2002, and sales to customers in Europe accounted for 25 percent in 2003 and 24 percent in 2002.

*Cost of revenues.* Cost of revenues for the year ended December 31, 2003, increased to \$10.1 million compared to \$7.8 million for the year ended December 31, 2002. The increase is a result of an increase in sales in 2003 and a write-off of \$0.4 million of BreathID inventory, resulting from the postponement of the BreathID U.S. activities.

*Gross margin.* Gross Margin decreased to 44.0 percent for the year ended December 31, 2003 from 44.2 percent for the year ended December 31, 2002. Pro-forma gross margin for fiscal year 2003 without the write-off of BreathID inventory, would be 46.0 percent.

*Research and Development expenses, net.* Research and development expenses, net, decreased to \$3.3 million for the year ended December 31, 2003, compared to \$3.6 million for the year ended December 31, 2002. The Company continues to invest in the development of many new Capnography products - both devices and consumables - currently in the pipeline and scheduled for launch in 2004 and beyond. In the Breath Testing business, Oridion completed development of its third Breath Test - Liver Function. Oridion's R&D team is continuing to develop additional applications for the BreathID platform for the diagnosis of a range of gastrointestinal disorders. Oridion funded its research and development out of the initial public offering proceeds and subsidies received from the Chief Scientist of Israel. Research and development expenses, net, represented 18 percent of revenues for the year ended December 31, 2003 compared to 26 percent for the year ended December 31, 2002.

*Selling and marketing expenses.* Selling and marketing expenses, net, for the year ended December 31, 2003, decreased to \$8.1 million compared to \$9.7 million for the year ended December 31, 2002. Selling and marketing expenses include the activities of Oridion's Capnography U.S. direct sales team. This team works together with Oridion's team of clinical education specialists in an effort to market Oridion's capnography products directly to end users in various medical care environments and has already proven instrumental in helping increase the sale of Oridion's consumable capnography products. These teams have also been active in educating various segments of the medical community on the benefits of Oridion's products, managing an increasing number of distributors currently selling Oridion's products, and training Oridion's constantly growing number of customers on how to use Microstream® enabled products. Further selling and marketing expenses include the activities of Oridion's European and Japanese marketing teams, established in 2001, to further enhance sales of Oridion's products to the installed base of Oridion's products in these countries.

Selling and marketing expenses for Oridion's breath testing business include three breath tests in clinical trials with leading European medical institutions in an effort to demonstrate to European, Israeli and Japanese opinion leaders on how the BreathID system helps address previously unmet clinical needs. In the U.S., where only Oridion's H. pylori breath test has received FDA clearance to date, the Company decided to suspend its pre-commercialization trial marketing and sales activities. The Company observed that only offering a single breath test for use with the BreathID system is not

# Management's Discussion and Analysis of Financial Condition and Results of Operations

sufficient to justify the required level of sales and marketing activities. Accordingly, commercialization was postponed until a platform of tests would be available.

Selling and marketing expenses, net, represented 45 percent of revenues for the year ended December 31, 2003, compared to 69 percent for the year ended December 31, 2002.

*General and administrative expenses.* For the year ended December 31, 2003, general and administrative expenses decreased to \$2.6 million compared to \$2.8 million for the year ended December 31, 2002. General and administrative expenses represented 14 percent of revenues for the year ended December 31, 2003 compared to 20 percent for the year ended December 31, 2002.

*Financial income (expenses), net.* For the year ended December 31, 2003, financial expenses, net, were \$(0.2) million compared to financial income of \$0.2 million for the year ended December 31, 2002. The decrease in income resulted mainly from a major reduction in the U.S. dollar interest rates and a lower average cash balance.

*Taxes.* For the year ended December 31, 2003, tax benefit was \$0.05 million as compared to tax benefit of \$0.08 million for the year ended December 31, 2002.

*Net Loss.* The net loss decreased to \$ 6.2 million compared to \$9.6 million for 2002.

## Financial Condition, Liquidity and Capital Resources

The Company had working capital of \$7.8 million at December 31, 2004, and \$7.1 million at December 31, 2003. Cash, cash equivalents and short-term deposits net of short-term bank credit amounted to \$6.3 million at December 31, 2004 and \$3.6 million at December 31, 2003. In May 2004, the Company entered into a loan agreement with a local bank for up to \$2.5 million with an option to increase the loan by an additional \$0.5 million, dependant on achieving certain covenants as of December 31, 2004. The loan proceeds have been invested in short-term deposits. The Company believes that its sources of funding – consisting of projected positive cash flow from operating activities, the availability of additional funds from banks and its accumulated cash and cash equivalents – will be sufficient to meet its short-term and long-term needs for operating activities, investing activities and financing activities.

Net cash provided by financing activities was \$1.9 million, \$0.8 million and \$0.004 million for fiscal years 2004, 2003 and 2002 respectively. The cash provided in 2004 was from proceeds from the \$2.5 million long-term loan, the issuance of ordinary stock under the Company's employee stock option plans less the return of \$0.8 million short-term bank credit. The cash provided in 2003 was from the receipt of short-term bank credit.

Net cash used for purchase of capital equipment was \$0.3 million and \$0.2 million for fiscal years 2004 and 2003 respectively. Mainly for the purchase of manufacturing and computer equipment. In addition \$2.5 million from the loan proceeds was invested in short term bank deposits. During the year ended December 31, 2002, cash provided by the sale of short-term deposits net of the purchase of production equipment, computer equipment and leasehold improvements, was \$9.2 million.

Net cash provided by operating activities for the year ended December 31, 2004, was \$0.2 million compared to net cash used in operating activities of \$5.7 million for the year ended December 31, 2003, and net cash used in operating activities of \$7.6 million for the year ended December 31, 2002. The improvements in cash flow in 2003 and 2004 were primarily due to the increase in sales, improved gross margins and a reduction in operating expenses.

*BreathID is a registered trademark of Oridion BreathID Ltd.*

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# Directive on Information Relating to Corporate Governance

## Preamble

Oridion Systems Ltd. (the “**Company or Oridion**”) was formed as a private limited liability company under the Israeli law on February 23, 1989 under the name of Elrad Analytical and Electro-Optical Systems Ltd. In May 1999, the Company’s name was changed to Oridion Systems 1989 Ltd. The Company changed its name from Oridion Systems 1989 Ltd. to Oridion Systems Ltd. in August 1999.

The Company’s registered office is at 7 HaMarpe Street, Jerusalem, Israel. The Company’s duration is for an unlimited period of time. The financial year of the Company is the calendar year.

The Company has the legal form of a public company with limited liability under Israeli law. As an Israeli corporation, the Company is required to comply with provisions and requirements of the Companies Law (as defined below) with respect to corporate governance of public companies as shall be described below.

## Definitions

In this annual report, the following terms shall have the meaning set opposite them:

“**Board of Directors**”, means the Board of Directors of the Company.

“**Companies Law**”, means the Israeli Companies Law 5759-1999.

“**Director**”, means a member of the Board of Directors of the Company.

“**Financial Statements**”, means the Consolidated Financial Statements of the Company for the calendar year ended on December 31, 2004.

“**Ordinary Shares**”, means Ordinary Shares of the Company par value NIS 0.01 each.

“**Oridion BreathID**”, means Oridion BreathID Ltd.

“**Oridion 1987**”, means Oridion Medical 1987 Ltd.

“**Outside Director**”, has the meaning set forth in the Companies Law, as detailed in Section 3.4.1 below.

“**Senior Manager**”, means each of the officers of the Company listed in Section 4.1 below.

“**Shareholders Register**”, means the Company’s register of shareholders to be kept in accordance with the provisions of the Companies Law.

“**Stock Option Plan**”, means any of the stock option plans approved by the Company, under which the Company may allocate options to purchase Ordinary Shares to employees, directors, consultants or other service providers of the Company and/or any of the Subsidiaries.

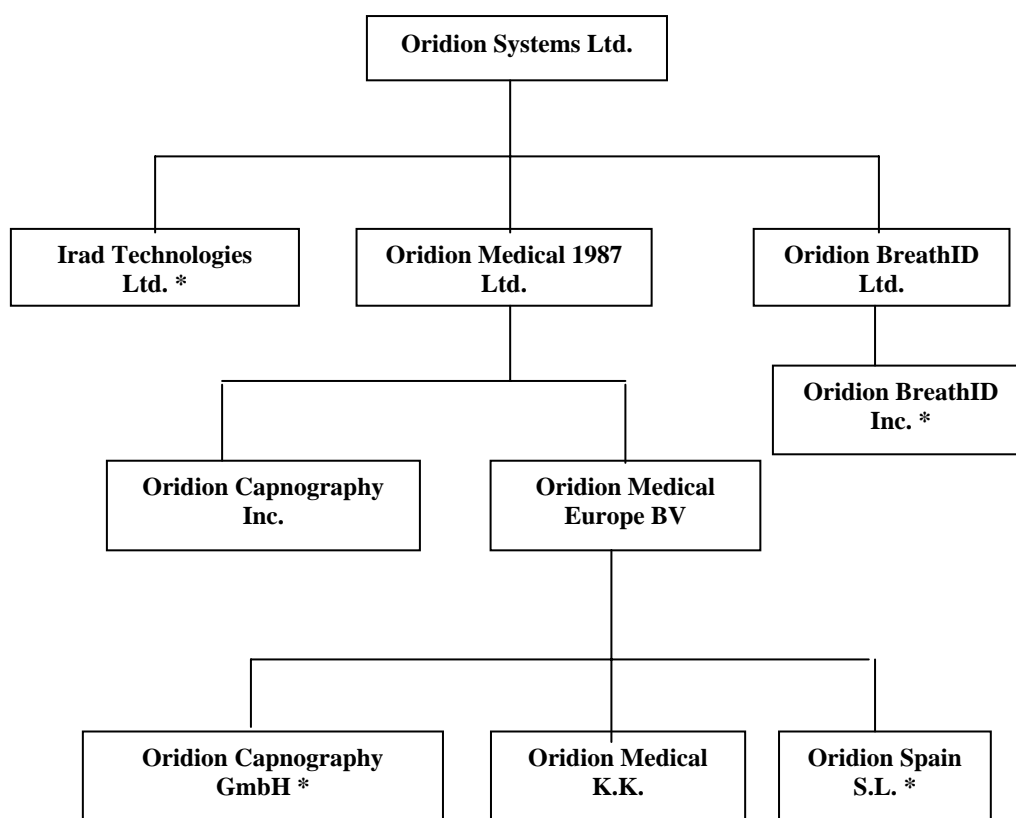
“**Special Resolution**”, means a resolution approved at a General Meeting of the Company by a majority of at least sixty-seven percent of the shareholders represented at such general meeting in person or by proxy.

“**Subsidiaries**”, means the corporations set forth in Section 1.1.3 below which are consolidated in the Company’s Financial Reports, and each of such corporations shall be referred to as a “**Subsidiary**”.

# 1. Group Structure and Shareholders

## 1.1 Group Structure

### 1.1.1 Description of the issuer's operational group structure



\* Dormant companies

The Company is a holding company, which directly wholly-owns and controls Irad Technologies Ltd., Oridion 1987 and Oridion BreathID; and indirectly wholly-owns each of the subsidiaries of Oridion 1987 and Oridion BreathID. The Company and its Subsidiaries design, manufacture and market proprietary medical devices and consumables that utilize its core Microstream™ technology in patient safety monitoring and point-of-care diagnostic testing.

Research and development, production and certain sales and marketing activities for Europe, are carried out by Oridion 1987 and Oridion BreathID. Other sales and marketing activities and clinical research activities around the world are carried out by the remaining Subsidiaries.

For more information, see Note 2 to the Financial Statements.

1.1.2 Listed Company: Oridion Systems Ltd., Jerusalem, Israel. Listed on SWX Swiss Exchange. Market capitalization as of December 31, 2004 was CHF 49.92 million. Percentage of shares of Oridion held by any of its Subsidiaries in 2004 was nil. The Company's ISIN security number is IL 0010837818. None of the Company's subsidiaries are publicly listed.

# Directive on Information Relating to Corporate Governance

1.1.3 The significant unlisted consolidated Subsidiaries of the Company are as follows:

Company Name	Domicile	Share Capital (in USD 000's)	% of Ownership
Oridion 1987	Israel	1,015	100
Oridion BreathID	Israel	1	100
Oridion Capnography Inc.	United States	100*	100
Oridion Medical Europe BV	Netherlands	18	100
Oridion Medical K.K.	Japan	84	100

\*The amounts are in actual numbers.

## 1.2 Significant Shareholders

Approximately 6.3% of the Company's shares is owned by 3V Asset Management Ltd. ("3V"), Zurich, Switzerland.

Other than 3V, the Company has not received any reports from its shareholders, and is not aware of any other shareholders or groups of shareholders who hold, as of the date of the Financial Statements, or the date of this report significant shareholdings of the Company.

## 1.3 Cross Shareholdings

The Company does not have any cross-shareholdings in any other joint stock Company that exceed 5% of the capital shareholdings or voting rights, either in the Company or such other joint stock Company.

## 2. Capital Structure

For information regarding the Company's share capital, see the Consolidated Balance Sheet of the Company as of December 31, 2004 and Note 10 to the Financial Statements.

### 2.1 Capital

On December 31, 2004 the authorized share capital of the Company consisted of NIS 200,000 divided into 20,000,000 Ordinary Shares, of which 11,092,853 Ordinary Shares were issued and outstanding.

### 2.2 Authorized and Conditional Capital in Particular

Under the Companies Law, the authorized share capital represents the maximum amount of shares, which are authorized for issuance by the Company. Should the Company wish to increase the number of its issued and outstanding Ordinary Shares beyond 20,000,000, it would have to increase its authorized share capital. Any such increase requires a Special Resolution of the shareholders. Any increase of the authorized share capital is valid as of the date of the approval thereof by the General Meeting of the Shareholders and should be reported to the Israeli Registrar of Companies within fourteen days thereafter. Authorized share capital, or any increase thereof, is not limited in time. However, the shareholders may, at a general meeting, cancel any authorized share capital that is not yet issued, provided that the Company has not undertaken any commitment to issue Ordinary Shares out of such authorized and unissued share capital.

The Board of Directors of the Company is the corporate body that may, from time to time, issue Ordinary Shares out of the authorized share capital. There exist no limitations by the authority of the Board of Directors to issue Ordinary Shares, as of the date hereof, for certain limitations under law regarding the issuance of shares to officers and directors and other “interested persons,” which require the additional approval of the shareholders of the Company and relating to the grant of options, as described further in this Section 2.2. Any such issuance of Ordinary Shares is valid as of the date of the approval thereof by the Board of Directors of the Company or any other date determined by the Board of Directors. The Company is obligated to report of any issuance of Ordinary Shares to the Israeli Registrar of Companies.

The Articles of Association of the Company contain a pre-emptive rights provision, according to which the shareholders of the Company are entitled to participate, pro rata, in any issuance of shares of the Company at a price per share less than the fair market value of the Company’s Ordinary Shares, except for grants of options to employees and service providers and affiliates thereof approved by the Company’s Board of Directors and the exercise of such options. Such pre-emptive rights could be cancelled by a Special Resolution amending the Articles of Association.

In addition, pursuant to the Articles of Association of the Company, the Board of Directors may from time to time determine the number of shares to be allocated to a stock option plan of the Company, provided that: (i) in the event the number of shares allocated to all such new Stock Option Plans, to be adopted after February 3, 2001, is in excess of fifteen percent, in the aggregate, of the issued and paid up share capital of the Company at such time, such allocation should be approved by shareholders who hold not less than sixty seven percent of the shares represented at the general meeting in which the allocation of options is discussed; or (ii) if the number of shares is less than the aforesaid amount, such allocation should be approved by a simple majority of the shareholders participating at the general meeting at which the allocation of options is discussed. This constitutes a limitation on the authority of the Board of Directors to issue share capital, as described above.

### **2.3 Changes of Capital**

The following changes of capital have taken place between January 1, 2001 and December 31, 2004:

As of December 31, 2000 the authorized share capital of the Company consisted of NIS 200,000 divided into 20,000,000 Ordinary Shares par value NIS 0.01 each (the “Ordinary Shares”). On such date the Company had 10,124,363 Ordinary Shares issued and outstanding.

In the year 2001 employees and service providers of the Company exercised options to purchase 376,058 Ordinary Shares.

In the year 2002, employees exercised options to purchase 1,000 Ordinary Shares.

In the year 2003 no additional Ordinary Shares were issued.

In the year 2004, 591,432 Ordinary Shares were issued, including 118,751 Ordinary Shares to employees upon the exercise of options, 19,750 Ordinary Shares to Service providers upon the exercise of options, and 52,931 Ordinary Shares to warrant holders upon the exercise of warrants held by Bank Mizrahi in connection with a credit facility.

In July 2004, an Extraordinary Shareholders Meeting approved the decision of the Board of Directors to issue 400,000 Ordinary Shares to the former-CEO, Mr. George Yariv.

For further information, see the Statements of Changes in Shareholders’ Equity (Deficiency) in the Financial Statements of the Company.

# Directive on Information Relating to Corporate Governance

## 2.4 Shares and Participation Certificates

As of December 31, 2004 the authorized share capital of the Company consisted of NIS 200,000 divided into 20,000,000 Ordinary Shares, of which 11,092,853 Ordinary Shares were issued and outstanding. There is no other class of shares in the authorized or outstanding share capital of the Company other than the Ordinary Shares. All the outstanding Ordinary Shares of the Company are fully paid.

Under the Articles of Association of the Company, the liability of the shareholders of the Company for the Company's obligation is limited to the par value of each of the Ordinary Shares held thereby.

The rights attached to the Company's Ordinary Shares, under the Articles of Association of the Company and the Companies Law, are as follows:

### Voting Rights

Beneficial holders of Ordinary Shares have one vote for each Ordinary Share held by a beneficial holder on all matters submitted to a vote of shareholders. However, the General Meeting of the Shareholders has the authority to create, and the Board of Directors could then issue, shares with different voting rights.

Pursuant to the Articles of Association of the Company, any shareholder may vote at a general meeting either in person or by proxy, or, if the shareholder is a corporation, by a representative authorized pursuant to Articles of Association.

For further information, see Section 6 below.

### Nomination of Directors

For information, see Section 3.4 below.

### Dividend rights

Holders of Ordinary Shares of the Company are entitled to receive dividends, in cash, shares or otherwise, if distributed. The Company may, by a resolution of a general meeting of the Company's shareholders, following a recommendation by the Board of Directors, distribute to the holders of Ordinary Shares dividends, out of profits of the Company, as defined in the Companies Law, and subject to the provisions thereof. Such rights of the Ordinary Shares may be affected by the grant of preferential dividends or distribution rights to the holders of a class of shares with preferential rights, which may be authorized in the future by a Special Resolution of the shareholders of the Company.

### Liquidation Rights

In the event of winding-up of the Company, the shareholders of the Company shall share, pro rata, but subject to any preferential liquidation rights by holders of any class of shares with preferential rights, if such class is created, in all assets remaining after payment of all liabilities and preferential rights under Israeli law, such as: certain land taxes, specific charges, liquidation expenses and employees' wages up to a certain sum, taxes withheld but not yet delivered to the tax authorities, municipal taxes, any taxes relating to the previous tax year, lease fees, and floating charges. The Company may recognize any official appointed to wind-up, dissolve or otherwise liquidate a corporate member, and a trustee, manager, receiver, liquidator or similar official appointed in bankruptcy or in connection with the reorganization of, or similar proceedings with respect to, a shareholder or its properties (each of the above shall be referred to as "**Appointee**"), as being entitled to the shares registered in the name of such shareholder. Any Appointee, upon producing such evidence as the Board of Directors may deem sufficient as to such Appointees authority to act in such capacity, shall with the consent of the Board of Directors (which the Board of Directors may grant or refuse in its

absolute discretion), be registered as a shareholder in respect of such Ordinary Shares, or may, subject to the regulations as to transfer herein contained, transfer such Ordinary Shares.

#### Special Rights; Modification of Rights

Subject to the Articles of Association of the Company, and without prejudice to any special rights previously conferred upon the holders of existing shares in the Company, the Company may, from time to time, by Special Resolution, provide for shares with such preferred or deferred rights or rights of redemption or other special rights and/or such restrictions, whether in regard to dividends, voting, repayment of share capital or otherwise, as may be stipulated in such Special Resolution.

In addition, the rights attached to any class (unless otherwise provided by the terms of issue of such class), such as voting rights and rights to dividends, may be varied with the written consent of the holders of sixty-seven percent of the issued shares of such class or the sanction of shareholders who hold the majority of the voting rights represented at a separate class meeting of the holders of the shares of such class.

## **2.5 Bonus Certificates**

As of December 31, 2004, the Company has not issued any bonus certificates.

## **2.6 Limitations on Transferability and Nominee Registrations**

2.6.1 **T**he ownership or voting of the Ordinary Shares by non-residents of Israel is not restricted in any way by the laws of Israel or the Articles of Association of the Company, except with respect to citizens of countries which are in a state of war with Israel.

Pursuant to the Company's Articles of Association, subject to contractual agreements to the contrary, fully paid Ordinary Shares may be transferred freely. No transfer of shares shall be registered in the Shareholders Register unless a proper writing or instrument of transfer has been submitted to the Company (or its transfer agent), together with the share certificate and such other evidence of title as the Board of Directors of the Company may reasonably require. Until the transferee has been registered in the Shareholders Register, the Company will continue to regard the transferor as the owner thereof.

Except as provided for in this Section 2.6, the Articles of Association of the Company do not contain provisions, which relate to group clauses or exceptions.

2.6.2 There were no exceptions regarding transferability of Ordinary shares in 2004.

2.6.3 The Ordinary Shares of the Company have been delivered into collective custody at SAG SEGA Aktienregister AG ("**SAG**"), and are issued in book entry form only. All Shares were held by the Swiss Nominee Company ("**SNOC**"). The Company was informed by SIS Segaintersettle AG ("**SIS**") that on June 28, 2001 SNOC was merged into SIS, and SIS undertook SNOC's obligations and liabilities towards the Company. Following said merger, SIS also acts as record owner of all Ordinary Shares on behalf of the beneficial owners of such Ordinary Shares in order to comply with certain legal requirements under the Companies Law, according to which a shareholder of record is any person who agrees to become a shareholder and whose name is registered in the Company's official register of record shareholders. Under Israeli law, issuance of shares should also be recorded with the Israeli Registrar of Companies.

As described above, beneficial ownership of Ordinary Shares are recorded on the books of SAG. On request, beneficial shareholders will be issued non-negotiable certificates without coupons attached evidencing their beneficial ownership of

# Directive on Information Relating to Corporate Governance

Ordinary Shares. Beneficial shareholders may become a shareholder of record of the Company by issuing written instructions to SAG, following which such shareholder's name will be recorded in the Company's official register of record shareholders and in the Israeli Registrar of Companies.

Under the Companies Law, a shareholder who is a trustee shall be registered as shareholder at the Company's Shareholders Register by mentioning the fact that he is a trustee.

2.6.4 Under the Articles of Association of the Company, the introduction of transfer restrictions into the Articles of Association of the Company will be approved only by a Special Resolution of the shareholders at a general meeting. For more information, see Section 2.4 above.

## 2.7 Convertible Bonds and Warrants /Options

### Convertible Bonds

There are no outstanding Convertible Bonds of the Company as of December 31, 2004.

### Warrants

In connection with a loan received by the Company from Bank Mizrahi, the Company issued to the bank a warrant to purchase up to 368,853 Ordinary Shares of the Company, at an exercise price of CHF 2.206 per share. In November 2004, the bank exercised 50% of the warrants by way of cashless exercise into 52,931 Ordinary Shares. As of December 31, 2004, 184,427 Ordinary Shares may still be purchased under the warrant to the bank.

### Options

As of December 31, 2004, the Company had allocated options to purchase up to 2,137,116 Ordinary Shares under its Stock Option Plans. The options were allocated with a subscription ratio 1:1, and allocated options expire on the seventh anniversary date of each option allotment date. The vesting period of such options ranges between three to four years and the average exercise price purchase is \$ 1.78.

For information of the Company's Stock Option Plans, see Note 10b to the Financial Statements.

## 3. Board of Directors

### 3.1 Members of the Board of Directors

The members of the Board of Directors of the Company are as follows:

Name of Director	Nationality	Position
Alan Adler	United States	Director (Chairman) and Chief Executive Officer
George Yariv	Israel	Director
Fred Robertson	United States	Director
Karen Sarid *	Israel	Director
Daniel Kropf	Italy	Director
Max Reis	Israel	Director
Raphael Melmed	Israel	Outside Director
Yerahmiel Egert	Israel	Outside Director

\* Karen Sarid was elected as Director on February 17, 2005. All other members of the Board of Directors were members as of December 31, 2004.

As of December 31, 2004, other than Mr. Adler, all of the Company's Directors are non-executive Directors. During 2004, Mr. George Yariv, was an executive director of the Company. On March 31, 2004, Mr. Yariv resigned from the position of Chief Executive Officer and President of the Company and is currently serving as a non-executive director.

**Alan Adler**, Chairman of the Board and Chief Executive Officer, has been a member of the Company's Board of Directors since November 1994 and was Chairman of the Board of Directors from December 1994 to July 2000 and again since May 2003. Mr. Adler has 14 years of prior experience as a consultant and partner with McKinsey & Company and has been a senior partner at the Evergreen Partners' Venture Capital group for the past 10 years. He has served as a Director on numerous Boards of technology and medical device companies. Mr. Adler holds an M.Sc. degree in Mathematics from Rensselaer Polytechnic Institute and an M.B.A. degree with honors from Stanford University.

**George Yariv**, Director, has been a member of the Board since the Company's inception. Mr. Yariv is the Company's former President and Chief Executive Officer, having resigned from this position on March 31, 2004. Mr. Yariv co-founded the company in 1987, and led the Company through several stages of growth, including its initial public offering in 2000, product development, and establishing marketing and technical functions. Prior to founding the Company, Mr. Yariv founded IRAD Technologies Ltd. in 1985 (which later evolved into the Company) in which he served as president and chief executive officer. Mr. Yariv holds a M.S. degree in physics from the Hebrew University of Jerusalem, Israel.

**Dr. Fred Robertson**, Director, has been a member of the Board since September 2002. Since January 2005, Dr. Robertson has served as CEO of TomoTherapy, a developer and manufacturer of radiation oncology therapeutic equipment. Prior to this he held a faculty appointment as assistant Professor of Anesthesiology at the Medical College of Wisconsin with both teaching and clinical responsibilities in Pediatric Anesthesiology, while also conducting original research in physiologic monitoring technology. Prior to this appointment, Dr. Robertson served as CEO and President at GE-Marquette Medical Systems. Dr. Robertson qualified as a medical doctor from the University of Wisconsin and holds an M.B.A. degree from San Diego State University.

**Karen Sarid**, Director, was elected as a member of the Board of Directors on February 1, 2005. Ms. Sarid is currently the Chief Operating Officer and General Manager of Orex Ltd. - private medical devices technology company founded in 1996 which is active in the development, manufacturing and marketing of innovative and proprietary advanced radiograph systems for use in the digital X-Ray market. Orex Ltd. was recently acquired by Kodak Inc. Ms. Sarid has over 20 years of senior management experience in a number of international technology companies, and has served as the Chief Financial Officers for a number of publicly traded companies including ESC Medical Systems Ltd. and Lanoptics Ltd. Ms. Sarid is currently a board member of Forsoft Ltd. - a subsidiary of the Formula Group and Lanoptics Ltd. an Israeli company traded on Nasdaq. Ms. Sarid holds a B.A. degree in Economics and Accounting from the University of Haifa, Israel.

**Daniel Kropf**, Director, has served as a Director of the Company since 1996. Following training with American Hospital Supply in the United States, he entered the businesses of Laboratori Don Baxter and Eurospital in Trieste, Italy, founded by his late father and managed by his mother. He later took responsibility for a French distribution house, which now forms part of the Gamida for Life Group of companies, and chaired Migada Ltd., a medical device manufacturing company in Israel. Having made his home in Israel at the end of the 1980s, Mr. Kropf is now the chairman of the Gamida for Life companies there, including Nasdaq-quoted Healthcare Technologies Ltd., as well as a director of several other companies both in Israel and abroad. In addition to his extensive business commitments, Mr. Kropf is the chairman of Education for Life, a non-profit foundation based in the Netherlands, the Secretary-General of the Centre Europeen Juif d'Information ("CEJI") in Brussels, a lifetime member of the ADL National Commission in the USA and the chairman of the Israeli Center for Nonviolent Communication ("MILA"). Mr. Kropf graduated in marketing at the School of Industrial Administration of the University of Torino.

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**Dr. Max Reis**, Director, was President of the Israel Institute of Technology from 1986-1990 and a Senior Vice President for Israel Chemicals Ltd from 1975-1986. Dr. Reis spent 8 years on the Board of the Union Bank of Israel and currently sits on the Board of many companies including Teva Pharmaceutical Industries, Degem Systems and Gaon Holdings. Dr. Reis holds a Ph.D. degree in Chemical Engineering from the University of London and received a “Fellowship of the City and Guilds of London Institute” for his contribution to the chemical industry and the advancement of science and technology.

On April 2, 2003, Oridion Medical 1987 Ltd., a Subsidiary of the Company, entered into a Consulting Service Agreement with Dr. Reis, a non-executive Director of the Company (the “**Reis Consulting Agreement**”) under which Dr Reis spends four days per month providing consultation services to the Company and its Subsidiaries. The term of the Reis Consulting Agreement is for six months commencing in May 1, 2003, and is automatically extended by additional periods of six months, unless either party notifies the other party of its intention not to extend the Reis Consulting Agreement. For information regarding the Reis Consulting Agreement, see Section 5.7 below.

**Professor Raphael Melmed**, Director, is an Outside Director of the Company. On January 29, 2004 he was reappointed to the Oridion Board after serving an initial period of three years from 2000 to 2003. Professor Melmed has worked as a senior physician in the Hadassah University Hospital Ein Kerem in Jerusalem since 1973. Professor Melmed is an Associate Professor of Medicine at the Hebrew University-Hadassah Medical School and served as an outside director in Rosebud Medical Ltd. from 1996 to 2000.

**Yerahmiel Egert**, Director, is an Outside Director of the Company. On January 29, 2004, he was reappointed to the Board of Directors after serving an initial period of three years from 2000 to 2003. Mr. Egert was the managing director of Har Hotzvim Technology Entrepreneurship Center from 1992 to November 2003. From 1998 to 1991, Mr. Egert was a business consultant to private enterprises in industry, agriculture and transportation. From 1984 to 1987, Mr. Egert was managing director of Advanced Plating Technologies, responsible for the development, manufacturing and export of technologies to coating industries. During the years 1979-1984 he served as chief economist and director of Clal Industries, a major industrial holding group. Mr. Egert serves as a Board member of Spectronix Ltd. an Israeli company traded on the Tel Aviv Stock Exchange (TASE). Mr. Egert holds an M.B.A. degree from the Hebrew University of Jerusalem.

None of the members of the Board of Directors, with the exception of Alan Adler and George Yariv, as described above, has been a member of the senior management of Oridion Systems Ltd. or one of its subsidiaries during the three financial years preceding the year 2004. With the exception of Dr. Max Reis, none of the other non-executive members of the Board of Directors has significant business connections with Oridion Systems Ltd. or any of its subsidiaries.

## 3.2 Other Activities and Vested Interests

None of the members of senior management have activities in governing and supervisory bodies of important Swiss and foreign organizations, institutions or foundations, nor do they have permanent management and consultancy functions for important Swiss and foreign interest groups.

## 3.3 Cross-involvement

There are no cross involvements among the Board of Directors of Oridion Systems Ltd. And the Board of Directors of other listed companies.

## 3.4 Elections and Terms of Office

### 3.4.1 Appointment of Directors

The Company's Articles of Association provide for a Board of Directors consisting of five to ten Directors. Each Director, other than an Outside Director, as specified below, is elected to serve at the Annual General Meeting of the Company until the next Annual General Meeting of the Company's shareholders, unless the Director is removed earlier in accordance with the provisions of the Articles of Association of the Company. The Ordinary Shares do not have cumulative voting rights in the election of Directors. Other than with respect to an Outside Director, the holders of Ordinary Shares conferring more than fifty percent of the voting power of the Company have the power to appoint a Director, to remove a Director from office, to elect Directors instead of Directors so removed or to fill any vacancy, however created, in the Board of Directors. Under the Companies Law, a corporation is also entitled to serve as a Director of the Company, provided that such elected corporation shall appoint an individual qualified to serve as Director as its representative at the Board of Directors.

#### Outside Director

Under the Companies Law, as a public company the Company is required to appoint two Outside Directors. The appointment of an Outside Director under the Companies Law or the removal thereof from such position must be approved by a general meeting of shareholders of the Company, provided that either: (a) the majority of shares voted at the meeting, including at least one third of the shares of non-controlling shareholders voted at the meeting, vote in favor of such appointment; or (b) the total number of shares voted against such appointment does not exceed one percent of the aggregate voting rights in the Company. The term of serving of an Outside Director is three years. Such term may be extended for one additional three year period. At the extraordinary General Meeting of the Shareholders of the Company held in January 2004, the shareholders appointed Professor Raphael Melmed and Mr. Yerahmiel Egert as the Company's Outside Directors for the second and final three year term.

Under the Companies Law, to qualify as an Outside Director, an individual may not have, and may not have had at any time during the two years prior to such appointment, any affiliations with the Company or its affiliates, as such terms are defined in the Companies Law. In addition, no individual may serve as an Outside Director if the individual's position or other activities thereof create or may create a conflict of interest with his or her role as an Outside Director, or may adversely affect such role. For a period of two years from the termination of the term of office as Outside Director, a former Outside Director may not serve as a Director or employee of the Company or provide, directly or indirectly, professional services to the Company for consideration.

#### Removal of Directors

Under the Articles of Association of the Company, a Director's term of office, excluding the Outside Directors as described above, shall be terminated before the end of the applicable period for any of the following reasons: (i) the Director resigned or was dismissed; (ii) the Director was convicted of an offense; (iii) by decision of the court; or (iv) the Director was declared bankrupt, and if it is a corporation, is in process of voluntary or involuntary liquidation, all in accordance with the provisions of the Companies Law.

In addition, the Board of Directors by an ordinary majority may from time to time appoint any other person as a Director, whether to fill a vacancy or in addition to those of their body. Any Director so appointed shall hold office until the first general meeting convened after such appointment and may be re-elected.

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- 3.4.2 The Company's Directors were first appointed, and their office is expected to terminate, at the following dates:

Name	Date of First Election of the Director	Date of Termination of Office
Alan Adler	December 1, 1994	the coming Annual General Meeting of the Shareholders (the "Next AGM")
George Yariv	February 23, 1989	the Next AGM
Fred Robertson	July 16, 2002	the Next AGM
Karen Sarid	February 17, 2005	the Next AGM
Daniel Kropf	April 20, 1996	the Next AGM
Max Reis	April 24, 2003	the Next AGM
Raphael Melmed*	January 30, 2001	January 29, 2007
Yerahmiel Egert*	January 30, 2001	January 29, 2007

\* Outside Director.

### 3.5 Internal Organizational Structure

- 3.5.1 Except as provided for in Section 3.1 above and in this Section 3.5, the Company has not allocated additional tasks to any of its Directors nor delegated any personal responsibilities to its Directors. For information regarding the membership of the Directors at the Board Committees, see clause 3.5.2 below.

#### Chairman and Co-Chairman of the Board of Directors

Under the Articles of Association of the Company, the Board of Directors may from time to time, elect one of its members to be the Chairman of the Board of Directors, and another of its members as Co-Chairman, remove such Chairman and Co-Chairman from office and appoint others in their place. The Chairman of the Board of Directors shall preside at every meeting of the Board of Directors, but if there is no such Chairman, or if at any meeting he is not present within fifteen minutes of the time fixed for the meeting or if he is unwilling to take the chair, the Co-Chairman shall preside. If both the Chairman and the Co-Chairman are not present or are unwilling to take the chair the Directors present shall choose one of their member to be the Chairman of such meeting. The Chairman shall not be entitled to a second or casting vote as a Director. To date no Co-Chairman has been appointed.

- 3.5.2 Board Committees

#### General

Subject to the provisions of the Companies Law and the Articles of Association of the Company, the Board of Directors may delegate any or all of its powers to Committees as the Board of Directors deems appropriate. In exercising such powers, each Committee shall observe any terms and conditions imposed on it by the Board of Directors. Any such Committee, which is authorized to exercise powers of the Board of Directors, must include at least one Outside Director. The Audit Committee must include all Outside Directors.

Under the Companies Law and the Articles of Association of the Company, the Board of Directors shall not delegate its powers on the following subjects to any of its Committees, except for purpose of recommendations only: (i) determination of the Company's economic policy; (ii) dividend distribution; (iii) determining the Board of Directors' standpoint on a matter that requires approval by the general meeting, or giving an opinion with respect to a special tender offer as required under the Companies Law; (iv) appointment of Directors; (v) issuance or allocation of the

Company's securities and convertible securities; (vi) approval of the Company's Financial Statements; and (vii) approval of interested parties transactions or actions which were made by breaching of a fiduciary duty, which under Companies Law require Board of Directors approval.

Audit Committee

Under the provisions of the Companies Law, the Board of Directors of the Company is required to appoint an Audit Committee whose members shall include all Outside Directors of the company. The number of members of such a committee must not be less than three. The Chairman of the Board of Directors of the Company and/or any Director who is employed by the Company or provides services thereto on a regular basis and/or a controlling shareholder or a relative thereof, cannot be a member of the Audit Committee.

The role of the Audit Committee is to examine flaws in the business management of the company, in consultation with the internal auditor and the external auditors of the Company, and to propose remedial measures to the Board of Directors. The Audit Committee also reviews for approval transactions between the company and officers, Directors or other interested parties (as set forth in the Companies Law).

Stock Option and Compensation Committee

The Board of Directors of the Company has appointed a Stock Option and Compensation Committee to make recommendations to the Board of Directors concerning employees and service providers stock options and other kinds of compensation.

Investment and Budget Committee

The Board of Directors of the Company has appointed an Investment and Budget Committee to make recommendations to the Board of Directors relating to the Company's banking and investment activities.

The following table sets forth the membership of each of the Company's Directors at the Committees of the Board:

<b>Name</b>	<b>Audit Committee</b>	<b>Stock and Compensation Committee</b>	<b>Investment and Budget Committee</b>
Alan Adler		<b>x</b>	<b>x</b>
George Yariv		<b>x</b>	<b>x</b>
Daniel Kropf		<b>x</b>	
Yerahmiel Egert*	<b>x</b>		<b>x</b>
Raphael Melmed*	<b>x</b>	<b>x</b>	
Max Reis			<b>x</b>
Karen Sarid	<b>x</b>		

\* Outside Director.

3.5.3 Meetings and Work Methods

Board of Directors

Under the Articles of Association of the Company, the Board of Directors may meet and adjourn its meetings, subject to the provisions of the Articles of Association, and otherwise regulate such meetings and proceedings as the Directors think fit, in accordance with the Company's needs and at least once in every ninety days. Any Director may at any time, and the Company's secretary shall, upon the request of

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such Director, convene a meeting of the Board of Directors, but not less than seven days' notice shall be given of any meeting so convened. Notice of any such meeting may be given orally, by telephone, in writing or by mail, e-mail, telex, cablegram or facsimile. Notwithstanding anything to the contrary herein set forth, failure to deliver notice to a Director of any such meeting in the manner required hereby may be waived by such Director, and a meeting shall be deemed to have been duly convened notwithstanding such defective notice if such failure or defect is waived prior to action being taken at such meeting, by all Directors entitled to participate at such meeting to whom notice was not duly given as aforesaid. In addition, the Board of Directors may convene without a notice, if all the Directors waived their right to receive such notice.

All acts done bona fide at any meeting of the Board of Directors, or of a committee of the Board of Directors, or by any person acting as Director, shall, notwithstanding the fact that it may afterwards be discovered that there was some defect in the appointment of the participants in such meetings, or that they or any of them were disqualified, be as valid as if there were no such defect or disqualification.

Until otherwise unanimously decided by the Board of Directors, a quorum at a meeting of the Board of Directors shall be constituted by the presence in person, by telephone conference or by any other means of communication provided that all participating directors will be able to hear each other simultaneously, of a majority of the Directors then in office who are lawfully entitled to participate in the meeting.

Under the Articles of Association of the Company, minutes of each meeting of the Board of Directors shall be recorded and duly entered in books provided for that purpose, and shall be held by the Company at its principal office or its registered office or such other place as shall have been determined by the Board of Directors. Such minutes shall, in all events, set forth the names of the persons present at the meeting and all resolutions adopted thereat. Any minutes as aforesaid, if purporting to be signed by the chairman of the meeting or by the chairman of the next succeeding meeting, shall constitute prima facie evidence of the matters recorded therein.

### Board Committees

Under the Companies Law, the provisions concerning the meetings of the Board of Directors apply also with respect to meetings of Board Committees.

### Work Methods

The Board of Directors of the Company meets at least once in a quarter. Each of the Board Committees conducts its meetings according to the needs of the relevant Board Committee. The length of each meeting of a Board Committee or of the Board of Directors usually ranges between two to five hours. During fiscal year 2004, the Board of Directors convened six times.

## **3.6 Definition of Areas of Responsibility**

### Board of Directors

In addition to all other authorities set forth in the Companies Law or as may be determined by the shareholders of the Company, pursuant to the Articles of Association of the Company, the Board of Directors shall determine the Company's policy and shall monitor the activities of the Chief Executive Officer. As part of such responsibilities, the Board of Directors: (i) shall determine the Company's plans of activity; (ii) shall examine the Company's financial situation and set the framework of the Company's credit; (iii) shall determine the organizational structure and the wage policy of the Company; (iv) may issue securities, convertible securities and/or debentures of the Company; (v) shall be responsible of the preparation and approval of the Company's Financial Statements; (vi) shall appoint and

dismiss the Chief Executive Officer of the Company; and (vii) may declare a dividend distribution. The powers of the Board of Directors described herein may not be delegated to the Chief Executive Officer of the Company.

The Board of Directors may appoint one or more persons, whether or not Directors, as Chief Executive Officer, President or other Senior Managers of the Company and may determine the duties authorities and title of such officer.

#### Senior Management

Unless otherwise determined by the Board of Directors, Senior Managers headed by the Company's Chief Executive Officer, have the authority and responsibility with respect to the management of the day-to-day activities and operation of the Company in the ordinary course of business.

Each of the Company's Senior Managers is employed by the Company on a full time basis. Senior Managers of the Company, excluding the Chief Executive Officer, are appointed and removed from office by the Company's Chief Executive Officer.

### **3.7 Information and Control Instruments *vis-à-vis* the Senior Management**

The manager of the risk-management system and the manager of the information system of the Company are required to report directly to the Chief Operating Officer of the Company. Thereafter the Chief Operating Officer of the Company submits his conclusions and recommendations to the Chief Executive Officer of the Company and thereafter the Chief Executive Officer submits his report to the Board of Directors.

#### Internal Auditor

Under the Companies Law, the Board of Directors is required to appoint an internal auditor proposed by the Audit Committee. The internal auditor may be an employee of the company, but may not be an interested party or office holder, or a relative of any interested party or officer, and may not be a member of the Company's independent accounting firm. The role of the internal auditor is to examine, among other things, whether the Company's activities comply with the law and with orderly business procedure. Accordingly, the Company appointed an internal auditor who reports directly to the Audit Committee of the Board of Directors of the Company.

## **4. Management Board**

### **4.1 Senior Management**

The members of the Senior Management of the Company and its Subsidiaries are as follows:

<b>Name of Officer</b>	<b>Nationality</b>	<b>Position</b>
Alan Adler	US	Director (Chairman) and Chief Executive Officer
Yacov Bubis	Israel	Chief Operating Officer
Walter Tabachnik	Israel	Chief Financial Officer
Gerald Feldman	US	President of Capnography
Ephraim Carlebach	Israel	Senior Vice President Research and Development Capnography
Shlomo Ruach	Israel	Senior Vice President Operations
Joshua Colman	Israel	Chief Technology Officer of Capnography
Ilan Ben Oren	Israel	Chief Technology Officer of Breath Testing

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**Alan Adler**, Director (Chairman) and Chief Executive Officer of the Company, please see Section 3.1 above.

**Yacov Bubis**, Chief Operating Officer, co-founded the Company with Mr. Yariv. Since 1987, Mr. Bubis has served in various positions with the Company, including in project management and as R&D manager. Mr. Bubis served as the Company's OEM Marketing Manager from January 1994 to December 1996. He has acted as Chief Operating Officer since January 1997. Mr. Bubis holds a Bachelor of Arts degree in economics and business management from the Hebrew University of Jerusalem.

**Walter Tabachnik**, Chief Financial Officer, brings to the Company several years of international and Israeli experience. He previously served as the chief financial officer for Ashot Ashkelon Industries Ltd., a company traded on the Tel Aviv Stock Exchange, as well as for Russells Furnishers Ltd., a South African national multiple outlet retail company. Mr. Tabachnik managed the Company's initial public offering and the follow on offering on the Swiss Stock Exchange. Mr. Tabachnik is a certified public accountant and holds a Bachelor of Arts degree in economics and accounting from the Hebrew University of Jerusalem.

**Gerald Feldman**, President Oridion Capnography, joined Oridion in September 2003 and is responsible for Capnography activities worldwide. Prior to joining Oridion, Mr. Feldman held senior management positions including President of the Clinical Diagnostics Division at Thermo Electron Corporation and President of International Technidyne Corporation of Edison New Jersey (USA) before and after its sale to Thermo. His prior positions were in health care including a long tenure as hospital administrator at the John F. Kennedy Medical Center in New Jersey, USA. Mr. Feldman has an M.B.A. and an M.P.H. from Columbia University and a B.A. from Queens College of CUNY (City University of New York).

**Dr. Ephraim Carlebach**, Senior Vice President Research and Development, has served as the Chief Technology Officer of the Company since November 1996. Prior to joining the Company, Dr. Carlebach served in various engineering and management positions, most recently as manager of technologies at Scitex Corporation. Prior to that, Dr. Carlebach served as electronic design manager at Indigo Graphics Systems, where he was responsible for the development of control and data processing electronics. Dr. Carlebach has over fifteen years of diversified experience in managing complex projects and leading inter-disciplinary development teams and holds various patents in the field of real-time processing systems. He holds a Bachelor of Arts degree in Electronic Engineering from the Fachhochschule Aachen (Germany), a M.Sc. in Computer Simulation from the University of Salford (UK), and a Ph.D. in Electrical Engineering from the University of London.

**Shlomo Ruach**, Senior Vice President Operations, joined the Company in June 1987, and has served in various positions related to manufacturing, operations and development. Mr. Ruach established the manufacturing facility of the Company for its first product, Capnodig, and now directs the manufacturing for the Company's single and multi-parameter monitors, CO2 modules and circuits. Mr. Ruach joined the Company after working at Intel Electronics, where he held engineering positions. Mr. Ruach holds a B.Sc. in Engineering from the Ort College in Jerusalem and an M.B.A. degree from the Management College in Jerusalem.

**Joshua Colman**, Chief Technology Officer Capnography, joined the Company in 1992. Mr. Colman is responsible for developing technologies that are unique to the Company that lead to improving existing and new products. Mr. Colman previously worked as a consultant to the fledgling company in 1987 while he was working on infrared source research (a core element of Oridion's current technology) at the Hebrew University. Over the years at Oridion, Mr. Colman has been responsible for submitting over 10 patents on Oridion's proprietary technology. Prior to joining Oridion, Mr. Colman was a Chief Engineer at Israel Aircraft Industries where he was responsible for developing the reconnaissance and surveillance system for unmanned aircraft. Mr. Colman holds a B.Sc. and M.Sc. in Physics and Electro-Optics from Machon Lev and Hebrew University of Jerusalem, respectively.

**Ilan Ben-Oren**, Chief Technology Officer Breath Testing, joined Oridion in 1997 and was in charge of the BreathID® project throughout its development. Before joining Oridion, Mr.

Ben-Oren held various positions at Scitex, which deals with digital printing and state of the art ultra-optical systems. Before joining Scitex, Mr. Ben-Oren participated for approximately five years in applied research at the laser center of Hadassah Ein-Karem and the Hebrew University and was involved in the beginning of the “Nanomed” start-up that was based on the technology developed there. Mr. Ben-Oren is the author of numerous patents in the field of medical equipment and applications and holds a master’s degree with special honors in applied physics and science of materials from Hebrew University, Jerusalem. Within the framework of his studies Mr. Ben-Oren was sent to Cornell University in New York State, USA for one year where he conducted research in biophysics.

Messrs. Adler, Bubis and Tabachnik also serve as board members on the boards of directors of certain Subsidiaries of the Company.

## **4.2 Other Activities and Functions**

None of the members of senior management have activities in governing and supervisory bodies of important Swiss and foreign organizations, institutions or foundations, nor do they have permanent management and consultancy functions for important Swiss and foreign interest groups.

## **4.3 Management Contracts**

Neither Oridion Systems Ltd. nor any of its subsidiaries have management contracts with any parties not belonging to the Group.

## **5. Compensation, Shareholdings and Loans**

### **5.1 Content and Method of Determining the Compensation and of the Shareholding Programs**

#### Board of Directors

The Companies Law requires that arrangements with a director as to his or her term of office or compensation, including approval of the purchase of insurance coverage for a director, undertaking to indemnify a director and exemption of a director from liability, should be approved by all of the following: the Audit Committee, the board of directors and last, the General Meeting of the Shareholders of the Company.

Certain directors of the Company are reimbursed for their participation at meetings of the Board of Directors and its committees in an amount that ranges between US\$750 to US\$1,500 per meeting. In addition, upon the appointment of a Director to the Board of Directors, the Company grants such Director options to purchase 10,000 Ordinary Shares of the Company, and grants an additional option to purchase 5,000 Ordinary Shares on each anniversary of his or her appointment, provided that such Director is reelected to serve in this capacity for the next year. For additional information concerning the terms of such options, see Section 5.6 below.

#### Outside Directors

Under the Companies Law and regulations promulgated there-under, including the Companies Regulations (Rules for the Compensation and Expenses for an External Director), 2000, (the “**Regulations**”) as amended, certain kinds of compensation with which we wish to provide our two Outside Directors require the approval of the shareholders of the Company.

The Regulations provide tables for payment of “annual compensation” and for additional compensation based on the participation of the Outside Directors in meetings or resolutions of the Board of Directors or committees thereof. The Regulations also allow for compensation of

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certain expenses to Outside Directors. Accordingly, the general meeting of the Company's shareholders approved in January 2004 the payment to each Outside Director of fixed compensation in the amount allowed under the Regulations.

### Senior Management

The Board of Directors of the Company determines the elements of compensation for the Chief Executive Officer, Chief Operating Officer and Chief Financial Officer of the Company, after receiving the recommendations of the Stock and Compensation Committee. The Chief Executive Officer of the Company is responsible for determining the elements of compensation for the other senior Managers of the Company.

Each year the Board of Directors and the Chief Executive Officer, respectively, receives an independent compensation survey on compensation of senior management in Israel and the US. This information together with an appraisal and recommendation by the Stock and Compensation Committee (with respect to the three main Senior Managers as described above) are the main factors in determining the compensation amount for each Senior Manager. The annual compensation package consists of salary, bonus and employee stock options. However, options are not granted on an annual basis.

The Company does not have any shareholding programs for its Directors or Senior Managers.

## 5.2 Compensations for Acting Members of Governing Bodies

5.2.1 The total cost of the aggregate compensation paid, and benefits in kind granted to or accrued on behalf of all the Company's Directors, including the Outside Directors, and Senior Managers for their services in all capacities during the year ended December 31, 2004 was approximately US\$1,387,222. Such sum is exclusive of any consultancy fee paid to Directors and Senior Managers, as set forth in Section 5.7 below.

5.2.2 The total cost of the aggregate compensation paid and benefits in kind granted to or accrued on behalf of all of the Company's executive Directors and Senior Managers for their services in all capacities during the year ended December 31, 2004 was approximately US\$1,054,387.

The total cost of the aggregate compensation paid, and benefits in kind granted to or accrued on behalf of all of the Company's non-executive Directors for their services in such capacity during the year ended December 31, 2004 was approximately US\$348,167.

5.2.3 No additional severance payments to Directors and Senior Managers who gave up their functions in a governing body of the Company for the year ended December 31, 2004.

## 5.3 Compensations for Former Members of Governing Bodies

In April 2004, the Company announced that Mr. George Yariv, the Company's Chief Executive Officer had decided to step down from his position. Accordingly Mr. Yariv ceased to serve as a member of senior management. Mr. Yariv continues to serve as a member of the Company's Board of Directors and as honorary Chairman. In July 2004, the Company's shareholders resolved to issue to Mr. Yariv 400,000 Ordinary Shares for par value consideration; to grant to him options to purchase up to 231,000 Ordinary Shares at exercise prices ranging between CHF 1.91 and 2.1; and to use the sum of \$270,000 as the basis of determining Mr. Yariv's pension and severance pay.

As of December 31, 2004, the Company recorded \$718,000 in non-cash retirement benefits for former members of the Company's Board of Directors.

5.3.1 Not applicable.

5.3.2 Not applicable.

## 5.4 Share Allotment in the Year Under Review

During the year ended on December 31, 2004, no Ordinary Shares were issued to its Executive Director and Senior Managers.

During the year ended on December 31, 2004, the Company allotted and issued 400,000 of its Ordinary Shares to a member of its Non-executive Directors.

## 5.5 Share Ownership

On December 31, 2004, the Executive Director and Senior Managers of the Company beneficially owned an aggregate of 42,231 Ordinary Shares of the Company, and an aggregate of 489,661 Ordinary Shares were beneficially owned by Non-executive Directors.

## 5.6 Options

### Executive Directors and Senior Management

On December 31, 2004, the executive Director and Senior Managers of the Company held options, under the Stock Option Plans of the Company, to purchase up to an aggregate total of 1,003,720 Ordinary Shares. These options have a subscription ratio of 1:1. Under the Company's Stock Option Plans, one-half of the shares under each option grant will become vested on the second anniversary of the grant. Thereafter, an additional quarter of the amount of shares under the option grant will become vested on each of the third and fourth anniversary of the grant. The options will expire after the seventh anniversary date of each option allotment date. For additional information, see Note 10b to the Financial Statements. The following table sets forth the amount of options granted during each year and the average exercise prices of the options:

Year	Amount of Options Granted	Average Exercise Price (in CHF)
1997	8,175	3.46
1998	118,370	6.00
1999	460,201	6.00
2000	20,000	29.00
2001	278,000	5.00
2002	10,000	6.00
2003	225,000	2.04
2004	269,000	2.08

### Non-Executive Directors

As of December 31 2004, non-executive Directors, in the aggregate, held options under the Stock Option Plans of the Company to purchase up to 341,000 Ordinary Shares. These options have a subscription ratio of 1:1. Under the Company's Stock Option Plans, one-third of the options shall become vested on each of the first, second and third anniversaries of the grant date of the options. The options will expire after the seventh anniversary date of each option grant date. For additional information, see Note 10b to the Financial Statements.

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The following table sets forth the amount of options granted during each year and the average exercise prices:

Allotment Year	Amount of Options	Average Exercise Price (in CHF)
2000	30,000	7.20
2001	--	--
2002	35,000	2.65
2003	162,519	2.17
2004	306,000*	1.94

\* Includes options granted to George Yariv as part of his termination compensation in 2004. For more information see Section 5.3.

### 5.7 Additional Honorariums and Remunerations

As set forth in Section 3.1 above, Dr. Reis, non-executive Director of the Company, provided consultation services to the Company and its Subsidiaries pursuant to the Consulting Agreement (as defined in Section 3.1 above). During the year ended on December 31, 2004, the total cost of Dr. Reis's consultation services, amounted to US\$15,332.

### 5.8 Loans Granted by Governing Bodies

As of December 31, 2004, there are no outstanding guarantees, loans, advances or credits granted to Directors or Senior Managers of the Company either by the Company or by any of its Subsidiaries.

### 5.9 Highest Total Compensation

The highest total cost of compensation and benefits in kind granted by the Company to a Director of the Company during the year ended on December 31, 2004, in accordance with Section 5.2 above, is equal to US\$ 257,243

The highest share amount allocated by the Company to a Director during the year ended December 31, 2004, in accordance with Section 5.6 above, is 400,000 Ordinary Shares, valued at \$718,000 at the date of grant.

The highest options amount allocated by the Company to a Director during the year ended December 31, 2004, in accordance with Section 5.6 above, is options to purchase 231,000 Ordinary Shares, at an exercise price of CHF 2.20 per share. The value of the options is included in Note 2j of the Financial Statements.

## 6. Shareholders' Participation Rights

### 6.1 Voting-rights Restrictions and Representation

6.1.1 The ownership or voting of the Ordinary Shares by non-residents of Israel is not restricted in any way by the laws of Israel or the Articles of Association of the Company, except with respect to citizens of countries which are in a state of war with Israel. For further information, see Section 2.4 above.

Except as provided for above, the Articles of Association of the Company do not contain provisions relating to restrictions on voting rights, such as group clauses or exceptions rules.

6.1.2 Not applicable.

6.1.3 Not applicable.

6.1.4 Under the Articles of Association of the Company, any shareholder may vote at a general meeting either in person or by proxy, or, if the shareholder is a corporation, by a representative authorized pursuant to Articles of Association, as described below. The proxy instrument shall either be presented to the chairman at the relevant general meeting or be delivered to the Company not less than two hours before the time fixed for such general meeting, provided that under certain circumstances as provided for in the Articles of Association of the Company, the proxy instrument shall be delivered to the Company a week before the time fixed for the general meeting.

Under the Articles of Association of the Company and the Companies Law, a corporation being a shareholder of the Company may duly authorize any person to be its representative at any meeting of the Company or to execute or deliver a proxy on its behalf. Any person so authorized shall be entitled to exercise on behalf of such shareholder all the power, which the latter could have exercised if it were an individual shareholder.

Under the Companies Law, a shareholder participating in a meeting relating to an extraordinary transaction with a Control Holder (as defined below) should notify the Company prior to the vote or on the proxy, if the vote is made by proxy, whether or not such a shareholder has a Personal Interest (as defined below) in such a transaction. Absent of such a notice, such member shall not vote at such meeting. Under the Companies Law, a "Control Holder" is defined as an entity that has the ability to control or direct the activities of such a corporation, as more specifically described in the Companies Law.

The Companies Law defines a "Personal Interest" of a person in an action or transaction of a company, including a personal interest of his relative, and of another corporation in which such person or his relative is an interested party, as this term is defined in the Companies Law.

## **6.2 Statutory Quorums**

Under the Company's Articles of Association, ordinary resolutions proposed at general and extraordinary general meetings of the shareholders shall be approved by a majority of the shareholders represented at such a meeting in person or by proxy and voting thereon. Resolutions relating to the following proposals at such meetings shall be approved by a Special Resolution of the shareholders of the Company: changes in the Articles of Association of the Company, changes in the authorized share capital of the Company or the rights of shares, introduction of preference shares or new classes of shares and the granting of special rights, reduction of the share capital of the Company, introduction of limitations on the transfer of shares and certain merger or winding up events.

In addition, pursuant to the Articles of Association of the Company, the Board of Directors may from time to time determine the number of shares to be allocated to a stock option plan of the Company, provided that: (i) in the event the number of shares allocated to all such new Stock Option Plans, to be adopted after February 3, 2001, is in excess of fifteen percent, in the aggregate, of the issued and paid up share capital of the Company at such time, such allocation should be approved by shareholders who hold not less than sixty seven percent of the shares represented at the general meeting in which the allocation of options is discussed; or (ii) if the number of shares is less than the aforesaid amount, such allocation should be approved by a simple majority of the shareholders participating at the general meeting at which the allocation of options is discussed.

Generally, under the Companies Law the compensation of Directors requires the approval of the Audit Committee, the Board of Directors and the General Meeting of the Shareholders of the company in such order. The Companies Law and regulations promulgated thereunder require that: (i) an extraordinary transaction between the Company with its Control Holder or

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in which the Control Holder has personal interest, and (ii) an arrangement as to the compensation of an Office Holder (as defined below) who is also defined as a Control Holder of the Company must be approved by the Audit Committee, the Board of Directors and a General Meeting of the Shareholders, provided that either: (a) the majority of shares voted at the meeting, including at least one third of the shares of non-controlling shareholders voted at the meeting, vote in favor of such arrangement or (b) the total number of shares voted against such arrangement does not exceed one percent of the aggregate voting rights in the Company.

An “Office Holder” is defined in the Companies Law as a director, general manager, chief executive officer, executive vice president, vice president, any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title and other managers directly subordinate to the general manager.

The Companies Law generally provides that a merger be approved by the board of directors and a majority of the shares voting on the proposed merger. For purposes of the shareholders vote, unless a court rules otherwise, the merger will not be approved if a majority of the shares held by persons other than the other party to the merger (or any person who holds twenty-five percent or more of the shares or the right to appoint twenty-five percent or more of the directors of the other party) vote against the merger.

In addition, the Companies Law also provides that certain “arrangements” between the Company and its shareholders and/or creditors require the approval of at least seventy-five percent of the shares and a majority of the shareholders voting at a shareholders meeting, or of seventy-five percent of the credit amount of the Company and a majority of the creditors voting at a separate meetings, as the case may be.

### 6.3 Convocation of the General Meeting of Shareholders

#### Kinds of General Meetings

Under the Company’s Articles of Association, an Annual General Meeting shall be held once in every calendar year at such time (within a period of not more than fifteen months after the last preceding annual general meeting) and at such place, either within or outside the State of Israel, as may be determined by the Board of Directors.

Under the Companies Law and the articles of Association of the Company, the Board of Directors of the Company may convene an extraordinary general meeting at its own decision, and shall be obliged to do so upon a requisition in writing of one of the following: (i) two Directors; (ii) one-fourth of the Directors; or (iii) one or more shareholders who hold five percent of the Ordinary Shares of the Company.

#### Notice of General Meetings

Under the Company’s Articles of Association, not less than twenty-one days prior notice shall be given of every General Meeting, including a meeting in which a Special Resolution is proposed to be passed. Each such notice shall specify the place, day and hour of the meeting and the general nature of each item to be acted upon thereat and may set forth arrangements as to vote by proxy, as required by the Articles of Association and the Companies Law. The said notice shall be given to all shareholders entitled to attend and vote at such general meeting. The accidental omission to give notice of a general meeting to any shareholder, or the non-receipt of notice sent to such shareholder, shall not invalidate the proceedings at the General Meeting.

#### Quorum

Under the Company’s Articles of Association, the quorum required for a General Meeting of Shareholders (whether Annual or Extraordinary) consists of at least two shareholders present in person or by proxy and holding, or representing, more than ten percent of the voting rights of the outstanding share capital. A General Meeting convened upon the request of shareholders as described above, and adjourned for lack of a quorum shall only be held if at

least the same number of shareholders which requested such meeting be convened, is present at the adjourned meeting. If the meeting is dissolved for any other reason, it shall be adjourned to the same day in the following week at the same time and place or at such time and place as the chairman may determine with the consent of the holders of a majority of the voting power represented at the meeting in person or by proxy and voting on the question of adjournment. If at such reconvened meeting a quorum is not present within half an hour from the time appointed for the meeting, any two shareholders present in person or by proxy shall constitute a quorum, regardless of the number of shares represented.

## **6.4 Agenda**

### Responsibility of the General Meeting

Under the Companies Law and the Articles of Association of the Company, the following corporate actions may only be resolved by a General Meeting of the Shareholders: changes in the Articles of Association, assumption of the function of the Board of Directors of such the Company in case it is unable to activate the vital functions thereof, appointment and establishment of the scope of employment for the Company's auditor, appointment of Outside Directors, approval of such transactions with Office Holders or interested parties that require the general meeting's approval, as set forth in the Companies Law, increase and decrease of the authorised share capital of the Company and approval of a merger.

### Agenda

Under the Companies Law, the agenda of a General Meeting shall be determined by the Board of Directors, and it shall also include the items which are the reason for convening of such meeting. In addition one or more shareholders that hold at least one percent of the voting rights of the Company may request the Board of Directors to include an item on the agenda of a General Meeting, provided that such item is adequate to be discussed at a general meeting. For further information regarding notices of General Meetings, see Section 6.3 above.

## **6.5 Registrations in the Share Register**

Under the Company's Articles of Association, the Board of Directors may determine a record date in advance to determine the shareholders entitled to notice or to vote at any annual or extraordinary general meeting. Under the Companies Law and regulations promulgated thereunder, such record date shall not be more than forty nor less than four days before the date of such meeting. A determination of shareholders of record entitled to notice of or to vote at a meeting shall apply to any adjournment of the meeting, provided, however, that the Board of Directors may determine a new record date for the adjourned meeting.

## **7. Changes of Control and Defense Measures**

### **7.1 Duty to Make an Offer**

The Companies Law provides that an acquisition of shares in 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 twenty-five percent shareholder, unless there is already a twenty-five percent shareholder. Similarly, an acquisition of shares must be made by means of a tender offer if as a result of the acquisition the purchaser would become a forty-five percent shareholder, unless there is already a shareholder holding more than fifty percent of the voting rights in a company. In any event, if as a result of an acquisition of shares the acquirer will hold more than ninety percent of a company's shares, the acquisition must be made by means of a tender offer for all of the shares. If more than ninety-five percent of the outstanding shares are tendered in the tender offer, all the shares that the acquirer offered to purchase will be transferred to it.

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Pursuant to Article 20 of the Swiss Federal Act on Stock Exchange and Securities Trading (“SESTA”) any person, directly, indirectly or in concert with third parties, who acquires or sells, for such person’s own account, stock in a corporation incorporated in Switzerland whose equity securities are listed, in whole or in part, in Switzerland and thereby attains, falls below or exceeds the threshold percentages of 5, 10, 20, 33 1/3, 50 or 66 2/3 percent of the voting rights, whether or not such rights are exercised, is obliged to notify the corporation and the stock exchanges on which the equity securities in question are listed. As the Company is not incorporated in Switzerland, the obligations to notify it pursuant to Article 20 of the SESTA do not apply. However, in the Listing Agreement (as defined below) the Company has agreed to make public any beneficial owner known to it of 5, 10, 20, 33 1/3, 50 or 66 2/3 percent of the voting rights of the Shares.

In connection with the Company’s initial public offering on the SWX New Market in April 2000, the Company entered into a listing agreement (the “**Listing Agreement**”) with the SWX Swiss Exchange. Pursuant to the Listing Agreement, the Company has agreed to comply with the publicity requirements (i.e., periodic and ad hoc publicity) of the listing rules of the SWX Swiss Exchange. Notices required under the listing rules of the SWX Swiss Exchange will be published in the L’Agéfi and the Neue Zürcher Zeitung, including notices of meetings of shareholders.

Pursuant to the applicable provisions of the SESTA, any person, who by acquiring securities exceeds the threshold of 33 1/3 percent of the voting rights (whether exercisable or not) of a Swiss company which shares are listed on the SWX Swiss Exchange, must make a mandatory offer to acquire all other shares. Since the Company is not incorporated in Switzerland, the Company believes that these provisions do not apply. However, there is no assurance that Swiss securities supervisory authorities or Swiss courts will not rule that such mandatory bid rules should apply depending on the circumstances surrounding a particular transaction.

## 7.2 **Clauses on Changes of Control**

Under the Stock Option Plans of the Company, the Board of Directors or the Stock Option and Compensation Committee may determine with respect to certain option agreement that there shall be a clause instructing that, if upon the occurrence of a Transaction (as defined below), the successor corporation or its subsidiary, as the case may be, do not agree to assume or substitute the number of outstanding unexercised options and/or their exercise price, the vesting periods shall be accelerated so that any unvested option shall be immediately vested in full prior to the effective date of the Transaction.

For the meaning of this Section 7.2 a “Transaction” means a merger of the Company with or in to a successor corporation, or the sale of all or substantially all of the assets or shares of the Company to a successor corporation, or reorganization or the like.

For information regarding options held by the Company’s Directors and Senior Mangers, see Section 5.6 above.

## 8. **Auditors**

### 8.1 **Duration of the Mandate and Term of Office of the Head Auditor**

8.1.1 The auditors of the Company are Kost Forer Gabbay & Kasierer, a member firm of Ernst & Young International, Tel Aviv, Israel (the “**Auditors**”). The mandate to audit the Company’s financial reports for the fiscal year 2004, started on January 1, 2004, and ends December 31, 2004.

8.1.2 The Head Auditor responsible for the existing audit has been responsible for the Company’s audit since January 1, 2000.

## **8.2 Auditing Fees**

The total fees paid to the Auditors for auditing purposes during the year ended December 31, 2004 is US\$48,000.

## **8.3 Additional Fees**

The total fees paid to the Auditors for other non-auditing services during the year ended December 31, 2004 is US\$32,000.

## **8.4 Supervisory and Control Instruments *vis-à-vis* the Auditors**

Under the Companies Law, the external auditor shall not depend on the Company, directly or indirectly.

As provided for in the Companies Law and the Articles of Association of the Company, the shareholders of the Company, at their annual general meeting, nominate the Company's external auditors after the opinion of the Board of Directors is brought before the participating shareholders. The elected external auditor serves until the next Annual General Meeting. At such Annual General Meeting the Shareholders of the Company authorize the Board of Directors to determine the remuneration of the external auditor.

The Company's external auditors report directly to the Board of Directors of the Company and participate at each meeting of the Board of Directors. In addition one of the roles of the Audit Committee of the Company is to examine flaws in the business management of the company, in consultation with the external auditors, and to propose remedial measures to the Board of Directors. For information regarding the Audit Committee of the Company, see Section 3.5.3 above.

## **9. Information Policy**

The Company reports its quarterly Financial Statements three times a year and the full year Financial Statements once a year. Included in this report is a letter from the Chief Executive Officer of the Company summarizing the quarterly and annual activities of the Company. This information is posted on the website of the Company. In addition the Company distributes this information to recognized media companies (e.g. Bloomberg, several daily newspapers and financial publications) for dissemination to the public.

### **The contact details are as follows:**

Oridion Systems Ltd.  
Attention: Ms. Elena Gerberg  
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Website: www.oridion.com

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# Report of Independent Auditor

## To the Shareholders of Oridion Systems Ltd.

We have audited the consolidated balance sheets of Oridion Systems Ltd. ("the Company") and its subsidiaries' as of December 31, 2004 and 2003 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, 2004. 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 audits.

We conducted our audits in accordance with auditing standards generally accepted 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, 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. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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 and its subsidiaries as of December 31, 2004 and 2003, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States.

*Kost Forer Gabbay and Kasierer*  
KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

Tel-Aviv, Israel  
January 27, 2005

# Consolidated Balance Sheets

U.S. dollars in thousands

	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 3,733	\$ 4,343
Short-term deposits	2,566	-
Trade receivables	4,501	3,195
Other accounts receivable and prepaid expenses (Note 3)	655	459
Inventories (Note 4)	2,255	4,010
<u>Total current assets</u>	<u>13,710</u>	<u>12,007</u>
SEVERANCE PAY FUND	1,474	1,294
PROPERTY AND EQUIPMENT, NET (Note 5)	3,272	4,191
LONG-TERM PREPAID EXPENSES	31	-
<u>Total assets</u>	<u>\$ 18,487</u>	<u>\$ 17,492</u>

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

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

	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Short-term bank credit (Note 6)	\$ 16	\$ 768
Trade payables	2,964	1,562
Other accounts payable and accrued expenses (Note 7)	2,912	2,601
<u>Total current liabilities</u>	<u>5,892</u>	<u>4,931</u>
<b>LONG-TERM LIABILITIES:</b>		
Long-term loans (Note 8)	2,500	-
Accrued severance pay	2,440	2,130
<u>Total long-term liabilities</u>	<u>4,940</u>	<u>2,130</u>
<b>COMMITMENTS AND CONTINGENT LIABILITIES (Note 9)</b>		
<b>SHAREHOLDERS' EQUITY (Note 10)</b>		
Share capital:		
Ordinary shares of NIS 0.01 par value -		
Authorized: 20,000,000 shares as of December 31, 2004 and 2003;		
Issued and outstanding: 11,092,853 shares as of December 31, 2004		
and 10,501,421 shares as of December 31, 2003	26	25
Additional paid-in capital	74,847	73,721
Accumulated deficit	(67,218)	(63,315)
<u>Total shareholders' equity</u>	<u>7,655</u>	<u>10,431</u>
<u>Total liabilities and shareholders' equity</u>	<u>\$ 18,487</u>	<u>\$ 17,492</u>

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

# Consolidated Statements of Operations

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

	Year ended December 31,		
	2004	2003	2002
Revenues (Note 13a and b)	\$ 22,450	\$ 18,117	\$ 14,060
Cost of goods sold	11,547	9,792	7,847
Inventory write-off (Note 1)	1,206	*) 350	-
Cost of revenues	12,753	10,142	7,847
Gross profit	9,697	7,975	6,213
Operating expenses:			
Research and development, net (Note 14a)	2,895	3,328	3,645
Selling and marketing	7,093	8,102	9,682
General and administrative	2,114	2,592	2,782
Retirement benefit (Note 15)	863	-	-
Impairment of long-lived assets (Note 1)	328	-	-
<u>Total operating expenses</u>	<u>13,293</u>	<u>14,022</u>	<u>16,109</u>
Operating loss	(3,596)	(6,047)	(9,896)
Financial income (expenses), net (Note 14b)	(308)	(168)	244
Loss before taxes on income (tax benefit)	(3,904)	(6,215)	(9,652)
Taxes on income (tax benefit) (Note 11)	(1)	(54)	(78)
Net loss	<u>\$ (3,903)</u>	<u>\$ (6,161)</u>	<u>\$ (9,574)</u>
Basic and diluted net loss per share	<u>\$ (0.36)</u>	<u>\$ (0.59)</u>	<u>\$ (0.91)</u>
Weighted average number of shares used in computing basic and diluted net loss per share	<u>10,712,874</u>	<u>10,501,421</u>	<u>10,501,004</u>

\*) Reclassified.

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

## Statements of Changes in Shareholders' Equity

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

	Share capital	Additional paid-in capital	Accumulated deficit	Total shareholders' equity
Balance as of January 1, 2002	\$ 25	\$ 73,609	\$ (47,580)	\$ 26,054
Exercise of options, net	*) -	4	-	4
Amortization of deferred stock compensation	-	66	-	66
Net loss	-	-	(9,574)	(9,574)
Balance as of December 31, 2002	25	73,679	(57,154)	16,550
Amortization of deferred stock compensation	-	42	-	42
Net loss	-	-	(6,161)	(6,161)
Balance as of December 31, 2003	25	73,721	(63,315)	10,431
Issuance of shares and options in respect of retirement benefit (Note 15)	1	718	-	719
Exercise of options, net	*) -	193	-	193
Exercise of warrants	*) -	-	-	*) -
Warrants issued to credit providers and others	-	177	-	177
Amortization of deferred stock compensation	-	38	-	38
Net loss	-	-	(3,903)	(3,903)
Balance as of December 31, 2004	<u>\$ 26</u>	<u>\$ 74,847</u>	<u>\$ (67,218)</u>	<u>\$ 7,655</u>

\*) Represents an amount lower than \$ 1.

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

# Consolidated Statements of Cash Flows

U.S. dollars in thousands

	Year ended December 31,		
	2004	2003	2002
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (3,903)	\$ (6,161)	\$ (9,574)
Adjustments required to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation	840	921	1,437
Impairment of long-lived assets	328	-	-
Non-cash retirement benefit	718	-	-
Amortization of deferred stock compensation	38	42	66
Amortization of deferred stock compensation related to warrants issued to credit providers and others	57	-	-
Accrued interest on short-term bank deposits	(16)	-	-
Accrued severance pay, net	130	97	(77)
Decrease (increase) in trade receivables	(1,306)	131	(1,122)
Decrease (increase) in other accounts receivable and prepaid expenses	(107)	221	(84)
Decrease (increase) in inventories	1,740	(912)	1,388
Increase (decrease) in trade payables	1,402	(201)	(13)
Increase in other accounts payable and accrued expenses	311	129	331
Loss (gain) on sale of property and equipment	7	(1)	(1)
Net cash provided by (used in) operating activities	<u>239</u>	<u>(5,734)</u>	<u>(7,649)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from sale of property and equipment	15	49	3
Purchase of property and equipment	(256)	(244)	(961)
Investment in short-term bank deposits, net	(2,550)	-	-
Proceeds from maturity of short-term bank deposits	-	-	10,148
Net cash provided by (used in) investing activities	<u>(2,791)</u>	<u>(195)</u>	<u>9,190</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Short-term bank credit, net	(752)	768	-
Proceeds from long-term loan	2,500	-	-
Proceeds from exercise of options and issuance of shares, net	194	-	4
Net cash provided by financing activities	<u>1,942</u>	<u>768</u>	<u>4</u>
Increase (decrease) in cash and cash equivalents	(610)	(5,161)	1,545
Cash and cash equivalents at the beginning of the year	<u>4,343</u>	<u>9,504</u>	<u>7,959</u>
Cash and cash equivalents at the end of the year	<u>\$ 3,733</u>	<u>\$ 4,343</u>	<u>\$ 9,504</u>

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

U.S. dollars in thousands

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	Year ended December 31,		
	2004	2003	2002
(a) <u>Significant non-cash transactions:</u>			
Classification of inventory to property and equipment	<u>\$ 15</u>	<u>\$ 154</u>	<u>\$ 225</u>
Prepaid expenses in respect of warrants issued to credit providers and others	<u>\$ 89</u>	<u>\$ -</u>	<u>\$ -</u>
Long-term prepaid expenses in respect of warrants issued to credit providers and others	<u>\$ 31</u>	<u>\$ -</u>	<u>\$ -</u>
(b) <u>Supplemental disclosure of cash flows information:</u>			
Cash paid (received) during the year for:			
Interest	<u>\$ 123</u>	<u>\$ 93</u>	<u>\$ 37</u>
Income taxes	<u>\$ (1)</u>	<u>\$ (54)</u>	<u>\$ (78)</u>

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

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

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## NOTE 1:- GENERAL

- a. Oridion Systems Ltd. ("the Company") is a holding company, which wholly-owns Oridion Medical 1987 Ltd. and Oridion BreathID Ltd. (together, "Oridion") and all of their subsidiaries. The Company is a medical technology company based in Jerusalem, Israel and Needham, Massachusetts, U.S.A. Oridion employs its patented Microstream® technology in the development, manufacturing and marketing of products used in two distinct businesses:
  1. The current core business, capnography - the non-invasive measurement of carbon dioxide contained in the exhaled breath to determine the status of adequacy of respiration.
  2. Oridion's early-stage business, breath testing (BreathID®) - the non-invasive analysis of gases in the breath to diagnose the adequacy of organ function and the presence of infectious diseases.
- b. As the continuation of the BreathID business is dependent on concluding agreements with strategic and/or financial investors in 2005, the Company has taken a conservative view of the potential to realize the Breath Test inventory going forward. As a result, in 2004 and 2003, the Company wrote off \$ 1,206 and \$ 350, respectively of specific Breath Test inventory. These write-offs were recorded in cost of revenues.
- c. Due to relatively low revenues in respect of the Breath Test segment in 2004, the Company performed a recoverability test on Breath Test long-lived assets. In conjunction with this analysis, the Company recorded a non-cash impairment charge of \$ 328 in operating expenses.
- d. For the years ended December 31, 2004, 2003 and 2002, 72%, 71% and 72% of the Company's sales, respectively, were to four customers (see Note 13c).

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are prepared according to accounting principles generally accepted in the United States ("U.S. 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 amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

- b. Financial statements in U.S. dollars:

A majority of Oridion and its subsidiaries' revenues are generated in U.S. dollars. In addition, approximately 80% of the Company's costs are incurred in U.S. dollars. The Company's management believes that the U.S. dollar is the primary currency of the economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the U.S. dollar.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards Board No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transactions gains and losses of the remeasured monetary balance sheet items are reflected in the statement of operations as financial income or expenses, as appropriate.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and those of the following companies:

	<u>% of ownership</u>
1. Oridion Medical 1987 Ltd.	100
2. Oridion BreathID Ltd. *)	100
3. Irad Technologies Ltd. **)	100
4. Oridion Capnography Inc. (through the subsidiary, Oridion Medical 1987 Ltd.)	100
5. Oridion BreathID Inc. (through the subsidiary, Oridion BreathID Ltd.) **)	100
6. Oridion Medical Europe BV (through the subsidiary, Oridion Medical 1987 Ltd.)	100
7. Oridion Spain S.L. (through the subsidiary, Oridion Medical Europe BV)**)	100
8. Oridion Capnography GmbH (through the subsidiary, Oridion Medical Europe BV) **)	100
9. Oridion Medical K.K. (through the subsidiary, Oridion Medical Europe BV)	100

\*) In December 2001, the Board of Directors of the Company resolved to split the breath tests activity of the Company into a new company, Oridion BreathID Ltd., which is a wholly-owned subsidiary of the Company. In March 2003 the District Court in Israel approved the split, effective as of January 1, 2002.

\*\*\*) Inactive.

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

d. Cash equivalents:

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

e. Short-term deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in U.S dollars and bear interest at an average rate of 1.1%. The short-term deposits are presented at there cost, including accrued interest.

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

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## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

f. Inventories:

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided to cover risks arising from discontinued or slow-moving products (see Note 1).

Cost is determined as follows:

Raw materials and packing materials - using the average cost method.

Work in progress - cost of manufacturing and subcontracted work, with the addition of allocable indirect manufacturing costs.

Finished goods - recorded on the basis of direct manufacturing costs and subcontracted work, with the addition of allocable indirect manufacturing costs.

g. 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:

	%
Computers and related equipment	20 - 33
Motor vehicles	20
Office furniture and equipment	6 - 15
Machinery equipment and installations	10
Diagnostic equipment	10 - 33
Leasehold improvements	Over the term of the lease

h. Impairment of long-lived assets and long-lived assets to be disposed:

Oridion's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards 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 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. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. As of December 31, 2004, impairment losses in the amount of \$ 328 have been identified (see Note 1).

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

i. Revenue recognition:

Oridion generates revenues mainly from selling its products through OEM partners and through its Oridion Distribution Network, both of whom are considered end users.

Oridion does not grant a right of return to its customers.

Revenues from product sales are recognized in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"), when delivery has occurred, persuasive evidence of an agreement exists, the fee is fixed or determinable, no future obligation exists and collectability is probable.

j. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Statement No. 25, "Accounting for Stock Options Issued to Employees" ("APB No. 25") and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44"), in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of an employee stock options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

The Company adopted the disclosure provisions of Financial Accounting Standards Board Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS No. 148"), which amended certain provisions of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123") to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation, effective as of the beginning of the fiscal year. The Company continues to apply the provisions of APB No. 25, in accounting for stock-based compensation.

Pro forma information regarding the Company's net loss and loss per share is required by SFAS 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method prescribed by SFAS No. 123.

The fair value for options granted in 2004, 2003 and 2002 is amortized over their vesting period and estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions: risk-free interest rates of 1%, 2% and 6%, respectively, dividend yields of 0% for each year, expected volatility of 0.82, 0.74 and 0.86, respectively and an expected life of the options of up to four years.

## Notes to Consolidated Financial Statements

U.S. dollars in thousands

### NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Pro forma information under SFAS No. 123 is as follows:

	<u>Year ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net loss - as reported	\$ (3,903)	\$ (6,161)	\$ (9,574)
Add - stock-based employee compensation - intrinsic value	41	-	-
Deduct - stock-based employee compensation - fair value	<u>(699)</u>	<u>(446)</u>	<u>(497)</u>
Pro forma net loss	<u>\$ (4,561)</u>	<u>\$ (6,607)</u>	<u>\$ (10,071)</u>
Pro forma basic and diluted net loss per share	<u>\$ (0.43)</u>	<u>\$ (0.63)</u>	<u>\$ (0.96)</u>

The Company applies SFAS No. 123 and Emerging Issues Task Force No. 96-18 "Accounting for Equity Instruments That are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18"), with respect to options and warrants issued to non-employees. SFAS No. 123 requires the use of option valuation models to measure the fair value of the options at the date of grant.

k. Provision for warranty:

Oridion offers a warranty of 15 to 18 months on all of its products, excluding consumables. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the product is sold. Oridion estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect Oridion's warranty liability include the number of units sold, historical and anticipated rates of warranty claims, and cost per claim. Oridion periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in Oridion's warranty liability during 2004 are as follows:

Balance at the beginning of the year	\$ 109
Warranties issued during the year	78
Settlements made during the year	<u>(91)</u>
Balance at the end of the year	<u>\$ 96</u>

l. Research and development costs:

Research and development costs, net of grants received, are charged to the statement of operations as incurred.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

m. Royalty-bearing grants:

Royalty-bearing grants from the Government of Israel for funding approved research and development projects are recognized at the time Oridion is entitled to such grants, on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants amounted to \$ 121, \$ 269 and \$ 424 in 2004, 2003 and 2002, respectively. Total royalties accrued or paid amounted to \$ 786, \$ 647 and \$ 493 in 2004, 2003 and 2002, respectively and were recorded as part of cost of goods sold.

n. Basic net loss per share:

Basic net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year, in accordance with Statement of Financial Accounting Standards No. 128 "Earnings Per Share" ("SFAS No. 128").

The total number of options and warrants outstanding as of December 31, 2004, 2003 and 2002 were 2,412,042, 1,344,802 and 1,783,521, respectively.

o. Income taxes:

The Company and its subsidiaries account for income taxes in accordance with Statement of Financial Accounting Standards No. 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.

p. 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 bank deposits and trade receivables.

Cash and cash equivalents and short-term bank deposits are invested in dollars with major banks in Israel and the United States. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management 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 trade receivables of Oridion are mainly derived from sales to customers located primarily in the U.S. and Europe. Oridion performs ongoing credit evaluations of its customers and to date has not experienced any material losses. Oridion has an insurance policy for foreign trade risks. An allowance for doubtful accounts was not determined since Oridion has no collection difficulties.

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

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## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

q. Severance pay:

Oridion's liability for severance pay of its Israeli employees is calculated pursuant to 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 employees 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 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 surrendered value of these policies, and includes immaterial profits.

Severance expenses for the years ended December 31, 2004, 2003 and 2002 amounted to \$ 435, \$ 361 and \$ 66, respectively.

The U.S. subsidiaries sponsor a retirement savings plan, which covers some of their employees. The Company's matching contribution to the plan was approximately \$ 33, \$ 34 and \$ 46 for the years ended December 31, 2004, 2003 and 2002, respectively.

r. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating fair value and disclosures for financial instruments:

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

The carrying amount of the long-term loans approximates their fair value.

s. Derivative instruments and hedging activities:

Financial Accounting Standard Board Statement No. 133, "Accounting for Derivatives Instruments and Hedging Activities" ("SFAS No. 133"), requires companies to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument, based upon the exposure being hedged, as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in financial income/expense in current earnings during the period of change.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

t. Reclassification:

Certain amounts from prior years referring to inventory write-off have been reclassified to conform to current year's presentation.

u. Impact of recently issued accounting standards:

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), *Share-Based Payment* ("Statement 123R"), which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation* ("Statement 123"). Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statements 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while Statement 123(R) requires all share-based payments to employees to be recognized based on their fair values. Statement 123R also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for the Company in the first interim period beginning after June 15, 2005. The adoption of Statement 123R will have a significant effect on the Company's results of operations.

**NOTE 3:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES**

	<u>December 31,</u>	
	<u>2004</u>	<u>2003</u>
Employees	\$ 14	\$ 11
Government authorities	221	172
Prepaid expenses	225	215
Prepaid expenses in respect of warrants issued to credit providers and others	89	-
Other	106	61
	<u>\$ 655</u>	<u>\$ 459</u>

**NOTE 4:- INVENTORIES**

Raw materials and packing materials	\$ 972	\$ 2,576
Work in progress	534	374
Finished goods	749	1,060
	<u>\$ 2,255</u>	<u>\$ 4,010</u>

## Notes to Consolidated Financial Statements

U.S. dollars in thousands

### NOTE 5:- PROPERTY AND EQUIPMENT, NET

	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
Cost:		
Computers and related equipment	\$ 2,418	\$ 2,535
Motor vehicles	10	37
Office furniture and equipment	1,466	1,717
Machinery equipment and installations	1,807	2,105
Diagnostic equipment	370	356
Leasehold improvements	2,692	2,693
	<u>8,763</u>	<u>9,443</u>
Less - accumulated depreciation	<u>5,491</u>	<u>5,252</u>
Depreciated cost	<u>\$ 3,272</u>	<u>\$ 4,191</u>

Depreciation expense amounted to \$ 840, \$ 921 and \$ 1,437 for the years ended December 31, 2004, 2003 and 2002, respectively.

As for pledges of assets, see Note 8.

### NOTE 6:- SHORT-TERM BANK CREDIT

	<b>Interest rates</b>		<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Bank credit in NIS	Prime + 3%	Prime + 3%	\$ 2	\$ 768
Bank credit in dollars	LIBOR + 2.9%	LIBOR + 2%	<u>14</u>	<u>-</u>
			<u>\$ 16</u>	<u>\$ 768</u>

As of December 31, 2004, Oridion has an authorized line of credit in the amount of \$ 690. The line of credit bears interest at an annual rate of Prime + 3% for the credit in NIS, and the rate of annual LIBOR + 2.9% for the credit in dollars. For overdrawn amounts in excess of Oridion's authorized line of credit, Oridion is subject to an annual interest rate of Prime + 6.5% for the credit in NIS and an average rate of annual LIBOR + 6.4% for the credit in dollars.

As of December 31, 2004, the Company has utilized \$ 16 out of the line of credit.

**NOTE 7:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>
Royalties payable	\$ 681	\$ 475
Employees and payroll accruals	1,565	1,256
Accrued expenses and other liabilities	666	870
	<u>\$ 2,912</u>	<u>\$ 2,601</u>

**NOTE 8:- LONG-TERM LOANS**

In May 2004, the Company signed a loan agreement of up to \$ 2,500 with a local bank. The loan will mature in one payment on April 30, 2006. The loan bears interest at an annual rate of LIBOR + 3.5%.

Pursuant to the loan agreement, the Company issued the bank 368,853 warrants to purchase Ordinary shares of the Company. The exercise price of the warrants is CHF 2.206. The warrants' exercise period is five years. In the event of liquidity or public offering, the bank may elect to convert the warrants into an alternative payment of \$ 250.

The Company placed a first priority floating charge on its assets and a fixed charge on its intellectual property and a fixed charge on its shares in Oridion in favor of the bank.

The loan agreement contains financial covenants which are to be evaluated on a quarterly basis. If the Company does not meet those covenants, the bank may require the Company to enhance its security by a higher interest rate and/or require the immediate repayment of the loan. As of December 31, 2004, the Company has complied with those covenants.

**NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES**

a. Royalties to the Chief Scientist:

Oridion participated in programs sponsored by the Israeli Government for the support of research and development activities. Through December 31, 2004, Oridion has obtained grants from the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade ("the OCS") aggregating to \$ 7,144 for certain of Oridion's research and development projects.

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

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## NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

Oridion is obligated to pay royalties to the OCS, amounting to 3.5% of the sales of the products and other related revenues generated from such projects, up to 100% of the grants received, linked to the U.S. dollar and for grants received after January 1, 1999 also bearing interest at the rate of 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.

Through December 31, 2004, Oridion has paid or accrued royalties to the OCS in the amount of \$ 3,487. As of December 31, 2004, the aggregate contingent liability to the OCS amounted to \$ 4,195.

b. Lease commitments:

The facilities of Oridion and its subsidiaries are leased under several operating lease agreements, which expire in 2006. Future minimum lease commitments under non-cancelable operating leases as of December 31, 2004, are as follows:

2005	\$	254
2006	\$	57

Rent expense for the years ended December 31, 2004, 2003 and 2002 were \$ 374 , \$ 332 and \$ 326, respectively.

c. In January 2003, the Company received a claim letter from Yissum Research Development Company of the Hebrew University of Jerusalem Limited. In the opinion of the Company's management and its legal counsel, the Company has good defenses against such claim.

d. Guarantees:

The Company has provided the lessor of its office building with a bank guarantee of up to \$ 54 for a period ended December 2005.

The Company has provided a subcontractor with a bank guarantee of up to \$ 100.

## NOTE 10:- SHAREHOLDERS' EQUITY

a. Issuance of shares:

In July 2004, the shareholders resolved to issue to the former CEO 400,000 Ordinary shares of the Company for no consideration (see Note 15).

**NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)**

## b. Issuance of options:

Under the Company's 1997, Other and 2003 Stock Option Plans ("the Plans"), options may be granted to officers, directors, employees and consultants of the Company or its subsidiaries.

Pursuant to the Plans, the Company reserved for issuance 623,516, 160,000 and 2,353,330 Ordinary shares, respectively. As of December 31, 2004, 100,650, 0 and 133,463 Ordinary shares of the Company are still available for future grant under each plan, respectively.

Each option granted under the Plans is exercisable until the earlier of seven years from the date of grant of the option or the expiration dates of the respective option Plans. The options vest primarily over four years. Any options which are cancelled or forfeited before expiration become available for future grants.

A summary of the Company's share option activity (except options to consultants) under the Plans is as follows:

	Year ended December 31,					
	2004		2003		2002	
	Amount of options	Weighted average exercise price	Amount of options	Weighted average exercise price	Amount of options	Weighted average exercise price
Outstanding - the beginning of the year	1,256,302	\$ 1.75	1,622,271	\$ 4.31	1,346,734	\$ 4.59
Granted	1,108,250	\$ 1.76	1,117,652	\$ 1.50	343,850	\$ 3.31
Exercised	(118,751)	\$ 1.51	-	\$ -	(1,000)	\$ 4.50
Forfeited	(108,685)	\$ 3.10	(217,900)	\$ 4.15	(67,313)	\$ 6.05
Cancelled	-	\$ -	(1,265,721)	\$ 5.02	-	\$ -
Outstanding - end of the year	<u>2,137,116</u>	<u>\$ 1.78</u>	<u>1,256,302</u>	<u>\$ 1.75</u>	<u>1,622,271</u>	<u>\$ 4.31</u>
Options exercisable - end of the year	<u>1,057,077</u>	<u>\$ 1.75</u>	<u>595,417</u>	<u>\$ 1.75</u>	<u>892,307</u>	<u>\$ 4.74</u>

The options outstanding as of December 31, 2004 have been separated into ranges of exercise price, as follows:

Exercise price	Options outstanding as of December 31, 2004	Weighted average remaining contractual life (years)	Weighted average exercise price	Options exercisable at December 31, 2004	Weighted average exercise price of exercisable options
\$ 1.48-1.51	859,097	3.53	\$ 1.51	556,440	\$ 1.51
\$ 1.69	167,000	6.54	\$ 1.69	167,000	\$ 1.69
\$ 1.79-1.94	1,013,019	6.22	\$ 1.86	285,487	\$ 1.89
\$ 2.34-5.42	98,000	4.62	\$ 3.53	48,150	\$ 3.88
	<u>2,137,116</u>	<u>5.09</u>	<u>\$ 1.78</u>	<u>1,057,077</u>	<u>\$ 1.75</u>

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

## NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)

Where the Company has recorded deferred stock compensation for options issued with an exercise price below the fair market value of the Ordinary shares, the deferred stock compensation has been recorded as compensation expense ratably over the vesting period of the options. Compensation expense of approximately \$ 5, \$ 11 and \$ 39 were recognized during the years ended December 31, 2004, 2003 and 2002, respectively.

The weighted-average fair value of the options granted for the years ended December 31, 2004, 2003 and 2002 were:

	For exercise price on the grant date that:								
	Equals market price			Exceeds market price			Less than market price		
	Year ended December 31,			Year ended December 31,			Year ended December 31,		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Weighted average exercise prices	\$ 2.65	\$ 1.77	\$ 3.1	\$ 1.51	\$ 1.39	\$ -	\$ 1.76	\$ -	\$ -
Weighted average fair value on grant date	\$ 1.28	\$ 1.04	\$ 1.1	\$ 0.59	\$ 0.70	\$ -	\$ 0.92	\$ -	\$ -

Cancellation and grant within 6 months and a day:

On June 25, 2003, the Company adopted a new voluntary stock option exchange program, under which the employees and certain consultants had the opportunity to cancel outstanding Stock Options. At such time, which is not less than six months and one day from the date of cancellation of such Stock Options, the Company shall grant one new option for every cancelled option to those employees who are employed by the Company at such time. Each new option will have the same vesting commencement date and vesting schedule as the option for which it was exchanged. The exercise price of the new options will be based on the fair market value of the Company's Ordinary shares at the time of the grant thereof. A total of 1,309,471 options were cancelled in connection with the option exchange program.

On December 30, 2003, as part of the option exchange program, the Company granted 716,633 options to employees.

In January 2004, as part of the option exchange program, the Company granted 138,500 options to employees and consultants.

**NOTE 10:- SHAREHOLDERS' EQUITY (Cont.)**

The Company's outstanding options to consultants as of December 31, 2004, are as follows:

<u>Issuance date</u>	<u>Options for Ordinary shares</u>	<u>Exercise price per share</u>	<u>Options exercisable</u>	<u>Exercisable through</u>
November 1998	1,000	\$ 4.50	1,000	November 2005
June 1999	20,000	\$ 4.50	20,000	June 2006
July 2000	1,000	\$ 27.00	1,000	July 2007
October 2001	13,000	\$ 5.30	13,000	October 2008
September 2002	19,500	\$ 2.34	12,250	September 2009
January 2004	24,000	\$ 1.51	24,000	January 2007
January 2004	3,000	\$ 1.48	3,000	January 2011
November 2004	9,000	\$ 2.65	2,000	November 2011
	<u>90,500</u>		<u>76,250</u>	

The Company had accounted for its options to consultants under the fair value method of SFAS No. 123 and EITF 96-18. Those options vest primarily over four years. The fair value for these options was estimated using Black-Scholes option-pricing model with the following weighted-average assumptions for 2004, 2003 and 2002: risk-free interest rates of 1% and 1% and 2%, respectively, dividend yields of 0% for each year, expected volatility of 0.78, 0.82 and 0.74, respectively and a weighted-average contractual life of the options of four years.

c. Issuance of warrants:

In connection with the loan received in May 2004, the Company issued to a bank warrants to purchase 368,853 Ordinary shares of the Company (see Note 8).

In November 2004, the bank exercised 50% of its warrants by way of cashless exercise into 52,931 Ordinary shares.

d. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

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## NOTE 11:- TAXES ON INCOME

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

Three expansion programs of Oridion have been granted the status of an "Approved Enterprise" status, under the above Law. For these expansion programs, Oridion has elected alternative benefits, waiving grants in return for tax exemptions. Pursuant thereto, the income derived from the following "Approved Enterprise" expansion programs is tax-exempt for a period of 10 years, commencing with the first taxable year.

1. Income derived from the first program, which commenced in 1997 and is to expire in 2006, entitled Oridion to a tax exemption for the ten-year period ending 2006.
2. Income derived from the second program, which commenced in 2000 and is to expire in 2009, entitled Oridion to a tax exemption for the ten-year period ending 2009.
3. The scope of the third program totals \$ 3,256 and the date for implementation is by April 1, 2005. As of December 31, 2004, \$ 1,272 were invested in the program.
4. The scope of the fourth program totals \$ 1,754 and the date for implementation is by April 1, 2005. As of December 31, 2004, \$ 531 were invested in the program.

The entitlement to the above benefits is conditional upon Oridion fulfilling the conditions stipulated by the above law, regulations published thereunder and the instruments of approval for the specific investments in "Approved Enterprise". In the event of failure to comply with these conditions, the benefits may be canceled and Oridion may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2004, management believes that Oridion is meeting all of the aforementioned conditions.

The period of tax benefits, detailed above, is subject to limits of the earlier of 12 years from the commencement of production, or 14 years from receiving the approval.

As of December 31, 2004, Oridion does not have any tax-exempt income.

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate of 34%.

- b. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

According to the above law, the Company is entitled to file a consolidated tax return together with Oridion under certain conditions and, as such, the Company has decided to file a consolidated tax return for 2003 and thereafter.

According to the above law, Oridion is an "industrial company" and, as such, is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment.

**NOTE 11:- TAXES ON INCOME (Cont.)**

- c. Measurement of results for tax purposes under the Income Tax Law (Inflationary Adjustments), 1985:

Results for tax purposes are measured in real terms of earnings in NIS, after certain adjustments for increases in the CPI (Consumer Price Index) in Israel. As explained in Note 2b, the financial statements are measured in U.S. dollars. The difference between the annual change in the CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on the difference between the functional currency and the tax bases of assets and liabilities.

- d. Carryforward losses:

As of December 31, 2004, Oridion has approximately \$ 42,411 in net operating loss carryforward in Israel. According to Israel's Income Tax Law, due to the split of Oridion BreathID, as described in Note 2c, the utilization of these carryforward losses during the five years commencing with the split date is limited for each year to the lower of 20% of said carryforward losses as of the split date or 50% of the taxable income. The Israeli loss carryforward has no expiration date. Oridion expects that during the period in which these tax losses are utilized, its income would be substantially tax-exempt. Accordingly, there will be no tax benefit available from such losses, and no deferred income taxes have been included in these financial statements.

- e. Non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed under the tax laws in their countries of domicile.

As of December 31, 2004 Oridion's subsidiaries in the U.S have estimated total available carry forward tax losses of \$ 10,336 to offset against future taxable profits for 20 years that expire between 2021 and 2024.

- f. Loss before taxes is comprised as follows:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Domestic	\$ (2,012)	\$ (3,025)	\$ (4,008)
Foreign	(1,892)	(3,190)	(5,644)
	<u>\$ (3,904)</u>	<u>\$ (6,215)</u>	<u>\$ (9,652)</u>

# Notes to Consolidated Financial Statements

U.S. dollars in thousands

## NOTE 12:- RELATED PARTY TRANSACTIONS

	Year ended December 31,		
	2004	2003	2002
General and administrative expenses:			
Directors fees	\$ 72	\$ 80	\$ 44
Compensation to Company's officers *)	\$ 2,250	\$ 1,268	\$ 1,075

\*) 2004 - including retirement benefit (see Note 15).

## NOTE 13:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION

- a. The Company has two reportable segments: Capnography and Breath Test. The data is presented in accordance with Statement of Financial Accounting Standards No. 131 "Disclosure about Segments of an Enterprise and Related Information" ("SFAS No. 131").

Capnography - is the business of supplying portable capnography monitors and patented monitoring technology and accessories, under Original Equipment Manufacture Agreements and Private Label Agreements.

Breath Test - is the business of developing and supplying patented breath testing equipment for the diagnosis of different organs in the human body.

The following data present the revenues, expenditures and other operating data of the Company's operating segments:

	Year ended December 31, 2004		
	Capnography	Breath Test	Total
Revenues from sales to unaffiliated customers	\$ 22,279	\$ 171	\$ 22,450
Financial expenses	\$ (71)	\$ (237)	\$ (308)
Depreciation	\$ 683	\$ 157	\$ 840
Segment profit (loss)	\$ 230	\$ (4,133)	\$ (3,903)
Segment assets	\$ 17,634	\$ 853	\$ 18,487
Capital expenditures	\$ 256	\$ -	\$ 256

	Year ended December 31, 2003		
	Capnography	Breath Test	Total
Revenues from sales to unaffiliated customers	\$ 17,710	\$ 407	\$ 18,117
Financial income (expenses)	\$ 384	\$ (552)	\$ (168)
Depreciation	\$ 728	\$ 193	\$ 921
Segment loss	\$ (470)	\$ (5,691)	\$ (6,161)
Segment assets	\$ 15,760	\$ 1,732	\$ 17,492
Capital expenditures	\$ 216	\$ 28	\$ 244

U.S. dollars in thousands

**NOTE 13:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)**

	<b>Year ended December 31, 2002</b>		
	<b>Capnography</b>	<b>Breath Test</b>	<b>Total</b>
Revenues from sales to unaffiliated customers	\$ 13,794	\$ 266	\$ 14,060
Financial income	\$ 240	\$ 4	\$ 244
Depreciation	\$ 1,182	\$ 255	\$ 1,437
Segment loss	\$ (4,591)	\$ (4,983)	\$ (9,574)
Segment assets	\$ 16,230	\$ 6,312	\$ 22,542
Capital expenditures	\$ 918	\$ 43	\$ 961

b. Geographic information:

	<b>Year ended December 31,</b>					
	<b>2004</b>		<b>2003</b>		<b>2002</b>	
	<b>Total revenues</b>	<b>Long-lived assets</b>	<b>Total revenues</b>	<b>Long-lived assets</b>	<b>Total revenues</b>	<b>Long-lived Assets</b>
The Company attributes revenues based on the customer's location as follows:						
United States	\$ 14,765	\$ 79	\$ 12,760	\$ 160	\$ 9,801	\$ 326
Germany	5,351	-	2,890	6	2,223	6
Europe	1,363	-	1,596	-	1,090	-
Asia	852	4	565	9	620	8
Israel	99	3,189	306	4,016	289	4,422
Other	20	-	-	-	37	-
	<u>\$ 22,450</u>	<u>\$ 3,272</u>	<u>\$ 18,117</u>	<u>\$ 4,191</u>	<u>\$ 14,060</u>	<u>\$ 4,762</u>

c. Major customers:

	<b>Year ended December 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>% of total revenues</b>		
Customer A	<u>23</u>	<u>32</u>	<u>26</u>
Customer B	<u>24</u>	<u>18</u>	<u>13</u>
Customer C	<u>15</u>	<u>12</u>	<u>22</u>
Customer D	<u>10</u>	<u>9</u>	<u>11</u>

## Notes to Consolidated Financial Statements

U.S. dollars in thousands

### NOTE 14:- SELECTED STATEMENTS OF OPERATIONS DATA

	Year ended December 31,		
	2004	2003	2002
a. Research and development expenses:			
Research and development expenses	\$ 3,016	\$ 3,597	\$ 4,069
Less - participation of the Government of Israel	121	269	424
	<u>\$ 2,895</u>	<u>\$ 3,328</u>	<u>\$ 3,645</u>
b. Financial income (expenses), net:			
Financial expenses:			
Interest on short-term bank credit	\$ (55)	\$ (13)	\$ -
Interest on long-term loan	(114)	-	-
Amortization of deferred stock compensation related to warrants issued to credit providers and others	(57)	-	-
Linkage differences	(39)	(93)	-
Others	(94)	(118)	(46)
	<u>(359)</u>	<u>(224)</u>	<u>(46)</u>
Financial income:			
Gain from derivatives	30	-	-
Linkage differences	-	-	73
Interest on cash equivalents and short-term bank deposits	21	56	217
	<u>51</u>	<u>56</u>	<u>290</u>
	<u>\$ (308)</u>	<u>\$ (168)</u>	<u>\$ 244</u>

### NOTE 15:- RETIREMENT BENEFIT EXPENSES

In April 2004, the Company announced that its CEO had decided to step down from his position. He will continue to serve as a member of the Company's Board of Directors and as Honorary Chairman. The Chairman of the Board of directors has taken on duties as interim CEO.

In July 2004, the shareholders resolved to grant to the former CEO 400,000 Ordinary shares of the Company for no consideration and to grant options to purchase 231,000 Ordinary shares of the Company. The exercise prices of the options are CHF 1.91 - CHF 2.1. The shareholders also resolved that an annual salary in the amount of \$ 270 per year be used to determine the pension and severance pay entitlement of the former CEO.

As a result of the abovementioned, the Company recorded retirement benefit expenses in the amount of \$ 863, of which \$ 718 are non-cash.

**NOTE 16:- SUBSEQUENT EVENTS**

The Chairman of the Board of Directors currently also acts as Chief Executive Officer of the Company whose term as acting Chief Executive Officer expires on March 31, 2005. The Board of Directors has requested him to serve as Chief Executive Officer for another term of up to two additional years, as well as to serve as Chairman of the Board. The Chairman of the Board of Directors has consented to this request. The Extraordinary General Meeting of Shareholders will therefore be asked to appoint him as the Company's Chief Executive Officer for a two-year period commencing on April 1, 2005. During the same Extraordinary General Meeting, to be held on February 17, 2005, the Shareholders of the Company will also be asked to approve a bonus compensation package of an option for the purchase of 60,000 Ordinary shares of the Company in consideration of the significant contribution of the Chief Executive Officer to the Company during 2004. If he is elected by the shareholders as the Company's Chief Executive Officer for another term of two years, commencing April 1, 2005, the shareholders will also be asked to approve a compensation package for that period. The shareholders will vote to approve the grant of an option to the Chief Executive Officer for the purchase of 180,000 Ordinary shares of the Company as a sole compensation for his services as Chief Executive Officer for the next two years. In the event that he does not serve as Chief Executive Officer for the full two years, this compensation package will be adjusted accordingly. The exercise price per share for both compensation packages shall be the closing price of the Ordinary share of the Company on February 17, 2005.

In January 2005, the Board of Directors resolved to increase the Company's option pool for grant of options to employees and service providers of the Company and its subsidiaries under the terms of the Company's Stock Options Plans, by an additional amount of 580,845 Ordinary shares.

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