

DEFENSE INDUSTRIES INTERNATIONAL INC
Form 10-K
March 31, 2009

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the fiscal year ended December 31, 2008

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

Commission File Number: 0-30105

DEFENSE INDUSTRIES INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

84-1421483
(I.R.S. Employer
Identification No.)

8 Brisel Street
Industrial Zone Sderot,
Israel
(Address of principal executive offices)

87711
(Zip Code)

Registrant's telephone number (011) **972-8-689-1611**

Securities registered under Section 12(b) of the Act: None

Securities registered under Section 12(g) of the Act:

| <u>Title of each class</u> | <u>Name of each exchange on which registered</u> |
|---|--|
| Common Stock, par value \$0.0001 per share | OTC Bulletin Board |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Securities registered under Section 12(b) of the Act: None Securities registered under Section 12(g) of the Act:

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes No

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the most recently completed second fiscal quarter: \$2,124,147

The number of the registrant's common shares (par value \$0.0001 per share) outstanding as of March 31, 2009 was 27,941,111 shares.

INTRODUCTION

Defense Industries International, Inc. is a manufacturer and global provider of personal military and civilian protective equipment and supplies. Our products are used by military, law enforcement, border patrol enforcement, and other special security forces, corporations, non-governmental organizations and individuals throughout the world. Our main products include body armor, bomb disposal suits, bullet proof vests and jackets, ballistic wall coverings, bullet proof ceramic and polyethylene panels, V.I.P. car armoring and lightweight armor kits for vehicles, personal military equipment, dry storage systems, liquid logistic products, tents and other camping and travel gear.

Our shares are traded on the Over the Counter Bulletin Board, or OTC Bulletin Board, under the symbol "DFNS.OB". As used in this annual report, the terms "we," "us" and "our" mean Defense Industries International, Inc. and its subsidiaries, unless otherwise indicated.

We use Achidatex, Export Erez and Argo as trade names. All other trade names and trademarks appearing in this annual report are owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to "dollars" or "\$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any previous filing with the Securities and Exchange Commission, or SEC, you may read the document itself for a complete recitation of its terms.

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Securities registered under Section 12(b) of the Act: None Securities registered under Section 12(g) of the Act:

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FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K contains various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and within the Private Securities Litigation Reform Act of 1995, as amended. Such forward-looking statements reflect our current view with respect to future events and financial results. Forward-looking statements usually include the verbs, "anticipates," "believes," "estimates," "expects," "intends," "plans," "projects," "understands" and other verbs suggesting uncertainty. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

We have attempted to identify additional significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section which appears in Item 1A.

PART I

Item 1. Description of Business.

General

We are a manufacturer and global provider of personal military and civilian protective equipment and supplies. Our products are used by military, law enforcement, border patrol enforcement, and other special security forces, corporations, non-governmental organizations and individuals throughout the world.

Our main products include body armor, bomb disposal suits, bullet proof vests and jackets, tactical combat vests, ballistic wall coverings, bullet proof ceramic and polyethylene panels, V.I.P. car armoring and lightweight armor kits for vehicles, personal military equipment, dry storage systems, liquid logistic products, tents and other camping and travel gear.

Company History

Our predecessor was incorporated in the State of Utah on July 9, 1997 as Pawnbrokers Exchange, Inc., or Pawnbrokers Exchange. On July 8, 2002, Pawnbrokers Exchange changed its corporate domicile from the State of Utah to the State of Nevada, through a merger with its wholly owned subsidiary, Defense Industries International, Inc., or Defense Industries, a Nevada corporation organized on July 1, 2002. As part of the reincorporation, Pawnbrokers Exchange changed its name to Defense Industries. Each issued and outstanding share of Pawnbrokers Exchange capital stock was converted into and exchanged for one share of Defense Industries common stock. Defense Industries is authorized to issue 250,000,000 shares of \$0.0001 par value common stock and 50,000,000 shares of \$0.0001 par value preferred stock.

Organization

We are a holding company whose wholly owned subsidiaries include Export Erez USA, Inc., Rizzo Inc. (doing business as Owen Mills Company), Export Erez, Ltd., or Export Erez, Mayotex, Ltd., or Mayotex, Dragonwear Trading Ltd., or Dragonwear, and Achidatex Nazareth Elite (1977) Ltd., or Achidatex.

Export Erez was incorporated in Israel on January 23, 1983 under the name R.T.V. Ltd. and changed its name to Export Erez on April 25, 1987. Export Erez is principally engaged in the design, production and marketing of personal military and civilian protective equipment and supplies such as body armor, bomb disposal suits, bulletproof vests, and associated heavy fabric products, such as battle pouches and combat harness units, tents and other camping equipment.

Mayotex was incorporated in Israel on March 7, 1990. Mayotex is engaged in weaving, processing and dyeing of webbings, cutting and sewing of bulletproof fabrics used by Export Erez in manufacturing its finished products and goods and in VIP car armoring and lightweight vehicle armor kit production. On December 20, 2005, Mayotex acquired the operations of Chemoplast Industries (1994) Ltd., or Chemoplast, including its machinery, computer systems, inventory, know-how and name. Chemoplast is an Israeli provider of controlled dry storage systems for tank, armored personnel carriers and other military vehicles, and of equipment that require battlefield readiness and quick deployment such as collapsible liquid storage tanks, mobile silos for storage of grains, liners for tanks shipping systems, custom-made covers for artillery, vehicles, communication equipment, tarpaulins, various technical products and special-purpose defense items.

In December 17, 2008, our Mayotex subsidiary entered into an Investment agreement, or the Sarino Agreement, with Sarino Crystal Technologies Ltd. and Sarino Optronics Ltd., together Sarino, to cooperate in the manufacture of optical grade germanium crystals and the sale of optical and infra-red night vision products utilizing the germanium crystals. Pursuant to the Sarino Agreement, Mayotex and Sarino incorporated Mayosar Technologies Ltd., or Mayosar, in which Mayotex holds 50.1% of the outstanding shares and Sarino holds the remaining 49.9% of the outstanding shares. Operations commenced in January 2009.

Dragonwear was incorporated in Cyprus in October 2000 and is engaged in trading textile products.

Achidatex was incorporated in Israel on August 2, 1977 as a limited liability company under the Israeli Companies Ordinance. Achidatex is a leading manufacturer of ballistic shields, long term storage systems, liquid logistic products, combat flak jackets, tents and other personal military and civilian protective equipment and supplies. Export Erez USA, Inc. acquired 76% of the outstanding shares of Achidatex in June 2001, from Mr. Avraham Hatzor, Mr. Freddy Davidovitz and Mr. Shmuel Davidovitz. On December 31, 2008, we entered into a stock purchase agreement with Achidatex and Messrs. Hatzor and Freddy and Shmuel Davidovitz, pursuant to which we purchased from them an aggregate of 1,050,000 shares of our common stock, 3.62% of our stock, at a price per share of \$0.24. In addition, we purchased from the Messrs. Hatzor and

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Freddy and Shmuel Daviedowitz, the remaining minority interest in Achidatex, in consideration for \$948,000. As a result of this purchase we now own 100% of Achidatex.

Rizzo Inc., is a California corporation doing business under the name Owen Mills Company. We acquired all of the outstanding shares of Rizzo Inc. in February 2005. Owen Mills specializes in military and industrial sewing of marine and ballistic fabric products. Owen Mills manufactures in the U.S. many products similar to our products. We believe that Owen Mills will begin to manufacture quick deployment tents in 2009.

Strategy

We believe that current international tensions, the subsequent war on terrorism, and the continuing military conflicts are all likely to result in additional interest in our products, and that the demand for our products will continue to grow.

We expect to address this growth by offering a comprehensive array of high quality branded security products that meet our customers' increasingly complex security products requirements. We intend to enhance our position in the industry through additional strategic acquisitions that will broaden our portfolio of products.

The following elements define our growth strategy:

Pursue strategic acquisitions. In addition to our acquisition of Owen Mills and of the operations of Chemoplast, we intend to continue to selectively pursue strategic acquisitions that complement our product offerings, provide access to new geographic markets, and provide additional distribution channels and new customer relations.

Pursue new strategic opportunities. We believe that the demand for infra-red night-vision systems is growing and established Mayosar, a joint venture company, to enter into this business. Mayosar established Isorad IR Optics Ltd, a company that will manufacture germanium crystals for use in the production of infra-red night vision systems based on the know how and equipment it purchased from an Israeli governmental entity. Operations commenced in January 2009.

Expand Distribution Networks and Product Offerings. We expect to continue to strengthen our distribution network by expanding our range of branded law enforcement equipment through the acquisition of and by investing in development of new and enhanced products which complement our existing offerings. We believe that a broader product line will strengthen our relationships with distributors and enhance our brand appeal with military, law enforcement and other end users.

Products

We target our product at three principal markets: the international military and defense market, the civilian market and the industrial/agriculture market.

Our military products include body armor, bulletproof and stab-resistant clothing, combat vests, bomb disposal suits, battle pouch and combat harness units, flak jackets, ballistic helmets, dust protectors, padded coats, sleeping bags, weapon straps and belts, dry storage systems, liquid logistics products, ceramic and UHMW polyethylene ballistic plates, ballistic wall coverings, tents, vehicle covers and lightweight vehicle armor kits. Products currently under development include sophisticated stab-resistant solutions, lighter polyethylene ballistic plates and new lightweight vehicle armor kits.

Our second product group is intended for the civilian market, including law enforcement, border patrol enforcement, prison forces, special security forces, corporations, non-governmental organizations and individuals worldwide. Our civilian market products include adaptations of our military products, heavy-duty clothing and other types of sporting and camping equipment and clothing including, tents and sleeping bags. This product group includes armor for VIP luxury cars.

Our industrial/agriculture market products include special industrial fabrics and cloth tapes as well as flexible enclosures for temporary storage of agriculture products.

The following table details our current product line and target markets:

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| Product description | Target markets | Geographical market |
|---|----------------------------------|---------------------|
| Dust protectors and various covers | Military | International |
| Padded coats | Military, civilian | International |
| Protective vests and flak jackets | Military, civilian | International |
| Cooling jackets | Military | International |
| Overalls | Military | International |
| Vests | Military, civilian | International |
| Sleeping bags | Military, civilian | International |
| Carriers for grenade launchers | Military | International |
| Bags and totes | Military | International |
| Tents | Military, civilian | International |
| Camp beds | Military, civilian | International |
| Collapsible storage containers | Military, civilian | International |
| Evacuation stretchers | Military, civilian | International |
| Personal belts and weapon straps | Military | International |
| Woven fabrics: canvas, corduroy, nylon, aramid | Military, civilian, industrial | International |
| Ballistic wall coverings | Military, civilian, industrial | International |
| Ballistic plates and panels | Military, civilian | International |
| Car armor | Civilian | Israel |
| Lightweight vehicle armor kits | Military, civilian | International |
| Range of woven tapes | Military, civilian, industrial | International |
| Horseback riding accessories | Civilian | International |
| Long-term storage systems | Military, industrial/agriculture | International |
| Regular/digital colored printed truck Coverings | Civilian | International |

We continue to improve our existing products and to develop new products for the military and the civilian markets, including mine protective shoes, stab-resistant solutions, improved armored car blast protection materials, and modified ballistic wall coverings. In addition, we are continuing to develop a new generation of complex products for protective vests to be used by security forces and armies.

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New Product Line

On December 17, 2008, our Mayotex subsidiary entered into an investment agreement, or the Sarino Agreement, with Sarino Crystal Technologies Ltd. and Sarino Optronics Ltd., together Sarino, to cooperate in the manufacture of optical grade germanium crystals and the sale of optical and infra-red night vision products utilizing the germanium crystals. Pursuant to the Sarino Agreement, Mayotex and Sarino incorporated Mayosar Technologies Ltd., or Mayosar, in which Mayotex holds 50.1% of the outstanding shares and Sarino holds the remaining 49.9% of the outstanding shares.

Mayotex agreed to provide a shareholder loan to Mayosar of up to \$2 million, under a timetable to be determined by Mayosar's board of directors, which is controlled by Mayotex. The loan will accrue interest at the rate of Libor + 2%. In addition, Mayotex agreed to pay Sarino Crystal Technologies Ltd. a fee of up to \$1 million. Of such amount, \$300,000 will be forgiven at the end of 24 months from the commencement of operations. In the event Mayosar reaches \$10 million in sales during the 36 months following the commencement of operations, the remaining \$700,000 will not have to be repaid.

On December 21, 2008, Mayosar signed an agreement with Isorad Ltd., an Israeli governmental company, or Isorad, to purchase certain knowledge, know how, equipment and inventory and the activity of a factory that manufactures germanium crystals for lenses used in infra-red night vision system applications, or the Isorad Agreement.

Mayosar incorporated a wholly owned subsidiary named Isorad Optronics Ltd. that later changed its name to Isorad IR Optics Ltd., or Isorad IR, to acquire the Isorad assets. Mayosar agreed to pay Isorad royalties of 3% of total sales with no deductions, except transportation costs and VAT, for a period of 15 years commencing January 1, 2009. The minimum royalty will be NIS 500,000 (approximately \$122,000) per year for the period beginning January 1, 2009 and ending on completion of the transfer of all activity from Isorad's facilities (no later than 18 months from January 1, 2009) and NIS 200,000 (approximately \$48,800) per year or \$50,000, whichever is greater, thereafter. Beginning January 1,

2009, and for a 24 month period, Isorad has the right to acquire 5% of the outstanding share capital of Isorad IR. In the event that such shares are issued to Isorad, Mayosar will issue an additional 539 of its shares to Mayotex, so that Mayotex will retain a 50.1% ownership interest in the entire operation. During the four year period commencing January 1, 2009, Mayosar has the option to purchase from Isorad this 5% interest of Isorad IR (if acquired by it) and the right to extinguish its royalty obligation to Isorad in consideration for \$750,000 less all the royalties paid to Isorad by Mayosar. If the Israeli government does not approve the ownership of the Isorad IR shares by Isorad before December 31, 2009, Isorad will be paid \$75,000 or NIS 300,000, whichever is greater, and the option to purchase the shares will terminate.

Product Quality

We have established a reputation for producing premium quality products that represent the cutting-edge in design and technological development. Through on going research and development efforts we believe that we are setting the standards for personal defense related products. Our manufacturing facilities meet American EQNET and the International ISO 9001; the United States Armed Forces MIL-STD-105D and MIL-I-45208A standards; the German Armed Forces and NATO AQAP standards; and the NIJ standards, NIJ 0101.03 and NIJ 0101.04, for Ballistic Resistance of Personal Body Armor that are accepted worldwide.

Production

We develop, manufacture and assemble our own products in Israel and the United States. Our production facilities in Israel are located in Sderot, Nazareth, Ashkelon and the Alon Tavor Industrial Zone near Afula. Our production facility in the United States is located in Van Nuys, California. We believe that we distinguish ourselves from most of our competition by our ability to manufacture the various components of our products and by the fact that we generally do not rely on other manufacturers. Our production process begins with the manufacture of fabrics and other basic components of our products and ends with quality control inspections of completed goods and products.

During 2004, the Israeli Government decided to evacuate the Erez Industrial Zone in the Gaza Strip, where part of our operations were located. We owned facilities, leased other facilities and maintained equipment and inventory within this area. In 2005, we moved our light cut and sew operation from the Erez Industrial Zone to Sderot and some of our webbing equipment to Nazareth. In August 2005, we evacuated our remaining operations and abandoned the buildings we owned and leased in the Erez Industrial Zone.

The Israeli Government's decision to evacuate the Gaza Strip was supported by certain resolutions, including the Evacuation Compensation Law that was adopted by the Israeli Parliament to compensate the Israeli Gaza Strip settlers as well as business and property owners in the Gaza Strip and in the Erez Industrial Zone. In February 2006, three of our subsidiaries, Export Erez, Mayotex and Achidatex filed claims for compensation pursuant to the Evacuation Compensation Law. In 2005, we recorded a receivable from the Israeli Government of \$217,477 related to our direct moving costs and loss on abandoned properties.

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In 2006, we were notified that we would receive advance payments in the aggregate amount of \$523,000. We applied this payment against the receivable established in 2005 and recorded the excess payment of \$240,658, net of taxes, as extraordinary gain.

On February 18, 2008 Export Erez, Mayotex and Achidatex signed definitive agreements with SELA, a government agency, established pursuant to the Evacuation Compensation Law, for compensation of approximately \$6.0 million, net of 5% related taxes, receipt of the previous advance payment and the other associated costs. The Company received and recorded an extraordinary gain of \$4.8 million during the year ended December 31, 2008.

Our production facilities provide us with the capability of independently weaving, cutting, sewing, gluing, welding and assembling products and integrating systems. If workloads require, we use the services of sub-contractors, mainly for obtaining raw materials, sewing metal work, cloth coating work, dyeing and finishing, and digital printing.

In connection with our production activities, we have established five principal departments: research and development, technical design, mechanics processing, product assembly and quality control.

Transportation and Distribution

Our manufacturing plants are located in Israel and in the State of California. Israel's marine transportation routes are well-developed and, accordingly, we have no logistic difficulty in distributing our products and in most cases our products reach their destination within two to three weeks, depending on the arrangements with the customer. Products for export are shipped mainly as Free on Board (F.O.B) shipping point, as per Incoterm standard. Consignments are sent by sea or air, depending on the nature of the order and the urgency of supply.

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To date, our U.S. facility only serves our U.S. based customers and we have had no difficulties in distributing our products within the U.S.

Competition

The ballistic-resistant and body armor industry is highly competitive and fragmented throughout the world. In the United States the great majority of manufacturers are privately held companies, ranging from small limited product companies to large multinational corporations. We estimate that there are approximately twenty U.S.-based companies that compete in the body armor industry. The principal elements of competition are performance, price, innovative design, and quality. Name recognition and reputation are highly important in each country where products are sold. We believe that our products are highly competitive and well regarded, evidenced by our ability to sell to customers such as the United States Military, Israeli Defense Forces, NATO and many foreign governments. We also believe that we distinguish ourselves from our competition by (i) our ability to manufacture the various components of our products, (ii) the fact that we generally do not rely on other manufacturers and (iii) the diversification and range of our product lines.

Barriers to entry for new companies entering the body armor industry are low, consequently, creating fierce competition. We believe that establishing a good reputation significantly enhances the competitive position of the industry's long-standing manufacturers. However, name and product reputation takes many years to develop. In the U.S. civilian market, (law enforcement, border patrol forces, prison forces and specialty forces) our products are less known than that of our competitors. We intend to use our highly regarded reputation in the international markets coupled with our U.S. manufacturing facilities, Owen Mills, to expand our U.S. presence and to achieve greater market penetration.

Although industry statistics are difficult to quantify, we believe that the number of active police officers has increased significantly in the past few years. In 2008, there were more than 850,000 law enforcement personnel and over 20,000 law enforcement agencies in the United States. We expect that governmental reaction to terrorist attacks will increase the market for our products. The United States has established the Office of Homeland Security that is developing a homeland security infrastructure and is devoting significant resources to this effort.

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Our proprietary products such as dry storage systems, ballistic wall coverings and liquid logistic products encounter significantly less competition than the traditional body armor product line.

A rising demand for armoring large vehicles and boats has increased the demand for large lightweight armor plates. Those lightweight plates are molded under extreme high pressure. With our unique 5,000 metric ton press, we have the ability to mold the large size plates. We encounter less competition with respect to large size plates than with our standard sized molded armor plates product line.

In the civilian market, we are aware of approximately twenty major companies manufacturing similar products worldwide. A number of major manufacturers with greater resources than ours compete in the same market. In 2008, we continued to increase our marketing efforts through distributors who concentrate on the civilian market.

Our major competitor in sales to the Israeli Ministry of Defense is Rabintex, a larger, more established Israeli corporation. We also have competition from other Israeli companies and from a number of importers. Internationally, our competitors in the defense market include companies such as Point Blank, Safari Land of Ontario, California, Armor Holdings and A.B.A. in the United States, L.B.A. in England, Indigo in Spain, Systema Compositi in Italy, Hellenic Arms Industries in Greece and Barman in Sweden. Each of these competitors offer a more limited product line than we do.

Raw Materials

We use variety of ballistic protection materials, including aramid woven and non-woven fabrics and non-woven polyethylene sheets and ceramic material for personal protection products and steel for car armoring. Aramid fabrics that we both weave ourselves and acquire from other manufacturers, and non-woven uni-directional polyethylene sheets are used together, as the basic components of our ballistic protection products. As a result, our protective equipment provides excellent protection with relatively low weight, and we believe that it is highly competitive. We obtain our supplies on the basis of an open letter of credit, specialized documentary credit, and in the case of suppliers with whom we have dealt with for years, on open account. We have long-term relationships with some of our suppliers, and we believe that these suppliers are stable and do not anticipate any disruption in the steady supply of materials that we require. A disruption in the supply of materials could have an adverse impact on our operating results.

Our products are made from raw materials produced in Israel and abroad including, specialized composite materials such as Kevlar® produced by DuPont Company, Twaron® produced by Twaron Teijn Ltd., Dyneema® produced by D.S.M. Ltd. and Spectra® and Gold Flex® produced by Honeywell. We also use other specialized materials produced by different manufacturers such as specialized glass mixed with polycarbonate and various resins.

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DuPont's Kevlar® brand fiber was initially introduced in 1965 and was the first material identified for use in the modern generation of concealable body armor. Kevlar® is a man-made organic fiber, with a combination of properties allowing high strength, low weight and high chemical and flame resistance. Through the years DuPont has continued to develop and design new generations of this high-performance fabric.

Spectra® fiber, manufactured by Honeywell, is an ultra-high-strength polyethylene fiber. It has one of the highest strength-to-weight ratios of any man-made fiber. Honeywell uses its Spectra® fiber to make its patented Spectra Shield®. Additional fibers that we use in the manufacture of body armor are Goldflex®, Twaron®, and Dyneema®. These state-of-the-art fibers are continuously being improved and advanced, which increases the possibility of superior new products entering the market.

As a result of the continuing conflict in Iraq, and in other geographical regions there was a worldwide increase in demand since 2005 for the raw materials used in our products. The suppliers have increased their production and the market shortages that existed in recent years no longer exist. We anticipate that this trend will continue in 2009.

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Seasonality

Sales of our military and security clothing products and industrial products are not seasonal in nature. We generally experience a slight increase in sales of our camping equipment during the second quarter and in sales of our protective clothing during the fourth quarter.

Marketing and Sales

Our sales and marketing strategies revolve principally around developing a reputable brand identity and ongoing customer relationships in addition to continuously improving the quality of our products and offering innovative new products. Specifically, our marketing strategy is designed to penetrate various markets by complying with stringent quality standards instituted in targeted countries.

Below are some of the steps we take in penetrating new markets with our next generation of products:

Locate domestic entities to market our products.

Actively participate in tenders and bids for contracts in military, police and civilian markets worldwide. We are currently negotiating for contract bids with the governments and governmental agencies in Turkey, Mexico, Brazil, Uruguay, Chile, Trinidad, and the U.S.

Advertise on the Internet.

Advertise in professional publications.

Appear in international databases, such as Kompass, various yellow page directories and other directories.

Distribute brochures describing procedures and product offerings.

Our local marketing group is divided into two sections. One section specializes in locating and submitting government bids and the second section specializes in marketing to the civilian sector. Separate offices in Sderot and Nazareth Elite handle the local civilian marketing. Each of these offices deals with a different geographical regions and a different line of products.

Our export marketing is handled by a free-lance marketing consultant and a group of in-house employees. Although he works almost exclusively for us, we do not have a formal written relationship with our marketing consultant. This marketing team carries out market surveys, market segmentation and searches for new markets for our products, as well as for new engagements with the international business community. The consultant is paid commissions that are determined in advance according to the scope and nature of the transaction.

Customers

We have a worldwide customer base, including in the United States, Israel, the Mediterranean, Europe, Latin America, South America, Africa and Asia. In 2008 and 2007, we sold approximately 45.1% and 36.2%, respectively, of our products to our international customers with

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the balance sold in Israel. The primary end users of our products can be divided into three main groups: (i) military defense and security forces, (ii) civilian defense customers and (iii) civilian customers.

Military Defense and Security Forces. We provide this group with personal military and protective equipment such as body armor, bomb disposal suits, bullet proof vests and jackets, ballistic helmets and plates, battle pouch and combat harness units, backpacks, dry storage systems, liquid logistics systems, clothing, tents, vehicle covers and sleeping bags. These items must meet certain human engineering requirements to provide comfort as well as maximum protection, to prevent penetration by bullets and knives, and to protect from fire, collisions and other hazards. On January 14, 2007, Mayotex signed a frame agreement to serve as a non-exclusive manufacturer and marketing representative of a leading U.S. provider of armored buses, based on truck chassis. In mid-2008 this U.S.-based provider of armored buses sold its assets to a company with whom we are not doing business.

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Civilian Defense Customers. This group includes members of civilian security forces such as law enforcement, prison forces, private security firms, airport security, personal bodyguards, and event security guards. The requirements of these customers for protective equipment are similar to those of military defense and security forces. However, since they primarily work in a civilian environment the products must meet certain aesthetic standards and the protective features need to be as unobtrusive as possible.

Civilian Customers. This group includes campers, hikers, pet owners and horse owners. We provide this group with equipment such as sleeping bags, tents, backpacks, and clothing adapted for specific needs such as mountain climbing, hiking and camping in all types of climates, horseback riding equipment and animal accessories. This customer group also includes those civilians in need of covers for cars, trucks, buses and other large vehicles.

The Israeli Ministry of Defense, accounted for 30.7% and 48.6% of our revenues for the years ended December 31, 2008 and 2007, respectively.

Backlog

We had approximately \$6.7 million of unfilled customer orders at December 31, 2008, as compared to approximately \$3.2 million of unfilled customer orders at December 31, 2007. Our sales to the Israel military forces decreased from \$9,706,945 for the year ended December 31, 2007 to \$6,226,225 for the year ended December 31, 2008 as the Israeli Ministry of Defense, the Israeli police and other Israeli law enforcement and special security force organizations decreased their purchases from Israeli companies.

Patents and Trademarks

Our subsidiary Achidatex holds several patents from various countries for our ballistic wall coverings, dry storage systems and mine protective shoes. The following patents are held by Achidatex:

U.S. patent No. 6,212,840 - Retrofit Blast Protection for walls and windows frames of a structure.

U.S. patent No. 5,309,684 - Multipurpose Dry Storage System.

German patent No. 94 11 142.1 correlated to the U.S. patent No. 5,309,684 - Multipurpose Dry Storage System.

U.S. patent application No. 10/098,344 - Minefield shoe.

German patent application No. 03005442.3 - Minefield shoe and methods for manufacture thereof.

U.S. trade name registration - "ergonomic - anatomic and ergonomic design" for bulletproof vests.

Regulation

Our operations are subject to extensive regulation by the U.S. and Israeli authorities and to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of our operations.

The U.S. National Institute of Justice, or NIJ, established standards for Ballistic Resistance of Personal Body Armor that are accepted worldwide. The NIJ issues performance standards that clearly specify a minimum performance level for each attribute that is critical for the equipment's intended use. This coveted compliance standard has gained global acceptance as a benchmark for evaluation of the effectiveness of a given body armor model. The NIJ body armor-testing program relies on voluntary participation by manufacturers. However, many police departments require that armor be tested and be found to be in compliance with NIJ standards before they purchase the armor. Four of our ballistic material combinations have been tested by NIJ certified ballistic laboratories and were found to comply with NIJ Standard 0101.03, 0101.04 and the recently introduced NIJ 2005 Interim Requirements for Bullet-Resistant Body Armor. As a result, these four ballistic combinations have been approved to carry NIJ labels.

Our manufacturing practices have obtained ISO 9001 certification. This international certification harmonizes and establishes standards for quality manufacturing throughout the world. Over the years, ISO standards have expanded beyond the quality system and now confirm conformity in environmental issues, safety and occupational health. This voluntary certification process is designed to provide consistency in manufacturing processes and quality control.

Other quality control standards pertaining to our manufacturing facilities consist of the following:

MIL-STD-105D, MIL-I-45208A (for the United States Armed Forces); and

AQAP (for the German Armed Forces and NATO).

In order to participate in bids of the Israeli Ministry of Defense and other governments, companies must follow various rules and procedures. The bidder must be registered as a recognized supplier. The bidder must have government certification and is authorized to participate in bids only to the limit of its approved security classification. Under Israeli bid regulations, goods produced in Israel are given priority over foreign bidders. The bidder must keep to contractual schedules and milestones and the goods must pass final quality control tests before delivery. There are no special taxes on bids apart from the Israeli value added tax.

Since our business is highly regulated, the laws, rules and regulations applicable to our business are subject to regular modification and change. Future laws, rules or regulations may be adopted, making compliance much more difficult or expensive, and may otherwise adversely affect our business or prospective business.

Research and Development

We continue to improve our existing products and develop new products for the military and civilian markets, including mine protective shoes, stab-resistant solutions, improved armored car blast protection materials, and modified ballistic wall coverings. We are also developing a new generation of complex products for protective vests used by security forces and armies all over the world.

In the years ended December 31, 2008 and 2007, we spent approximately \$120,608 and \$115,000, respectively, on research and development, which expenses have been charged to operations. We anticipate that our research and development expenses for 2009 will total approximately \$140,000.

Environmental Laws

We are unaware of any environmental laws that are applicable to us that will require us to spend any material amounts to achieve compliance.

Employees

As of December 31, 2008, we had 161 full-time employees. We had 158 employees in Israel and 3 employees in the United States. We believe our relationship with our employees is good. Our employees are not represented by a collective bargaining organization and we have not experienced any work stoppages.

Item 1A. Risk Factors

Investing in our stock involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our stock. Our business, prospects, financial condition and results of operations could be adversely affected due to any of the following risks. In that case, the value of our stock could decline, and you could lose all or part of your investment.

Risks Related to Our Business and Our Industry

The products we sell are used in applications that are inherently risky and could give rise to product liability and other claims.

The products that we manufacture are typically used in applications and situations that involve high levels of risk of personal injury. Failure to use our products for their intended purposes, failure to use them properly, their malfunction, or, in some limited circumstances, even correct use of our products, could result in serious bodily injury or death. Our main products include personal military and civilian protective equipment and supplies such as body armor, bomb disposal suits, ballistic wall coverings, bulletproof vests, and associated heavy fabric products, such as battle pouches and combat harness units, dry storage systems, liquid logistic products, tents and other camping and travel gear.

The manufacture and sale of certain of our products may be the subject of product liability claims arising from the design, manufacture or use of such goods. If we are found to be liable in such claim, we may be required to pay substantial damages and our insurance costs may increase significantly as a result. Also, a significant or extended lawsuit, such as a class action, could also divert significant amounts of management's time and attention. Our insurance coverage may not be sufficient to cover the payment of any potential claim. In addition, this or any other insurance coverage may not be available or, if available, we may not be able to obtain it at a reasonable cost. Any material uninsured loss could have a material adverse effect on our business, financial condition and results of operations. In addition, the inability to obtain product liability coverage would prohibit us from bidding for orders from certain governmental customers since, at present, many bids from governmental entities require such coverage, and any such inability would have a material adverse effect on our business, financial condition and results of operations.

We are subject to extensive government regulation and our failure or inability to comply with these regulations could materially restrict our operations and subject us to substantial penalties.

We are subject to extensive regulation by governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on our operations. Furthermore, we have material contracts with governmental entities and are subject to rules, regulations and approvals applicable to government contractors. For the years ended December 31, 2008 and 2007 the Israeli Ministry of Defense accounted for \$5,585,355 and \$9,367,382 of our sales, respectively. We are also subject to routine audits to assure our compliance with these requirements. In addition, a number of our employees are required to obtain specified levels of security classification. Our business may suffer if we or our employees are unable to obtain the security classifications that are needed to perform services contracted for the Israeli Ministry of Defense, one of our major customers. Our failure to comply with these contract terms, rules or regulations could expose us to substantial penalties, including the loss of these contracts and disqualification as a government contractor of certain governments.

We have significant international operations and are therefore subject to additional financial and regulatory risks.

While our principal executive offices are located in Israel, 45.1% of our sales in the year ended December 31, 2008, and 36.2% of our sales in the year ended December 31, 2007 were generated from exports. We are seeking to increase the level of our international business activity. Our overseas operations are subject to various risks, including: foreign import controls (which may be arbitrarily imposed and enforced and which could preclude sales to certain customers).

One component of our strategy is to expand our operations into selected international markets. Military procurement, for example, has traditionally been international in scope. Countries in which we actively market include Turkey, Chile, Mexico, Guatemala, India, Peru, Georgia, Australia and Brazil. We, however, may be unable to execute our business model in these markets or new markets. Further, foreign providers of competing products and services may have a substantial advantage over us in attracting consumers and businesses in their country due to earlier established businesses in that country, greater knowledge with respect to the cultural differences of consumers and businesses residing in that country and/or their focus on a single market.

In pursuing our international expansion strategy, we face several additional risks, including:

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Reduced protection of intellectual property rights in some countries;

Licenses, tariffs and other trade barriers;

Longer sales and payment cycles;

Greater difficulties in collecting accounts receivable;

Potential adverse tax consequences;

Laws and business practices favoring local competition;

Costs and difficulties of doing business and customizing products for foreign countries;

Compliance with a wide variety of complex foreign laws and treaties;

Political and economic instability; and

Variance and unexpected changes in local laws and regulations.

We may operate in areas where local government policies regarding foreign entities and the local tax and legal regimes are often uncertain, poorly administered and in a state of flux. We cannot be certain that we are in compliance with, or will be protected by, all relevant local laws at any given point in time. A subsequent determination that we failed to comply with relevant local laws and taxation regimes could have a material adverse effect on our business, financial condition and results of operations.

One or more of these factors could adversely effect our future international operations and, consequently, could have a material adverse effect on our business, financial condition and results of operation.

Our business may be negatively affected by the current global economic and credit crisis.

The current economic climate and the uncertainty in the global economic conditions resulting from the recent disruption in credit markets pose a risk to the overall economy that could impact customer demand for our products, as well as our ability to manage normal commercial relationships with our customers, suppliers and creditors. If the current situation deteriorates significantly, our business could be negatively impacted, including such areas as reduced demand for our products from a slow-down in the general economy, reduced governmental and military budgets, or supplier or customer disruptions resulting from tighter credit markets.

Currency exchange rate fluctuations in the world markets in which we conduct business could have a material adverse effect on our business, results of operations and financial condition.

We may be adversely affected by fluctuations in currency exchange rates. A significant portion of our expenses are incurred in NIS and Euros. We do not currently engage in any currency hedging transactions intended to reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. If we were to determine that it was in our best interests to enter into any hedging transactions in the future, there can be no assurance that we will be able to do so or that such transactions, if entered into, will materially reduce the effect of fluctuations in foreign currency exchange rates on our results of operations. In addition, if for any reason exchange or price controls or other restrictions on the conversion of foreign currencies into NIS were imposed, our business could be adversely affected.

There can be no assurance such fluctuations in the future will not have a material adverse effect on revenues from international sales, and consequently, on our business, operating results and financial condition.

Reduction in military budgets worldwide may cause a reduction in our revenues, which would adversely affect our business, operating results and financial condition.

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A significant portion of our revenues is derived from the sale of products to military markets. These revenues, on a consolidated basis, totaled approximately \$13.4 million, or 73.9%, of our revenues for the year ended December 31, 2008 and \$14.9 million, or 77.4%, of our revenues for the year ended December 31, 2007. The military budgets of a number of countries may be reduced in the future. Declines in government military budgets may result in reduced demand for our products, resulting in a reduction of our revenues and would adversely affect our business, results of operations and financial condition.

Sales of our products are subject to governmental procurement procedures and practices; termination, reduction or modification of contracts with our customers, and especially with the government of Israel, or a substantial decrease in our customers' budgets may adversely affect our business, operating results and financial condition.

Our military products are sold primarily to government agencies and authorities, many of which have complex and time-consuming procurement procedures. A long period of time often elapses from the time we begin marketing a product until we actually sell that product to a particular customer. In addition, our sales to government agencies, authorities and companies are directly affected by those customers' budgetary constraints and the priority given in their budgets to the procurement of our products.

The termination, reduction or modification of our contracts or subcontracts with the Government of Israel in the event of change in requirements, policies or budgetary constraints would have an adverse effect on our business, operating results and financial condition.

We depend on sales to key customers and the loss of one or more of our key customers would result in a loss of a significant amount of our revenues.

A significant portion of our revenues is derived from a small number of customers. The Israeli Ministry of Defense accounted for 30.7% of our revenues for the year ended December 31, 2008. In the fiscal year ended December 31, 2007, the Israeli Ministry of Defense accounted for 48.6% of our revenues.

We anticipate that a significant portion of our future revenues will continue to be derived from sales to a small number of customers. If our principal customers do not continue to purchase products from us at current levels or if such customers are not retained and we are not able to derive sufficient revenues from sales to new customers to compensate for their loss, our revenues would be reduced and adversely affect our business, financial condition and results of operations.

Our markets are highly competitive and if we are unable to compete effectively, we will be adversely affected.

The markets in which we operate are highly competitive with a large number of competitors ranging from small businesses to multinational corporations. Competitors who are larger, better financed and better known than us may compete more effectively than we can. In order to stay competitive in our industry, we must keep pace with changing technologies and client preferences.

If we are unable to differentiate our products from those of our competitors, our revenues may decline. In addition, our competitors have established relationships among themselves or with third parties to increase their ability to address client needs. As a result, new competitors or alliances among competitors may emerge and compete more effectively than we can.

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There are limited sources for some of our raw materials and any shortage may significantly curtail our manufacturing operations.

The raw materials that we use in manufacturing ballistic resistant garments and cars armoring include: Kevlar® produced by Dupont Ltd., Twaron® produced by Twaron Teijn Ltd., Dyneema® produced by DSM Ltd. and Spectra® and Gold Flex® produced by Honeywell. We purchase these materials in the form of woven cloth from independent weaving companies. In the event DuPont or Twaron Teijn ceases for any reason to produce or sell Kevlar® or Twaron® to us, we would utilize the other ballistic resistant materials as a substitute. However, none of them is expected to become a complete substitute for Kevlar® or Twaron® in the near future. If our supply of any of these materials were materially reduced or cut off, or if there were a material increase in the prices of these materials, our manufacturing operations could be adversely affected and our costs increased, and our business, financial condition and results of operations would be materially adversely affected.

We may be unable to complete or integrate acquisitions effectively, if at all, and as a result may incur unanticipated costs or liabilities or operational difficulties.

We intend to grow through the acquisition of businesses and assets that will complement our current businesses. In December 2008, our Mayotex subsidiary entered into a joint venture agreement to cooperate in the manufacture of optical grade germanium crystals and the sale of infra-red night vision products utilizing the germanium crystals based on know-how and other assets acquired from a commercial entity of the Government of Israel. We may not be able to successfully operate or exploit this new business. Furthermore, we may have to divert our management's attention and our financial and other resources from other areas of our business to this new business. We cannot be certain that we will be able to identify other attractive acquisition targets, obtain financing for acquisitions on satisfactory terms, or successfully acquire identified targets. Our inability to implement our acquisition strategy successfully may hinder the expansion of our business.

Because we intend to acquire new businesses and assets to develop and offer new products, failure to implement our acquisition strategy may also adversely affect our ability to offer new products in line with industry trends.

We may not be successful in integrating the operations of businesses into our existing operations. Integration may result in unanticipated liabilities or unforeseen operational difficulties, which may be material, or require a disproportionate amount of management's attention. Acquisitions may result in us incurring additional indebtedness or issuing preferred stock or additional common stock. Competition for acquisition opportunities in the industry may rise, thereby increasing our cost of making acquisitions or causing us to refrain from making further acquisitions.

Our resources may be insufficient to manage the demands imposed by any future growth.

Expansion of our operations may place significant demands on our management, administrative, operating and financial resources. Growth of our customer base, the types of products offered and the geographic markets served can place a significant strain on our resources. In addition, we believe that we may encounter difficulties in identifying and hiring personnel who are qualified both in the provision and marketing of our security products, based on our current compensation levels. Our future performance and profitability will depend in large part on our ability to attract and retain additional management and other key personnel, our ability to implement successful enhancements to our management, accounting and information technology systems, and our ability to adapt those systems, as necessary, to respond to growth in our business.

Technological advances, the introduction of new products, and new design and manufacturing techniques could adversely affect our operations unless we are able to adapt to the resulting change in conditions.

Our future success and competitive position depend to a significant extent upon our proprietary technology. We must make significant investments to continue to develop and refine our technologies. We will be required to expend substantial funds for and commit significant resources to the conduct of continuing research and development activities, the engagement of additional engineering and other technical personnel, the purchase of advanced design, production and test equipment, and the enhancement of design and manufacturing processes and techniques. Our future operating results will depend to a significant extent on our ability to continue to provide design and manufacturing services for new products that compare favorably on the basis of time to market, cost and performance with the design and manufacturing capabilities. The success of new design and manufacturing services depends on various factors, including utilization of advances in technology, innovative development of new solutions for customer products, efficient and cost-effective services, timely completion and delivery of new product solutions and market acceptance of customers' end products. Because of the complexity of some of our products, we may experience delays from time to time in completing the design and manufacture of new product solutions. In addition, there can be no assurance that any new product solutions will receive or maintain customer or market acceptance. If we were unable to design and manufacture solutions for new products of our customers on a timely and cost-effective basis, such inability could have a material adverse effect on our business, financial condition and results of operations.

We may need to raise additional capital in the future, which may not be available to us.

We may need to raise additional funds for a number of uses, including:

Maintaining and expanding research and development;

Implementing marketing and sales activities for our products;

Hiring additional qualified personnel; and

Supporting an increased level of operations.

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We may not be able to obtain additional funds on acceptable terms or at all. If we cannot raise needed funds on acceptable terms, we may be required to delay, scale back or eliminate some aspects of our operations and we may not be able to:

- Develop new products;
- Enhance our existing products;
- Remain current with evolving industry standards;
- Take advantage of future opportunities; or
- Respond to competitive pressures or unanticipated requirements.

If adequate funds are not available to us, our business, results of operations and financial condition will be materially and adversely affected. Any equity or debt financings, if available at all, may cause dilution to our then-existing shareholders and may increase our financing expenses. If additional funds are raised through the issuance of equity securities, the net tangible book value per share of our common stock would decrease and the percentage ownership of then current shareholders would be diluted.

We may fail to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 governing internal controls and procedures for financial reporting, which started in connection with this Annual Report on Form 10-KSB, have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to require the continued commitment of significant resources. We may identify material weaknesses or significant deficiencies in our assessments of our internal controls over financial reporting. Failure to maintain effective internal controls over financial reporting could result in investigation or sanctions by regulatory authorities and could have a material adverse effect on our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

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Risk Factors Related to our Common Stock

If we fail to remain current on our reporting requirements, we could be removed from the OTC Bulletin Board which would limit the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market. We would also incur penalties under our agreement with the investors in our private placement.

Companies trading on the OTC Bulletin Board, such as our company, must be reporting companies under Section 12 of the Securities Exchange Act of 1934, as amended, and must be current in their reports under Section 13, in order to maintain price quotation privileges on the OTC Bulletin Board. If we fail to remain current in our reporting requirements, we could be removed from the OTC Bulletin Board. As a result, the market liquidity for our securities could be severely adversely affected by limiting the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market. We would also incur penalties under our agreement with the investors in our private placement, pursuant to which we are obligated to maintain our shares on the OTC Bulletin Board.

Our shares of common stock are thinly traded, so you may be unable to sell at or near ask prices or at all if you need to sell your shares to raise money or otherwise desire to liquidate your shares.

Our shares of common stock are thinly-traded on the OTC Bulletin Board, meaning that the number of persons interested in purchasing our common stock at or near ask prices at any given time may be relatively small or non-existent. This situation is attributable to a number of factors, including the fact that we are a small company which is relatively unknown to stock analysts, stock brokers, institutional investors and others in the investment community that generate or influence sales volume, and that even if we came to the attention of such persons, they tend to be risk-averse and would be reluctant to follow an unproven development stage company such as ours or purchase or recommend the purchase of our shares until such time as we became more seasoned and viable. As a consequence, there may be periods of several days or more when trading activity in our shares is minimal or non-existent. We cannot give you any assurance that a broader or more active public trading market for our common stock will develop or be sustained, or that current trading levels will be sustained. Due to these conditions, we can give you no assurance that you will be able to sell your shares at or near ask prices or at all if you need money or otherwise desire to liquidate your holdings.

We are subject to the penny stock rules and these rules may adversely effect trading in our common stock.

Until our shares qualify for inclusion in the NASDAQ Stock Market system, the public trading, if any, of our common stock will be on the OTC Bulletin Board. As a result, an investor may find it more difficult to dispose of, or to obtain accurate quotations as to the price of, the common stock offered. Our common stock is subject to provisions of Section 15(g) and Rule 15g-9 of the Securities Exchange Act of 1934, as amended (the Exchange Act), commonly referred to as the penny stock rule. Section 15(g) sets forth certain requirements for transactions in penny stocks, and Rule 15g-9(d) incorporates the definition of penny stock that is found in Rule 3a51-1 of the Exchange Act. The SEC generally defines penny stock to be any equity security that has a market price less than \$5.00 per share, subject to certain exceptions. If our common stock is deemed to be a penny stock, trading in the shares will be subject to additional sales practice requirements on broker-dealers who sell penny stock to persons other than established customers and accredited investors. The definition of Accredited Investors includes among others, persons with assets in excess of \$1,000,000 or annual income exceeding \$200,000 or \$300,000 together with their spouse. For transactions covered by these rules, broker-dealers must make a special suitability determination for the purchase of such security and must have the purchaser's written consent to the transaction prior to the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the rules require the delivery, prior to the first transaction, of a risk disclosure document, prepared by the SEC, relating to the penny stock market. A broker-dealer also must disclose the commissions payable to both the broker-dealer and the registered representative, and current quotations for the securities. Finally, monthly statements must be sent disclosing recent price information for the penny stocks held in an account and information on the limited market in penny stocks. Consequently, these rules may restrict the ability of a broker-dealer to trade and/or maintain a market in our common stock and may affect the ability of our shareholders to sell their shares.

Dividends policy

Although we have not declared or distributed dividends in the past we don't currently have a dividend distribution policy. The declaration of dividends is subject to the discretion of our Board of Directors and the applicable law and will depend on various factors, including our operating results, financial condition, current and anticipated cash needs, contractual restrictions and any other factors deemed relevant by our board of directors. You should not rely on an investment in our company if you require dividend income from your investment in our company. The success of your investment will likely depend entirely upon any future appreciation of the market price of our common stock, which is uncertain and unpredictable. There is no guarantee that our common stock will appreciate in value or even maintain the price at which you purchased your common stock.

Risks Relating to our Location in Israel

Political, economic and military instability in Israel may disrupt our operations and negatively affect our business condition, harm our results of operations and adversely affect our share price.

Our subsidiaries Export Erez, Achidatex and Mayotex are incorporated and based in, and currently derive substantially most of their revenues from markets within the State of Israel. As a result, political, economic and military conditions affecting Israel directly influence us. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could have a material adverse effect on our business, financial condition and results of operations.

Since the establishment of the State of Israel in 1948, Israel and its Arab neighbors have engaged in a number of armed conflicts. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Major hostilities between Israel and its neighbors may hinder Israel's international trade and lead to economic downturn. This, in turn, could have a material adverse effect on our operations and business. There has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2007. The future effect of this deterioration and violence on the Israeli economy and our operations is unclear. The election of representatives of the Hamas movement to a majority of seats in the Palestinian Legislative Council in January 2006 resulted in an escalation in violence among Israel, the Palestinian Authority and other groups. In July 2006, extensive hostilities began along Israel's northern border with Lebanon and to a lesser extent in the Gaza Strip. In June 2007, there was an escalation in violence in the Gaza Strip resulting in Hamas effectively controlling the Gaza Strip. Our executive offices and one of our manufacturing and production facilities are located in the Industrial Area of Sderot, and another manufacturing and production facility of ours is located in the Industrial Area of Ashkelon. Since October 2000, Sderot, located 2 miles from the Gaza Strip, has been constantly subjected to rockets attacks from the Gaza Strip, which have caused deaths, injuries and significant damage to homes and property. Moreover, in March 2008, rockets fired from the Gaza Strip hit Ashkelon. At the end of December 2008, there was an increase in hostility between Israel and Hamas in the region of Gaza which lasted several weeks. Ongoing violence between Israel and the Palestinians as well as tension between Israel and the neighboring Syria and Lebanon may have a material adverse effect on our business, financial conditions and results of operations.

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Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

Many of our executive officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

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Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Our executive offices are located at 8 Brisel Street, Industrial Zone, Sderot. Our manufacturing, production and distribution facilities are scattered over several locations in Israel and in our location in the United States. The locations are:

The production activities of our subsidiary, Achidatex, are located in a 6,000 square meter building in Nazareth Industrial Area is owned by an affiliated party. In 2005, following the decision of the Israeli Government to remove Israeli residents from the Erez Industrial Zone, we relocated the major production activities of our subsidiary Export Erez from Erez Industrial Area to this facility. The annual rental expense for this facility was \$180,000 in 2007. The lease expired on December 31, 2007 and we entered into a new lease agreement, under which we agreed to pay monthly rent of \$22,800 to be paid quarterly in NIS, in accordance with the current exchange rate, but in any event, an agreed upon exchange rate of no less than \$1 = 3.95 NIS. The lease will expire on December 31, 2009. In 2008 our rent expense for this facility was \$273,600.

Achidatex leases approximately 300 square meters of office space for its executive offices in Petach-Tikva at an annual rental expense of NIS 110,310 (\$30,746) in 2008. The lease will expire in April 2012.

Mayotex leases 500 square meters of industrial space and additional 1,280 square meters of outdoor space in the Industrial Area of Ashkelon for its car armor installations. The annual rental expense for this space was \$30,000 in 2008. The lease expired on June 30, 2008 and was renewed for an additional year under the same terms.

Mayotex leases approximately 1,219 square meters of space in the Industrial Area of Sderot primarily for its cut and sew operations. The annual rental expense for this space was \$58,512 in 2008. The lease expired on December 31, 2008 and was renewed for an additional year at an annual rental of \$73,140.

Mayotex leases approximately 1,740 square meters of industrial space in the Alon Tavor Industrial Zone near Afula, for the operations purchased from Chemoplast, at an annual rental expense of \$83,650. The lease, which expires on March 31, 2009, is expected to be renewed. Under the lease, the annual rental expense in NIS increases by 2.5% annually and is linked to the Israeli CPI.

Owen Mills leases approximately 9,000 square feet of space in Van Nuys, California for its operations. The lease expired on August 31, 2008 and was renewed on a month to month basis at a monthly rent of \$4,950. The annual rental expense for this space was \$65,340 in 2008.

We believe that our facilities are adequate for our purposes and that all of the above mentioned properties are adequately covered by insurance.

Item 3. Legal Proceedings.

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On February 11, 2009, a lawsuit was filed in the Jerusalem District Court against our Achidatex subsidiary, its chief executive officer, Mr. Avraham Hazor, and our subsidiary Export Erez USA Inc. The suit alleges that Achidatex materially breached its agreement with the plaintiff, dated February 22, 2000, relating to the development of inflatable mine-field crossing enabling sandals, because Achidatex allegedly failed to register patents for the technology worldwide and only registered patents in the United States. The plaintiff further claims that the defendants, jointly and severally, committed a breach of trust. The plaintiff is seeking damages in the amount of NIS 10 million (approximately \$2.4 million). Contemporaneously with the filing of the claim, the plaintiff also filed a motion seeking an exemption from payment of the requisite court filing fee, and stated that he would withdraw the lawsuit if the motion is not granted. On March 12, 2009, Achidatex filed a request to respond to the motion and requested a 30 day extension to file its statement of defense. We believe that it is likely that the plaintiff's motion for an exemption from payment of the court filing fee will be granted and that the lawsuit will therefore proceed. We believe that the plaintiff's claim is unfounded and intend to vigorously defend against the claim. Due to the preliminary stage of the claim, we and our legal advisors cannot currently assess the outcome or possible adverse effect on our financial position or results of operations, however, we believe we have substantial legal arguments to oppose the allegations.

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In February 2006, three of our subsidiaries, Export Erez, Mayotex and Achidatex filed claims for compensation pursuant to the Evacuation Compensation Law. In January 2007 we received advanced payments in the amounts of approximately \$523,000. On February 18, 2008 Export Erez, Mayotex and Achidatex signed definitive agreements with SELA, a government agency, established pursuant to the Evacuation Compensation Law, for compensation of approximately \$6.0 million, net of 5% related taxes, receipt of the previous advance payment and the other associated costs. The Company received and recorded gain in the amount of \$4.8 million during the year ended December 31, 2008.

Item 4. Submission of Matters to a Vote of Security Holders.

There were no matters submitted to the shareholders for approval during the fourth quarter of the fiscal year ended December 31, 2008.

PART II

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

Market Information

Our common stock is traded on the Over the Counter Bulletin Board under the symbol DFNS.OB. The table below contains the high and low bid closing prices of our common stock as reported on the OTCBB for the time periods indicated. These quotations reflect inter-dealer prices, without retail mark-up, markdown or commission, and may not necessarily represent actual transactions.

| Fiscal Year Ended December 31, 2008 | Price Range | |
|-------------------------------------|-------------|---------|
| | High | Low |
| First Quarter | \$ 0.41 | \$ 0.26 |
| Second Quarter | 0.45 | 0.27 |
| Third Quarter | 0.33 | 0.21 |
| Fourth Quarter | 0.27 | 0.15 |
| Fiscal Year Ended December 31, 2007 | High | Low |
| First Quarter | \$ 0.63 | \$ 0.31 |
| Second Quarter | 0.70 | 0.46 |
| Third Quarter | 0.67 | 0.55 |
| Fourth Quarter | 0.60 | 0.24 |

Shareholders

OTC Transfer Agent, located at 231 E 2100 S, Salt Lake City, Utah is the registrar and transfer agent for our common stock. As of March 31, 2009, there were 27,941,111 shares of our common stock outstanding and we had 33 shareholders of record.

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Dividends

We have not declared or distributed dividends in the past and do not currently have a dividend distribution policy. Any future dividend policy will be determined by our Board of Directors, subject to the applicable law, and will be based upon conditions then existing, including our results of operations, financial condition, current and anticipated cash needs, contractual restrictions and other factors as the Board of Directors may deem relevant.

Compensation Plans

We currently do not have any compensation plans under which our securities are authorized for issuance.

We have an employment agreement with Mr. Baruch Tosh, our President, pursuant to which, Mr. Tosh is entitled to additional compensation of 1.5% of the growth in our revenues. Mr. Tosh, at his option, may receive shares of common stock in lieu of cash. Mr. Tosh was not entitled to any additional compensation in 2008.

Sales of Unregistered Securities

On February 28, 2005, we acquired all of the outstanding shares of Owen Mills, a company specializing in military and industrial sewing of marine and ballistic fabric products. Pursuant to the terms of the securities purchase agreement, we purchased all of the outstanding stock of Owen Mills in consideration for \$200,000 and shares of our common stock having a value of \$200,000, based on the average closing price per share of our common stock for the ten trading days preceding the issuance of such shares. Under the agreement the aggregate consideration of \$400,000 was to be paid by us as follows: (i) \$3,333.33 each month commencing on March 31, 2005 and thereafter on the last business day of each successive month until the we have paid \$200,000 to the former shareholder of Owen Mills; (ii) \$40,000 in the form of shares of our common stock payable shortly after the closing of the transaction; and (iii) \$160,000 in the form of shares of our common stock to be issued in four installments beginning on the last business day in February 2006 and on the anniversary of such date for the following three years. In accordance with the agreement, we issued on April 27, 2005, April 3, 2006, May 1, 2007, and March 18, 2008, 36,463 shares, 123,077 shares, 74,074 shares and 123,839 shares of our common stock, respectively, each issuance having a fair market value of \$40,000.

On June 15, 2005, we executed a securities purchase agreement, with Gov Financial Holdings, Avshalom Hershovich, Multi Concept Ltd. and Ruth Creative Business Ltd., all of which are accredited investors, for a \$1.1 million private placement of our common stock, along with 627,500 warrants to purchase our common stock. Pursuant to this agreement we issued 1,833,334 shares of our common stock at \$0.60 per share. The investors also received 365,000 warrants at an exercise price of \$0.94 per share, which expired on June 30, 2007, and 182,500 warrants at an exercise price of \$2.40 per share exercisable until June 30, 2010. The agreement also provided for the issuance by us of up to additional 1,368,191 shares of our common stock to the investors, a year after the closing, in the event of decrease in the share price. As a result of a decline in the share price on the due date below \$0.35, we issued 1,368,191 shares according to the agreement. In addition, we agreed to issue 82,133 shares of our common stock, as well as 60,000 warrants at an exercise price of \$0.94 per share, which expired on June 30, 2007, and 20,000 warrants at an exercise price of \$2.40 per share exercisable until June 30, 2010, as finders' fees. The transaction was exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D. As part of the transaction, we filed a registration statement with the SEC for the purpose of registering for resale the common stock issued in the private placement and the shares underlying the warrants. Such Registration Statement was declared effective on December 9, 2005.

Purchase of Equity Securities By the Issuer and Affiliates

On December 31, 2008, we entered into a stock purchase agreement with Achidatex and Messrs. Hatzor and Freddy and Shmuel Davidowitz, pursuant to which we purchased from them an aggregate of 1,050,000 shares of our common stock, and the remaining minority interest in Achidatex in consideration for an aggregate purchase price of \$1.2 million. As a result of this purchase we now own 100% of Achidatex.

Item 6. Selected Financial Data.

Not applicable.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following is management's discussion and analysis of certain significant factors which have affected our financial position and operating results during the periods included in the accompanying consolidated financial statements, as well as information relating to the plans of our current management.

Overview

We are a manufacturer and global provider of personal military and civilian protective equipment and supplies. Our products are used by military, law enforcement, border patrol enforcement, and other special security forces, corporations, non-governmental organizations and individuals throughout the world.

Our main products include body armor, bomb disposal suits, bullet proof vests and jackets, ballistic wall coverings, bullet proof ceramic and polyethylene panels, V.I.P. car armoring and lightweight armor kits for vehicles, personal military equipment, dry storage systems, liquid logistic products, tents and other camping and travel gear.

We believe that current international tensions, the events of September 11, 2001 as well as terror attacks in Europe, Asia and Africa in recent years, the subsequent war on terrorism, and the continuing conflict in Iraq are all likely to result in additional interest in our products, and that the demand for our products will continue to grow.

We expect to address this growth by offering a comprehensive array of high quality branded security products that meet our customers increasingly complex security products requirements. We intend to enhance our position in the industry through additional strategic acquisitions and we believe that these acquisitions will also assist us to broaden our portfolio of products.

The following elements define our growth strategy:

Pursue strategic acquisitions. In addition to our acquisition of Owen Mills and of the operations of Chemoplast, we intend to continue to selectively pursue strategic acquisitions that complement our product offerings, provide access to new geographic markets, and provide additional distribution channels and new customer relations.

Pursue new strategic opportunities. We believe that the demand for infra-red night-vision systems is growing and established Mayosar Ltd., a joint venture company, to enter into this business. Mayosar established Isorad IR Optics Ltd, a company that will manufacture germanium crystals for use in the production of infra-red night-vision systems based on the know how and equipment it purchased from an Israeli governmental entity in January, 2009.

Expand Distribution Networks and Product Offerings. We expect to continue to strengthen our distribution network by expanding our range of branded law enforcement equipment through the acquisition of and by investing in development of new and enhanced products which complement our existing offerings. We believe that a broader product line will strengthen our relationships with distributors and enhance our brand appeal with military, law enforcement and other end users.

Material Trends

Local Military Market. During 2007, the demand for our products increased significantly, mainly due to the effect of the war between Israel and the Hezbollah in Lebanon, which took place in July and August of 2006. **While our** sales to the Local Military Market declined in 2008 compared to 2007, our sales to this market exceeded the levels reached prior to 2007, when our sales in this market began to grow significantly. In 2008, sales to the Israeli Ministry of Defense declined to \$5,585,355 from \$9,367,382 in 2007, accounting for 30.7% and 48.6% of our sales, respectively.

In the second half of 2005, the Israeli Government evacuated the Gaza strip. As a result of the Israeli Government's decisions and the evacuation, the Israeli Defense Forces, or IDF, indicated that it would slightly reduce its manpower and that its battlefield equipment will be stored for long periods in environments that will promote battlefield readiness and the capability of quick deployment. In addition, as a result of the war between Israel and the Hezbollah in Lebanon, which started in July 2006, many Israeli reserve forces were activated, and a large amount of stored equipment was removed from dry-storage compartments and mobilized. Since then and during the years 2007 and 2008 our military business has grown as a result of increased demand for our dry storage systems products, bulletproof vests and other military gear. As of March 25, 2009, we had a backlog of firm orders from the Israeli Ministry of Defense of approximately \$2.7 million, including orders of approximately \$900,000 that we received subsequent to December 31, 2008. We shipped approximately \$1.7 million to the Israeli Ministry of Defense during the first quarter of 2009.

Export Military Market. Our customers in this market are military and law enforcement organizations, mostly in South America, North America and Europe. Their budgets fluctuate and as a result we cannot identify definite trends in these markets. In 2008 and in 2007, we had sales of \$2,242,477 and \$1,511,891 in South America, sales of \$651,453 and \$1,654,375 in North America, sales of \$1,533,500 and \$1,691,835 in Europe, \$2,771,583 and none in Africa, respectively. We also had sales of \$349,720 in Australia in 2007.

Since 2003, we have increased our export efforts as a consequence of the worldwide environment resulting from the events of September 11, 2001, the subsequent war on terrorism and the continuing conflict in Iraq. We are continuing our efforts to strengthen our position in our existing export markets in the U.S., South America, Asia and Europe, and to extend our presence to new export markets in South America, Africa, Europe and Australia. We believe that these markets are growing and that any future success in such markets is mainly dependant on our ability to be competitive in our pricing and the quality of our products.

The following table presents details of our export military sales during the two years ended December 31, 2008:

| | Year Ended December 31, | |
|-----------------------------|----------------------------|--------------|
| | 2008 | 2007 |
| Sales to South America | \$ 2,242,477 | \$ 1,511,891 |
| Sales to North America | 651,453 | 1,654,375 |
| Sales to Europe and Asia | 1,533,500 | 1,691,835 |
| Sales to Africa | 2,771,583 | - |
| Sales to Australia | - | 349,720 |
| | <hr/> | <hr/> |
| Total Export Military Sales | \$ 7,199,013 | \$ 5,207,821 |
| | <hr/> | <hr/> |

Local Civilian Market. Our product range to the civilian market is diversified. In 2007, our local market business grew as a result of the improvement of the economic situation in Israel. In 2008 our local market business remained at a level consistent with 2007. We expect a modest increase in this market in 2009 and in the future.

Backlog. We had approximately \$6.7 million of unfilled customer orders at December 31, 2008, out of which approximately \$2.0 million was attributable to orders from military customers in South America, approximately \$0.5 million was attributable to orders from civilian and military customers in Africa and Asia, approximately \$0.4 million was attributable to local civilian market, approximately \$0.3 million was attributable to the U.S. civilian market and approximately \$3.5 million was attributable to the Israeli Ministry of Defense.

Gross Profit Margins. Our pricing policy, although slightly different from one product to the other, is based on maintaining our existing overall gross margins. We do not expect a material change in our gross profit margins in the foreseeable future.

Current Economic Overview. We generate revenues from sales of our products to the civilian and military markets. Accordingly, our business is affected by economic conditions. The volatile economic conditions throughout 2008 have slowed-down our sales process and complicated our ability to conduct transactions. The current economic climate and the uncertainty in the global economic conditions could impact the ability of our customers, including governmental entities, to make capital expenditures, thereby affecting their ability to purchase our products. In addition, the turmoil in the financial markets may limit our ability to obtain financing in 2009. Our business and financial performance, including collection of our accounts receivable, realization of inventory and recoverability of assets including investments, may be adversely affected if economic conditions deteriorate or continue to be volatile. Our profitability may also be adversely affected by our fixed costs and the possibility that we would be unable to scale back other costs within a time frame sufficient to match any decreases in revenue relating to changes in market and economic conditions. The turmoil in the financial markets may limit our ability to obtain financing for our working capital requirements.

Exchange rate fluctuation. Exchange rate fluctuation affects our financial results in several ways. Most of our deposits and a portion of our tradable securities are linked to the rate of exchange between the U.S. dollar and the NIS. Accordingly, devaluation of the U.S. dollar against the NIS is reflected as a comprehensive income in our consolidated statement.

In addition, we develop products in Israel and sell them in Israel, North and South America, Asia, Africa and several European countries. Our sales in Israel are denominated in NIS, while most of our export sales are denominated in U.S. dollars. Under U.S. GAAP we report all of our sales in U.S. dollars. Accordingly, appreciation of the U.S. dollar against the NIS reduces our reported sales while the devaluation of the U.S. dollar against the NIS increases our reported sales.

Our cost of sales and operating expenses are affected in the same manner. Most of our purchases of raw material are made in U.S. dollars while most of our labor and other operating expenses are in NIS, however, under U.S. GAAP we report our cost of sales and operating expenses in U.S. dollars. Accordingly, appreciation of the U.S. dollar against the NIS reduces our reported cost of sales and operating expenses while the devaluation of the U.S. dollar against the NIS increases our reported cost of sales and operating expenses.

In the year ended December 31, 2008 the U.S. dollar depreciated against the NIS by approximately 1.14%, and our financial results were positively impacted. However, because exchange rates between the U.S. dollar and the NIS fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

Operations in the Erez Industrial Zone

During 2004, the Israeli Government decided to evacuate the Erez Industrial Zone in the Gaza Strip, where part of our operations were located. We owned facilities, leased other facilities and maintained equipment and inventory within this area. In 2005, we moved our light cut and sew operation from the Erez Industrial Zone to Sderot and some of our webbing equipment to Nazareth. In August 2005, we evacuated our remaining operations and abandoned the buildings we owned and leased in the Erez Industrial Zone.

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The Israeli Government's decision to evacuate the Gaza Strip was supported by certain resolutions, including the Evacuation Compensation Law that was adopted by the Israeli Parliament to compensate the Israeli Gaza Strip settlers as well as business and property owners in the Gaza Strip and in the Erez Industrial Zone. In February 2006, three of our subsidiaries, Export Erez, Mayotex and Achidatex filed claims for compensation pursuant to the Evacuation Compensation Law. In 2005, we recorded a receivable from the Israeli Government of \$217,477 related to our direct moving costs and loss on abandoned properties.

In 2006, we were notified that we would receive advance payments in the aggregate amount of \$523,000. We applied this payment against the receivable established in 2005 and recorded the excess payment of \$240,658, net of taxes, as extraordinary gain. On February 18, 2008 our three subsidiaries, Export Erez, Mayotex and Achidatex signed definitive agreements with SELA Agency, a government agency established pursuant to the Evacuation Compensation Law, for compensation of approximately \$6 million, net of the \$523,000 we received in 2007. In the year ended December 31, 2008, the net compensation payments after our payment of approximately \$600,000 of expenses were recognized as an extraordinary gain net of the 5% taxes payment on such payment.

Critical Accounting Policies

We have identified the following policies as critical to the understanding of our financial statements. The preparation of our financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and expenses during the reporting periods. Our financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

Segments. During 2008 and 2007, we operated and managed two strategic business units: production for the civilian market and the military market. These operational segments are further broken down between Israel (local) and other (export) sales in order to better analyze trends in sales and profit margins. We do not allocate assets between segments because assets are used in more than one segment and any allocation would be impractical (See Note 15(A) to our financial statements for segment information).

Revenue Recognition. Revenues from sales of products are recognized upon shipment to customers. We provide a warranty on goods ranging from three to four years. Our policy to consider the establishment of a reserve for warranty expenses, based upon our historical experience. We did not establish a reserve at December 31, 2008 and December 31, 2007. If we change any of our assumptions with regard to our recognition of revenues, or if there is a change with respect to warranties expenses our financial position and results of operations may change materially.

Foreign Currency Translation and Transactions. The functional currency of Export Erez, Mayotex, and Achidatex is the New Israeli Shekel, or NIS. The functional currency of Dragonwear is the U.S. dollar. The financial statements of Dragonwear are translated into NIS. The financial statements for all of these entities are then translated into U.S. dollars from NIS at period-end exchange rates as to assets and liabilities and average exchange rates as to revenues and expenses. Capital accounts are translated at their historical exchange rates when the capital transactions occurred. Foreign currency transaction gains or losses from transactions denominated in currencies other than NIS are recognized in net income in the period the gain or loss occurs. Any change in exchange rates may have a material impact on our financial position and results of operations.

Fair Value of Financial Instruments. Our financial instruments are principally non-derivative assets and non-derivative liabilities (non-derivative assets include cash and cash equivalents, deposits in banks and other financial institutions, marketable securities, trade accounts receivable, other assets; non-derivative liabilities include short-term debt, trade accounts payable, and other current liabilities). Because of the nature of these financial instruments, fair value generally equals or approximates the amounts presented in the consolidated financial statements. The carrying amount of our long-term debt approximates quoted market prices or current rates offered to us for debt of the same remaining maturities.

Disclosure of Certain Risks and Concentrations of Credit Risk. The industry in which we are involved is competitive and is characterized by the risks of rapidly changing technologies and penetration into world markets. Part of our sales are made to government institutions and private industry in Israel. Consequently, the exposure to credit risks relating to these trade receivables is limited. Export sales are made primarily with a letter of credit by the buyer or under controlled credit with specific accredited customers, so the receivable is collectible. We perform ongoing credit evaluations of our customers and generally do not require collateral. An appropriate allowance for doubtful accounts is included in trade accounts receivable.

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At December 31, 2008 and 2007, we held cash and cash equivalents, in the aggregate amount of \$1,719,921 and \$1,120,054, respectively, and most of these amounts were deposited with Israeli banks. Under Israeli law, the Bank of Israel insures all bank deposits without limits on the amount. Therefore, we do not anticipate losses in respect to these items.

Trading Securities. We invest in mutual funds and common stock in Israel and in common stock in the United States. All trading securities as of December 31, 2008 and 2007 are carried at their fair market value based upon quoted market prices of those investments at year-end. Net realized and unrealized gains and losses on trading securities are included in net earnings in other income for the years ended December 31, 2008 and 2007.

Accounts Receivable. Accounts receivable consist primarily of receivables from customers and institutions. We record a provision for doubtful accounts, when appropriate, to allow for any amounts which may be unrecoverable based upon an analysis of our prior collection experience, customer creditworthiness and current economic trends.

Inventories. Inventories are valued at the lower of cost or market value. Inventories allowances are provided to cover risks arising from obsolete and slow-moving items, discontinued products and excess inventories according to revenue forecasts. As of December 31, 2008 and 2007, inventories allowances were \$371,800 and \$380,675, respectively.

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Cost is determined as follows:

Raw materials and components using the first-in, first-out (FIFO) method.

Work in progress and finished goods represents the cost of raw materials, components and, manufacturing costs which include direct and indirect allocable costs.

Any change in our assumptions with respect to the need to write-off or write-down the value of our inventories may have material affect on our financial position or results of operations.

Property Plant and Equipment. Fixed assets are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of three to twenty-five years.

Leasehold improvements are amortized using the straight line method over the period of the lease contract, provided that this period does not exceed the useful life of the asset. Fixed assets not in use, held for resale, are stated at the lower of net cost or estimated realizable value. Expenditures for maintenance and repairs are charged to expense as incurred, while renewals and betterment of a permanent nature are capitalized.

Accounting for Registration Payment Arrangements. As of January 1, 2007, we adopted FSP EITF 00-19-2, Accounting for Registration Payment Arrangements, or FSP, which addresses an issuer's accounting for registration payment arrangements. This FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. This FSP further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles (GAAP) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. As a result of our adoption of the FSP, our financial statements includes a cumulative-effect adjustment to the opening balance of shareholders' equity in the amount of \$123,654 as of January 1, 2007.

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Results of Operations

Key Indicators

Our management views revenues, the sources of our revenues, gross profit margin and the level of inventory compared to revenues as the key performance indicators in assessing our company's financial condition and results of operations. Our management believes that the decrease in our revenues is reflective primarily of the decrease in demand of the Israeli Ministry of Defense for our products. While our management believes that demand for our products is stable, our business is subject to a high degree of volatility because of the impact of geopolitical events and government budgeting.

Year Ended December 31, 2008 Compared with Year Ended December 31, 2007

Net Revenues and Gross Profit Margin. Net revenues for the year ended December 31, 2008 decreased to \$18,170,508 from \$19,262,928 in the year ended December 31, 2007, a decrease of 5.7%. The decrease is primarily attributable to a decrease of approximately \$3.5 million in our sales to the local military market segment, a decrease of approximately \$0.9 million in our sales to the export civilian market segment and the loss of our U.S. based customer in the export civilian market, which was offset in part by an increase of approximately \$2.0 million in the export military market segment, an increase of approximately \$1.2 million in the local civilian market segment and the devaluation of the U.S. dollar. The decreased revenues in our local military market segment is attributable to a general decrease in orders from the Israeli Ministry of Defense.

In the year ended December 31, 2008, Export Erez accounted for \$12,982,395 or 71.4%, of our revenues, Achidatex accounted for \$4,184,071 or 23.0% of our revenues and Owen Mills accounted for \$1,004,042 or 5.6% of our revenues. In the year ended December 31, 2007, Export Erez accounted for \$12,563,440 or 65.2%, of our revenues, Achidatex accounted for \$5,522,757 or 28.7% of our revenues, and Owen Mills accounted for \$1,176,731 or 6.1% of our revenues.

The following table sets forth the breakdown of sales by segment for the years ended December 31, 2008 and December 31, 2007.

Year Ended December 31,

| | 2008 | 2007 |
|------------------------------------|----------------------|----------------------|
| Sales to the local civilian market | \$ 3,741,228 | \$ 2,453,886 |
| Sales to export civilian market | 1,004,042 | 1,894,276 |
| Sales to the local military market | 6,226,225 | 9,706,945 |
| Sales to export military market | 7,199,013 | 5,207,821 |
| Total | \$ 18,170,508 | \$ 19,262,928 |

Gross Profit. Gross profit for the year ended December 31, 2008 was \$4,076,633 compared to \$6,205,152 for the year ended December 31, 2007. This decrease in gross profit in 2008 is primarily attributable to the decrease in revenues, higher overhead expenses, higher labor costs due to currency fluctuations, and a large lower margin sale. In the year ended December 31, 2008, Achidatex, Export Erez and Owen Mills accounted for 37.4%, 61.2%, and 1.4%, of our gross profit, respectively. In the year ended December 31, 2007, Achidatex, Export Erez and Owen Mills accounted for 31.3%, 66.5%, and 2.2%, of our gross profit, respectively.

Our gross profit margin for the year ended December 31, 2008 was 22.4% compared to 32.2% for the year ended December 31, 2007. The decline is primarily attributable to the decrease in revenues, higher overhead expenses, higher labor costs due to currency fluctuations, and a large lower margin sale. Achidatex's gross margin for the year ended December 31, 2008 was 20.1% compared to 25.6% for the year ended December 31, 2007 primarily due to a decrease in revenues. Export Erez's gross margin for the year ended December 31, 2008 was 17.5% compared to 31.0% for the year ended December 31, 2007 primarily due to a decrease in revenues. Owen Mills' gross margin was 5.5% for the year ended December 31, 2008 compared to 16.9% for the year ended December 31, 2007.

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Selling Expenses. Selling expenses for the year ended December 31, 2008 increased by 9% to \$1,160,734 from \$1,064,959 for the year ended December 31, 2007. The increase in our selling expenses was attributable primarily to an increase in export sales and commissions paid on export sales. Achidatex's selling expenses for the year ended December 31, 2008 were \$521,551 compared to \$370,562 for the year ended December 31, 2007. Export Erez's selling expenses for the year ended December 31, 2008 were \$620,369 compared to \$681,729 for the year ended December 31, 2007. Owen Mills selling expenses for the year ended December 31, 2008 were \$18,814 compared to \$12,668 for the year ended December 31, 2007.

General and Administrative Expenses. General and administrative expenses for the year ended December 31, 2008 increased by 4.7% to \$2,201,027 from \$2,102,060 for the year ended December 31, 2007, primarily due to an increase in our provision for doubtful accounts receivables and increased professional fees.

Financial Expenses. Our net financial income increased to \$228,676 for the year ended December 31, 2008 comparable to a financial expense of \$269,000 for the year ended December 31, 2007 mainly due to the change in the U.S. dollar exchange rate versus the NIS, which resulted in an income of \$280,000 for the year ended December 31, 2008 comparable to a loss of \$133,000 for the year ended December 31, 2007.

Other Income (Expense), Net. We had other expense, net for the year ended December 31, 2008 of \$129,713 as compared to other income, net of \$39,125 for the year ended December 31, 2007. Our other expense in 2008 is attributable primarily to realized and unrealized losses on trading securities and losses due to changes in the fair market value of investments allocated to funds invested in respect of employee rights upon retirement.

Income Tax Expense. Our income tax expense for the year ended December 31, 2008 was \$127,004 as compared to an income tax expense of \$1,264,281 for the year ended December 31, 2007. We did not record a tax benefit related to the loss incurred by our U.S. operation due to our deferred tax valuation allowance.

Achidatex's income tax expense for the year ended December 31, 2008 was \$82,988 compared to income expense of \$326,067 for the year ended December 31, 2007. Export Erez's income tax expense for the year ended December 31, 2008 was \$43,216 (including income of \$273,103 from changes in our income tax estimate from a prior year) compared to an income tax expense of \$937,414 for the year ended December 31,

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2007. Income tax decreased substantially due to the decrease in our operating profit.

Minority Interest. For the year ended December 31, 2008 we recognized and recorded minority share in our profit of \$25,094 compared with the minority share in our profit of \$122,685 for the year ended December 31, 2007.

Net Income (Loss) Before Minority Interest and Extraordinary Income. Our consolidated net income before extraordinary income was \$686,831 in the year ended December 31, 2008 compared to net income of \$1,543,977 for the year ended December 31, 2007. Achidatex's net income for the year ended December 31, 2008 was \$44,452 compared to net income of \$265,819 for the year ended December 31, 2007. Export Erez's net income for the year ended December 31, 2008 was \$909,395 compared to net income of \$1,473,028 for the year ended December 31, 2007. Owen Mills' net loss for the year ended December 31, 2008 was \$295,346 compared to a net loss of \$153,690 for the year ended December 31, 2007. Defense Industries' net income for the year ended December 31, 2008 was \$28,330 compared to a net loss of \$286,550 for the year ended December 31, 2007.

Extraordinary Income. In February 2006, three of our subsidiaries, Export Erez, Mayotex and Achidatex filed compensation claims for compensation pursuant to the Evacuation Compensation Law as a result of the evacuation of the Gaza Strip. In 2006, we were notified that we would receive advance payments aggregating \$523,000 in respect of our claims. On February 18, 2008 our three subsidiaries signed definitive agreements with SELA Agency, a government agency established pursuant to the Evacuation Compensation Law, for compensation of approximately \$6 million, net of the \$523,000 we previously received. We received the payments in 2008 and recognized a \$4,827,280 extraordinary gain

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Liquidity and Capital Resources

Cash Flows

| | Years ended | |
|--|-------------------|-------------------|
| | December 31, 2008 | December 31, 2007 |
| Net cash provided by operating activities | \$ 5,538,714 | \$ 1,574,502 |
| Net cash used in investing activities | (4,237,482) | (595,697) |
| Net cash used in financing activities | (417,118) | (1,547,711) |
| Net increase (decrease) in cash and cash equivalents | 599,867 | (550,858) |
| Cash and cash equivalents at beginning of year | 1,120,054 | 1,670,912 |
| Cash and cash equivalents at end of year | 1,719,921 | 1,120,054 |

As of December 31, 2008, we had \$1,719,921 in cash and cash equivalents, \$2,384,727 in trading securities and working capital of \$10,088,528 as compared to \$1,120,054 in cash and cash equivalents, \$2,951,604 in trading securities and working capital of \$6,649,604 at December 31, 2007.

Net cash provided by operating activities was \$5,538,714 for the year ended December 31, 2008 as compared to \$1,574,502 provided by operating activities in the year ended December 31, 2007. This was primarily attributable to extraordinary income of \$4,827,280, net income (less extraordinary income) of \$661,737, a decrease in trading securities of \$632,050, and depreciation and amortization of \$580,255, offset by an increase in inventory of \$1,701,140, and a decrease in other liabilities of \$208,055.

Net cash used in investing activities was \$4,237,482 for the year ended December 31, 2008 as compared to \$595,697 in the year ended December 31, 2007. During the year ended December 31, 2008, \$237,482 (net of sales of fixed assets in the amount of \$68,922), was used to purchase fixed assets. Of the \$237,482 used to purchase fixed assets \$105,586 was used by Achidatex, \$128,987 was used by Export Erez and \$2,909 was used by Owen Mills.

Net cash used in financing activities was \$417,118 for the year ended December 31, 2008 as compared to \$1,547,711 net cash provided from financing activities for the year ended December 31, 2007. During the year ended December 31, 2008, we repaid short-term debt of \$154,175 and \$630,856 of long-term debt.

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Most of our large contracts, which are Israeli Governmental contracts, are supported by letters of credit. As a result, we believe that we have limited exposure to doubtful accounts receivables. We have strived to balance our accounts payable and accounts receivable.

Subject to an unexpected growth in inventories as a result of future growth in sales and to a significant change in raw material prices, we intend to use our cash flow from operations for the acquisition of companies or equipment to expand our capabilities.

We anticipate that our research and development expenses in 2009 will total approximately \$140,000.

We believe that we have sufficient working capital and borrowing capability to sustain our current level of operations for the next twelve months.

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Contractual Obligations

The following table summarizes our contractual obligations and commercial commitments as of December 31, 2008.

| Contractual Obligations | Payments due by Period | | | | |
|--|------------------------|-------------------|-------------------|-------------------|-------------------|
| | Total | less than 1 year | 2 - 3 years | 4 - 5 years | more than 5 years |
| Long-term debt obligations | \$ 907,248 | \$ 352,204 | \$ 450,802 | \$ 104,242 | - |
| Estimated interest payments on long-term debt obligations | 81,612 | 40,958 | 35,453 | 5,201 | - |
| Operating lease obligations | 419,622 | 351,941 | 58,012 | 9,669 | - |
| Other long-term liabilities reflected on the Company's balance sheet under U.S. GAAP | - | - | - | - | - |
| Total | \$ 1,408,482 | \$ 745,103 | \$ 544,267 | \$ 119,112 | - |

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statement No. 87, 88, 106 and 132(R), (*FAS 158*). This Standard requires recognition of the funded status of a benefit plan in the statement of financial position. The Standard also requires recognition in other comprehensive income certain gains and losses that arise during the period but are deferred under pension accounting rules, as well as modifies the timing of reporting and adds certain disclosures. FAS 158 provides recognition and disclosure elements to be effective as of the end of the fiscal year after December 15, 2006 and measurement elements to be effective for fiscal years ending after December 15, 2008. We do not expect the remaining elements of this Statement to have a material impact on our financial condition, results of operations, cash flows when adopted.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007) *Business Combinations*, a revision of the original "SFAS No. 141". This statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces the original Statement 141, cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. We are required to adopt the revised SFAS No. 141 on January 1, 2009. We are currently evaluating the potential impact of the revised SFAS No. 141 on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51. This statement establishes accounting and reporting standards for noncontrolling interests in subsidiaries and for the deconsolidation of subsidiaries and clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS No. 160 also required expanded disclosures that clearly identify and distinguish between the interests of the parent owners and the interests of the noncontrolling owners of a subsidiary. We are required to adopt SFAS No. 160 on January 1, 2009. We are currently evaluating the potential impact of this Statement on our consolidated financial statements.

In March 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 161 (SFAS 161), Disclosures about Derivative Instruments and Hedging Activities . SFAS 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 Accounting for Derivative Instruments and Hedging Activities and how derivative instruments and related hedged items affect a company s financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We are currently evaluating the potential impact that SFAS 161 will have on our consolidated financial statements.

In December 2008, the FASB issued FSP FAS 132R-1, Employers Disclosures about Postretirement Benefit Plan Assets (FSP FAS 132R-1), which provides additional guidance on employers disclosures about the plan assets of defined benefit pension or other postretirement plans. The disclosures required by FSP FAS 132R-1 include a description of how investment allocation decisions are made, major categories of plan assets, valuation techniques used to measure the fair value of plan assets, the impact of measurements using significant unobservable inputs and concentrations of risk within plan assets. The disclosures about plan assets required by this FSP must be provided for fiscal years ending after December 15, 2009. For us, FSP FAS 132R-1 will be effective for the fiscal year ending January 30, 2010 and will result in additional disclosures related to the assets of defined benefit pension plans in notes to our consolidated financial statements.

Foreign Currency Exchange Risk

We develop products in Israel and sell them in Israel, North and South America, Asia, Africa and several European countries. Our sales in Israel are denominated in NIS while most of our export sales are denominated in U.S. dollars. In addition, our labor expenses are primarily paid in NIS while our expenses for raw materials are paid primarily in U.S. dollars. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

Our foreign currency exposure is significant due to the depreciation of the U.S. dollar versus the NIS. We expect our exposure will continue to be significant, since a significant portion of the prices of our raw material purchases, as well as part of our sales are denominated in U.S. dollars.

In the year ended December 31, 2008, the inflation rate in Israel was 4.5% and the NIS appreciated in relation to the U.S. dollar at a rate of 1.14%, from NIS 3.846 per \$1 on December 31, 2007 to NIS 3.802 per \$1 on December 31, 2008. In the period ending in December 31, 2007 deflation in Israel was 2.8% while the NIS appreciated in relation to the U.S. dollar at a rate of 20.29%. If future inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of such devaluation lags behind increases in inflation in Israel, our results of operations may be materially adversely affected.

We did not enter into any foreign exchange contracts in the year ended December 31, 2008.

Inflation and Seasonality

We do not believe that our operating results have been materially affected by inflation during the preceding two years. There can be no assurance, however, that our operating results will not be affected by inflation in the future. Our business is subject to minimal seasonal variations with slightly increased sales historically in the second and third quarters of fiscal year. We expect to continue to experience slightly higher sales in the second and third quarters, and slightly lower sales in the fourth and first quarters, as a result of reduced sales on nondairy frozen desserts during those periods.

Market Risk

At December 31, 2008 and 2007, we held cash and cash equivalents, in the aggregate amount of \$1,719,921 and \$1,120,054, respectively, and most of these amounts were deposited with Israeli banks. Under Israeli law, the Bank of Israel insures all bank deposits without limits on the amount. Therefore, we do not anticipate losses in respect to these deposits.

As of December 31, 2008 we held \$2,384,727 of trading securities compared to \$2,951,604 as of December 31, 2007. Such securities are subject to market risk, and in 2008 we recorded recognized and unrecognized losses of \$92,836 with respect to our holdings due to the decline in the stock market.

Interest Rate Risk

We have variable rate loans that we borrow from Israeli banks which are based on the local Prime Rate. Each increase of 1% in the Prime Rate will increase our interest expense by \$8,566.

Off-Balance Sheet Arrangements

None.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk.

Not Applicable

Item 8. Financial Statements.

See Index to Consolidated Financial Statements on page F-1

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A(T). Controls and Procedures.

Disclosure Controls and Procedures

Management is responsible for establishing and maintaining effective disclosure controls and procedures. As of December 31, 2008, our chief executive officer and chief financial officer participated with our management in evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Our disclosure controls and procedures are designed to ensure that information required to be disclosed in the SEC reports we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time period specified by the SEC's rules and forms and that such information is accumulated and communicated to management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure. Management believes that the financial statements included in this Annual Report on Form 10-K fairly present, in all material respects, our financial condition, result of operations and cash flows for the periods presented.

Management's Annual Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined under Exchange Act Rules 13a-15(f) and 15d-15(f). Our company's internal control over financial reporting is a process designed by, or under the supervision of, a public company's principal executive and principal financial officers, or persons performing similar functions, and effected by the board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP including those policies and procedures that: (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors of the company, and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our company's assets that could

have a material effect on the financial statements.

Our management, with the participation of our chief executive officer and chief financial officer, has assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. In making this assessment, our management used the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Their assessment included an evaluation of the design of the our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Based on their assessment and those criteria, our chief executive officer and chief financial officer, concluded that our company maintained effective internal control over financial reporting as of December 31, 2008.

Changes in Internal Control over Financial Reporting

Management previously identified the following material weaknesses in our internal control over financial reporting: (i) A lack of sufficient personal and resources and an insufficient level of monitoring and oversight, restricts our ability to gather, analyze and report information relative to the financial statements in a timely manner; and (ii) the limited number of management and accounting personal makes it impracticable to achieve an optimum separation of duties. With the assistance of our new controller, our new production manager and significant improvement in our financial reporting software, we have remitted the previously reported material weaknesses in reported in our prior filings.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial report. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

Item 9B. Other Information.

None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance.

Officers and Directors

Set forth below are the name, age, principal position and a biographical description of each of our directors, executive officers and key management personnel. Our Board of Directors is comprised of only one class. All of our directors will serve until the next annual meeting of stockholders and until their successors are elected and qualified, or until their earlier death, retirement, resignation or removal. Executive officers serve at the discretion of the Board of Directors, and are appointed to serve until the first Board of Directors meeting following the annual meeting of stockholders.

| <u>Name</u> | <u>Age</u> | <u>Position Held</u> |
|-------------------|------------|---|
| Joseph Postbinder | 62 | Chief Executive Officer and Chairman of the Board of Directors |
| Baruch Tosh | 53 | President |
| Meira Postbinder | 62 | Vice President of Finance, Secretary, Treasurer and Director |
| Dan Zarchin | 61 | Vice President of Marketing and International Business Development and Director |
| Tsippy Moldovan | 52 | Chief Financial Officer and Director |
| Motti Hassan | 58 | Director |

Joseph Postbinder has served as chairman of our Board of Directors since March 2002 and as our chief executive officer since March 1, 2003. Mr. Postbinder has served as the chief executive officer and chairman of the board of directors of Export Erez USA Inc., Mayotex and

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Dragonwear since he founded those companies in 1983, 1990 and 2000, respectively, and of Export Erez since July 1983. He also serves as the chairman of the board of directors of Owen Mills. Mr. Postbinder has a technical background in fine mechanics.

Baruch Tosh has served as our president since March 1, 2003, when he joined our company. From March 1998 to December 31, 2002, Mr. Tosh served as the business development manager of FMS Enterprises Ltd., an Israeli company that produces woven aramid fabrics, unidirectional shields and plates/panels for ballistic protection. Mr. Tosh holds a B.Sc. degree in Mechanical Engineering from Ben Gurion University, Beer-Sheva, Israel and a Diploma in Business Administration from The Technion, Israel Institute of Technology, Haifa, Israel.

Meira Postbinder has served as our vice president of finance and a director of Export Erez since June 6, 1996.

Dan Zarchin has served as our manager of marketing and International business development since March 2002 and as a director since March 2002. Mr. Zarchin has provided counseling services through his company, Zarchin Consultants, Tel-Aviv, Israel, since 1981, and has provided us with consulting services since March 1991. Mr. Zarchin holds a B.A. degree in Textile Engineering from the College of Textile Science of Philadelphia, Pennsylvania and a Masters of Business Administration from Tel-Aviv University, Israel.

Tsippy Moldovan has served as our chief financial officer and as our director since March 2002. Prior to that and since 1987 Mrs. Moldovan served as our Deputy Vice President of Finance. Since September 1, 1987 Mrs. Moldovan had served as the deputy managing director of finance of Export Erez. Mrs. Moldovan attended Buchnich Accounting School in Ashkelon, Israel and completed course work in economics and management accounting from Mishlav School, Tel Aviv, Israel.

Motti Hassan has served as our director since October 30, 2002. Mr. Hassan is an electronics engineer. Mr. Hassan served in the Israeli Army as a system engineer for 15 years until July 2000 when he retired and joined a private company in the field of professional video as a sales and business development manager. Mr. Hassan holds a B.Sc. degree in Electronic Engineering from the Ben Gurion University, Beer Sheva, Israel.

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Family Relationships

Joseph Postbinder and Meira Postbinder are husband and wife.

Audit Committee Financial Expert

Since we are an OTC Bulletin Board company, we are not required to establish an audit committee or to have an audit committee financial expert to serve on such committee. We hope to comply with those requirements in the future.

Section 16(a) Beneficial Ownership Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers, directors and persons who own more than 10% of a registered class of our equity securities to file with the SSEC initial statements of beneficial ownership, reports of changes in ownership and annual reports concerning their ownership of common stock and other of our equity securities on Forms 3, 4 and 5, respectively. Executive officers, directors and greater than 10% shareholders are required by Commission regulations to furnish us with copies of all Section 16(a) reports they file.

To our knowledge, based solely on our review of the copies of such forms received by us, or written representations from certain reporting persons that no additional forms were required for those persons, we believe that during fiscal 2008 all of our executive officers and directors subject to these reporting requirements filed the required reports on a timely basis. We believe that a 10% shareholder, Gov Financial Holdings Ltd., did not file Forms 3 and 4 in connection with their holdings and sales of our shares.

Code of Ethics

We have adopted a Code of Ethics for Executive and Financial Officers, which applies to our chief executive officer, chief financial officer, corporate controller and other finance organization employees, and a Code of Conduct, which applies to all of our employees. The Code of Ethics and the Code of Conduct are publicly available on our website at www.defense-industries.com. Written copies are available upon request. If we make any substantive amendments to the Code of Ethics or the Code of Conduct or grant any waivers, including any implicit waiver, from a provision of these codes to our chief executive officer, chief financial officer or corporate controller, we will disclose the nature of such amendment or waiver on our website.

Item 11. Executive Compensation**Summary Compensation**

The following table sets forth information concerning the total compensation during the last two fiscal years. As of December 31, 2008, no other executive officer was paid in excess of \$100,000.

Summary Compensation Table

| Name and Principal Position | Year | Salary (\$) | Bonus (\$) | Stock Awards (\$) | Option Awards (\$) | Non-Equity Incentive Plan Compensation (\$) | All Other Compensation (\$) | Total |
|--|------|-------------|------------|-------------------|--------------------|---|-----------------------------|------------|
| Joseph Postbinder - Chief Executive Officer and Chairman of the Board of Directors | 2008 | \$ 73,240 | - | - | - | - | - | \$ 73,240 |
| | 2007 | \$ 46,451 | - | - | - | - | - | \$ 46,451 |
| Baruch Tosh - President | 2008 | \$ 112,102 | - | - | - | - | - | \$ 112,102 |
| | 2007 | \$ 104,549 | \$ 129,920 | - | - | - | - | \$ 221,906 |

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The aggregate value of all other perquisites and other personal benefits furnished in each of the last two years to each of these executive officers was less than \$10,000 for the years ended December 31, 2008 and 2007.

Grants of Plan-Based Awards for 2008

We did not award any stock options to our executive officers during the fiscal year ended December 31, 2008.

Long-Term Incentive Plans-Awards in Last Fiscal Year

We do not currently have any long-term incentive plans.

Outstanding Equity Awards at Fiscal Year End

We did not grant any equity awards to our executive officers during the fiscal year ended December 31, 2008.

Option exercises and stock vested table.

None

Directors Compensation

Our directors do not receive compensation for their services on our Board of Directors or any committee thereof. The following table sets for the compensation received by each of our Directors.

| Name | Fees Earned or Paid in Cash (\$) | Stock Awards (\$) | Option Awards (\$) | Non-Equity Incentive Plan Compensation (\$) | Nonqualified Deferred Compensation (\$) | All Other Compensation (\$) | Total (\$) |
|------|----------------------------------|-------------------|--------------------|---|---|-----------------------------|------------|
| | | | | | | | |

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| Name | Fees Earned or Paid in Cash (\$) | Stock Awards (\$) | Option Awards (\$) | Non-Equity Incentive Plan Compensation (\$) | Nonqualified Deferred Compensation (\$) | All Other Compensation (\$) | Total (\$) |
|-------------------|----------------------------------|-------------------|--------------------|---|---|-----------------------------|------------|
| Joseph Postbinder | - | - | - | - | - | \$ 73,240(1) | \$ 73,240 |
| Meira Postbinder | - | - | - | - | - | \$ 15,560(2) | \$ 15,560 |
| Dan Zarchin | - | - | - | - | - | \$ 115,611(3) | \$ 115,611 |
| Tsippy Moldovan | - | - | - | - | - | \$ 36,507(4) | \$ 36,507 |

(1) Mr. Postbinder earned \$73,240 in consideration for his employment as our Chief Executive Officer.

(2) Ms. Postbinder earned \$15,560 in consideration for her employment as our vice president of finance, secretary and treasurer.

(3) Mr. Zarchin earned \$115,611 in consideration for his consulting services to us.

(4) Ms. Moldovan earned \$36,507 in consideration for her employment as our chief financial officer.

Employment Agreements

We have an employment agreement with Mr. Baruch Tosh, our president; pursuant to which, Mr. Tosh is entitled to additional annual compensation of 1.5% of growth in our revenues. Mr. Tosh, at his option, may receive shares of common stock in lieu of cash. According to this compensation plan, Mr. Tosh was not entitled to any additional compensation in 2008. According to this compensation plan, Mr. Tosh was entitled to additional compensation of \$129,921 for 2007, which he received in 2008.

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Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following table sets forth the number of shares of common stock beneficially owned as of March 31, 2009 by (i) those persons or groups known to us who will beneficially own more than 5% of our common stock; (ii) each director; (iii) each named executive officer whose compensation exceeded \$100,000 in the fiscal year ended December 31, 2008; and (iv) all directors and executive officers as a group. The information is determined in accordance with Rule 13(d)-3 promulgated under the Exchange Act based upon information furnished by persons listed or contained in filings made by them with the SEC by information provided by such persons directly to us. Except as indicated, the stockholders listed below possess sole voting and investment power with respect to their shares.

| Name (1) | Number of Shares of Common Stock Beneficially Owned (2) | Percentage of Outstanding Shares of Common Stock (3) |
|---|---|--|
| Joseph Postbinder (4) | 19,440,212 | 69.57% |
| Baruch Tosh | - | - |
| Meira Postbinder (4) | 9,788 | * |
| Dan Zarchin | - | - |
| Tsippy Moldovan | 55,000 | * |
| Motti Hassan | - | - |
| Gov Financial Holdings Ltd. (5) | 1,992,922 | 7.13% |
| All officers and directors as a group (7 persons) | 19,767,500 | 69.61% |

* Less than 1% percent

- (1) The addresses of Joseph Postbinder, Baruch Tosh, Meira Postbinder, Dan Zarchin, Tsippy Moldovan and Motti Hassan are c/o Defense Industries International, Inc., 8 Brisel Street, Industrial Zone Sderot, Israel.
- (2) Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Common stock relating to options currently exercisable or exercisable within 60 days of the date of this table, are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.
- (3) Based upon 27,941,111 shares of common stock outstanding.
- (4) Joseph Postbinder is the spouse of Meira Postbinder.
- (5) Includes 168,967 shares of common stock issuable upon the exercise of series B warrants.

Item 13. Certain Relationships and Related Transactions and Director Independence.

Facility Leases

Pursuant to a lease agreement effective since January 1, 2001, our subsidiary Achidatex leases an industrial building located in the Nazareth Industrial Zone, from a company owned by the former shareholders of Achidatex, Mr. Avraham Hatzor, Mr. Freddy Davidovitz, Mr. Shmuel Davidovitz and a company owned by Mr. Postbinder. Following the decision of the Israeli Government to evacuate Israeli residents and businesses from the Erez Industrial Zone, we relocated the major production activities of our subsidiary Export Erez from the Erez Industrial Area to this facility. The \$273,600 rental expense in 2008 was allocated between the two subsidiaries. The lease will expire on December 31, 2009. According to the agreement 75% of the rental expenses for this facility will be allocated to Achidatex and 25% of the rental expenses will be allocated to Export Erez. The monthly rent of \$22,800 to be paid quarterly, in NIS, in accordance with the current exchange rate, but in any event, an agreed upon exchange rate of no less than \$1 = NIS 3.95

Mayotex leases approximately 1,219 square meters of space in the Industrial Area of Sderot from Mr. Joseph Postbinder, our chief executive officer and chairman of the Board of Directors, primarily for its cut and sew operations. The annual rental expense for this space was \$58,512 in 2008. The lease expired on December 31, 2008 and was renewed for an additional one-year term at an annual rental of \$73,140.

Item 14. Principal Accountant Fees and Services

Fees to Principal Accountants

The following table sets forth, for each of the years indicated, the fees incurred to our independent public accountants, Virchow, Krause & Company, LLP during 2008 and 2007 All of such fees were pre-approved by our Board of Directors.

| | Year Ended December 31, | |
|-------------------|-------------------------|-----------|
| | 2008 | 2007 |
| Services Rendered | Fees | Fees |
| Audit (1) | \$ 93,028 | \$ 55,610 |
| Audit-related (2) | - | 11,000 |

| | Year Ended December 31, | |
|--------------|-------------------------|-----------|
| | 2008 | 2007 |
| Tax fees (3) | 45,000 | - |
| Total | \$ 138,028 | \$ 66,610 |

- (1) Audit services consist of work performed in connection with the audited financial statements for each fiscal year and in the review of financial statements included in quarterly reports during the year, as well as work normally done by the independent auditor in connection with statutory and regulatory filings, such as consent letters for SEC registration statements.
- (2) Audit related fees relate to fees paid to our previous principal accountant, Weinberg & Company, P.A. for their review and issuance of consent letters with respect to our SEC filings.
- (3) Tax fees relate to the completion of prior tax filings in the U.S.

Pre-Approval Policies and Procedures

Our Board of Directors has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent public accountants, Virchow, Krause & Company, LLP. The policy generally pre-approves certain specific services in the categories of audit services, audit-related services, and tax services up to specified amounts, and sets requirements for specific case-by-case pre-approval of discrete projects, those which may have a material effect on our operations or services over certain amounts. All services were pre-approved during 2008. Pre-approval may be given as part of the Board of Directors' approval of the scope of the engagement of our independent auditor or on an individual basis. The pre-approval of services may be delegated to one or more of the Board of Directors' members, but the decision must be presented to the Board of Directors at its next scheduled meeting. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act or the rules of the SEC, and also considers whether proposed services are compatible with the independence of the public accountants.

PART IV

Item 15. Exhibits, Financial Statement Schedules.

- (a) The following documents are filed as a part of this Report:

1. **Financial Statements.**

See Index to Consolidated Financial Statements on page F-1

2. **Financial Statements Schedules.**

No Financial Statement Schedules are included herein because either the amounts are not sufficient to require submission of the schedules or because the information is included in the Financial Statements or notes thereto.

3. **Exhibits.** The following is a list of exhibits filed as part of this Annual Report on Form 10-K. Where so indicated by footnote, exhibits that were previously filed are incorporated by reference.

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| <u>Exhibit Number</u> | <u>Description</u> |
|-----------------------|--|
| 3.1 | Certificate of Incorporation (1) |
| 3.2 | Certificate of Amendment to the Certificate of Incorporation (2) |
| 3.3 | By-laws (3) |
| 4.1 | Securities Purchase Agreement dated June 15, 2005 (4) |
| 4.2 | Stockholders Agreement dated June 15, 2005 (5) |
| 4.4 | Form of Warrant A dated June 15, 2005 (4) |
| 4.5 | Form of Warrant B dated June 15, 2005 (4) |
| 10.1 | Translation of Employment Agreement with Baruch Tosh (5) |
| 23.1 | Subsidiaries of the Company |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended. |
| 32.1 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended. |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

-
- (1) Filed as Exhibit 3 to the Registrant's Form 10-KSB for the year ended December 31, 2001.
 - (2) Filed as Appendix C to the Registrant's Filing on Schedule 14C, filed with the Commission on December 30, 2002.
 - (3) Filed as Appendix D to the Registrant's Filing on Schedule 14C, filed with the Commission on December 30, 2002
 - (4) Filed as Exhibit 10.1 to the Registrant's Report on Form 8-K dated filed June 20, 2005.
 - (5) Filed as Exhibit 10.2 to the Registrant's Form 10-KSB for the year ended December 31, 2003.

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SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Company caused this amended report to be signed on its behalf by the undersigned, thereunto duly authorized.

DEFENSE INDUSTRIES INTERNATIONAL, INC.

Dated: March 31, 2009

By: /s/ Joseph Postbinder

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Joseph Postbinder
Chairman and Chief Executive Officer

In accordance with the Securities Exchange Act of 1934, this amended report has been signed below on March 31, 2009 by the following persons on behalf of the Registrant and in the capacities indicated.

By: /s/ Joseph Postbinder

Joseph Postbinder
Chairman and Chief Executive Officer

By: /s/ Baruch Tosh

Baruch Tosh
President

By: /s/ Meira Postbinder

Meira Postbinder
Vice President of Finance and Director

By: /s/ Tsippy Moldovan

Tsippy Moldovan
Chief Financial Officer and Director

By: /s/ Dan Zarchin

Dan Zarchin
Director

By: /s/ Motti Hassan

Motti Hassan
Director

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**DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2008 and 2007**

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of:
Defense Industries International, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Defense Industries International, Inc. and Subsidiaries (the "Company") as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders' equity and comprehensive income and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 Defense Industries International, Inc. and Subsidiaries as of December 31, 2008 and 2007 and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Virchow, Krause & Company, LLP

Virchow, Krause & Company, LLP
An independent member of Baker Tilly International

Minneapolis, Minnesota
March 31, 2009

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

| <u>Note</u> | <u>December 31, 2008</u> | <u>December 31, 2007</u> |
|-------------|------------------------------|------------------------------|
|-------------|------------------------------|------------------------------|

CURRENT ASSETS

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| | | | |
|--|----|-----------------------------|-----------------------------|
| Cash and cash equivalents | | \$ 1,719,921 | \$ 1,120,054 |
| Restricted bank deposits | 3 | 3,000,000 | |
| Accounts receivable, net of allowance for doubtful accounts of \$298,354 and \$208,464, respectively | | 3,449,852 | 3,603,528 |
| Accounts receivable - related parties | | | 1,113 |
| Inventories | 5 | 5,373,627 | 3,698,878 |
| Trading securities | 4 | 2,384,727 | 2,951,604 |
| Deferred taxes | 11 | 168,231 | 165,902 |
| Other current assets | | 178,825 | 219,330 |
| | | <u> </u> | <u> </u> |
| Total Current Assets | | 16,275,183 | 11,760,409 |
| | | <u> </u> | <u> </u> |
| PROPERTY, PLANT AND EQUIPMENT, NET | 6 | 2,177,526 | 2,454,549 |
| | | <u> </u> | <u> </u> |
| OTHER ASSETS | | | |
| Fund in respect of employee rights upon retirement | 10 | 646,905 | 751,609 |
| Deferred taxes | 11 | 62,873 | 36,365 |
| Deposit on purchase of a business | 16 | 1,000,000 | |
| | | <u> </u> | <u> </u> |
| Total Other Assets | | 1,709,778 | 787,974 |
| | | <u> </u> | <u> </u> |
| TOTAL ASSETS | | \$ 20,162,487 | \$ 15,002,932 |
| | | <u> </u> | <u> </u> |

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

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (CONT.)

LIABILITIES AND SHAREHOLDERS' EQUITY

| | Note | December 31, 2008 | December 31, 2007 |
|------------------------------------|------|-----------------------------|-----------------------------|
| | | <u> </u> | <u> </u> |
| CURRENT LIABILITIES | | | |
| Accounts payable | | \$ 1,720,913 | \$ 1,670,029 |
| Accounts payable - related parties | 14 | 1,581,097 | 50,448 |
| Short-term debt | 7 | 956,801 | 1,264,793 |
| Common stock to be issued | | 40,000 | 40,000 |
| Other current liabilities | 8 | 1,887,844 | 2,085,535 |
| | | <u> </u> | <u> </u> |
| Total Current Liabilities | | 6,186,655 | 5,110,805 |
| | | <u> </u> | <u> </u> |
| LONG-TERM LIABILITIES | | | |
| Long-term portion of debt | 9 | 555,044 | 618,676 |

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| | | | |
|---|----|-----------------------------|-----------------------------|
| Liability for employee rights upon retirement | 10 | 821,909 | 734,652 |
| Common stock to be issued | | | 40,000 |
| | | | <u> </u> |
| Total Long-Term Liabilities | | 1,376,953 | 1,393,328 |
| | | <u> </u> | <u> </u> |
| TOTAL LIABILITIES | | 7,563,608 | 6,504,133 |
| | | <u> </u> | <u> </u> |
| Minority interest | | | 1,077,708 |
| COMMITMENTS AND CONTINGENCIES | 12 | | |
| SHAREHOLDERS' EQUITY | 13 | | |
| Preferred stock, \$0.0001 par value, 50,000,000 shares authorized, none issued and outstanding | | | |
| Common stock, \$0.0001 par value, 250,000,000 shares authorized; 28,991,111 shares outstanding and 27,941,111 shares issued in 2008; and 28,867,272 shares issued and outstanding in 2007 | | 2,899 | 2,886 |
| Additional paid-in capital | | 2,957,391 | 2,764,328 |
| Treasury stock (1,050,000 shares at cost) | | (252,000) | |
| Retained earnings | | 9,654,086 | 4,165,069 |
| Accumulated other comprehensive gain | | 236,503 | 488,808 |
| | | <u> </u> | <u> </u> |
| TOTAL SHAREHOLDERS EQUITY | | 12,598,879 | 7,421,091 |
| | | <u> </u> | <u> </u> |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | | \$ 20,162,487 | \$ 15,002,932 |
| | | <u> </u> | <u> </u> |

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

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

| | Year ended December 31, | |
|---------------------------|-----------------------------|-----------------------------|
| | 2008 | 2007 |
| | <u> </u> | <u> </u> |
| NET REVENUES | \$ 18,170,508 | \$ 19,262,928 |
| COST OF SALES | 14,093,875 | 13,057,776 |
| | <u> </u> | <u> </u> |
| GROSS PROFIT | 4,076,633 | 6,205,152 |
| | <u> </u> | <u> </u> |
| OPERATING EXPENSES | | |

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| | Year ended December 31, | |
|--|-----------------------------|-----------------------------|
| Selling | 1,160,734 | 1,064,959 |
| General and administrative | 2,201,027 | 2,102,060 |
| | <u> </u> | <u> </u> |
| Total Operating Expenses | 3,361,761 | 3,167,019 |
| | <u> </u> | <u> </u> |
| INCOME FROM OPERATIONS | 714,872 | 3,038,133 |
| | <u> </u> | <u> </u> |
| OTHER INCOME (EXPENSES) | | |
| Financial expense | (208,936) | (314,753) |
| Financial income | 437,612 | 45,753 |
| Other (expense) income, net | (129,713) | 39,125 |
| | <u> </u> | <u> </u> |
| Total Other Income (Expenses) | 98,963 | (229,875) |
| | <u> </u> | <u> </u> |
| INCOME BEFORE INCOME TAXES | 813,835 | 2,808,258 |
| Income tax expense (Note 11) | 127,004 | 1,264,281 |
| | <u> </u> | <u> </u> |
| NET INCOME BEFORE MINORITY INTEREST AND EXTRAORDINARY INCOME | 686,831 | 1,543,977 |
| Minority interest income | 25,094 | 122,685 |
| | <u> </u> | <u> </u> |
| Income before extraordinary income | 661,737 | 1,421,292 |
| Extraordinary income, net of tax (Note 12) | 4,827,280 | |
| | <u> </u> | <u> </u> |
| NET INCOME | \$ 5,489,017 | \$ 1,421,292 |
| | <u> </u> | <u> </u> |
| Net income per share before extraordinary income - basic and diluted | 0.02 | 0.05 |
| Net extraordinary income per share - basic and diluted | 0.17 | |
| | <u> </u> | <u> </u> |
| Net income per share - basic and diluted | \$ 0.19 | \$ 0.05 |
| | <u> </u> | <u> </u> |
| Weighted average number of shares outstanding - basic and diluted | 28,964,719 | 28,842,919 |
| | <u> </u> | <u> </u> |

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

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME

| | Common Stock | | Treasury Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Comprehensive Income | Total shareholders' Equity |
|--|--------------|----------|----------------|-----------|----------------------------------|----------------------|--|----------------------------------|----------------------------------|
| | Shares | Dollars | Shares | Dollars | | | | | |
| Balance as of January 1, 2007 | 28,793,198 | \$ 2,879 | - | - | \$ 2,552,738 | \$ 2,791,720 | \$ (35,144) | | \$ 5,312,193 |
| Effect of adoption of new accounting pronouncement (1) | - | - | - | - | 171,597 | (47,943) | - | | 123,654 |
| Common stock issued to acquire Rizzo Inc. (1) | 74,074 | 7 | - | - | 39,993 | - | - | | 40,000 |
| Comprehensive income: | | | | | | | | | |
| Net income | - | - | - | - | - | 1,421,292 | - | \$ 1,421,292 | 1,421,292 |
| Foreign currency translation gain | - | - | - | - | - | - | 523,952 | 523,952 | 523,952 |
| Total comprehensive income | | | | | | | \$ 1,945,244 | | |
| Balance as of December 31, 2007 | 28,867,272 | 2,886 | - | - | 2,764,328 | 4,165,069 | 488,808 | | 7,421,091 |
| Common stock issued to acquire Rizzo Inc. (1) | 123,839 | 13 | - | - | 39,987 | - | - | | 40,000 |
| Purchase of treasury stock (2) | - | - | 1,050,000 | (252,000) | - | - | - | | (252,000) |
| Excess of fair value over consideration for the purchase of Achidatex Nazareth Elite (1977) Ltd. shares (2) | - | - | - | - | 153,076 | - | - | | 153,076 |
| Comprehensive income: | | | | | | | | | |
| Net income | - | - | - | - | - | 5,489,017 | - | \$ 5,489,017 | 5,489,017 |
| Foreign currency translation loss | - | - | - | - | - | - | (252,305) | (252,305) | (252,305) |

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| | Common Stock | | Treasury Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Comprehensive Income | Total shareholders' Equity |
|---------------------------------|--------------|----------|----------------|--------------|----------------------------------|----------------------|--|----------------------------------|----------------------------------|
| Total comprehensive income | | | | | | | 5,236,712 | | |
| | | | | | | | \$ | | |
| Balance as of December 31, 2008 | 28,991,111 | \$ 2,899 | 1,050,000 | \$ (252,000) | \$ 2,957,391 | \$ 9,654,086 | \$ 236,503 | | \$ 12,598,879 |

(1) See Note 13

(2) See Note 1

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

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Year ended December 31, | |
|--|-------------------------|--------------|
| | 2008 | 2007 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 5,489,017 | \$ 1,421,292 |
| Less – extraordinary income, net of tax | (4,827,280) | |
| | 661,737 | 1,421,292 |
| <u>Adjustments to reconcile net income to net cash provided by (used in) operating activities:</u> | | |
| <u>Items not effecting cash:</u> | | |
| Depreciation and amortization | 580,255 | 495,856 |
| Gain from sale of property, plant and equipment | (36,271) | (22,394) |
| Impairment of long live assets and goodwill | | 111,775 |
| Provision for doubtful accounts | 141,946 | 11,323 |
| Deferred taxes | (28,078) | (66,098) |
| Net unrealized loss on trading securities | 4,869 | 28,149 |
| Accrued interest and exchange rate differences of long-term debt | (3,763) | |
| Minority interest in income of subsidiary | 25,094 | 122,685 |
| <u>Changes in assets and liabilities:</u> | | |
| Decrease (increase) in accounts receivable | 64,386 | (616,417) |
| Increase in inventories | (1,701,140) | (692,856) |
| Decrease (increase) in trading securities | 632,050 | (1,970,186) |
| Increase in related parties accounts | 347,505 | 279,685 |
| Decrease in other current assets | 14,608 | 756,504 |
| Increase (decrease) in funds in respect of employee rights upon retirement | 120,174 | (231,088) |
| Increase in accounts payable | 12,659 | 604,895 |
| (Decrease) increase in other current liabilities | (208,055) | 1,003,764 |
| Increase in liability for employee rights upon retirement | 83,458 | 337,613 |

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| | Year ended December 31, | |
|--|-------------------------|---------------------|
| | 711,434 | 1,574,502 |
| Net Cash Provided By Operating Activities | 711,434 | 1,574,502 |
| Cash provided by extraordinary items | 4,827,280 | |
| | <u>5,538,714</u> | <u>1,574,502</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Investment in short-term restricted bank deposits | (3,000,000) | |
| Purchases of property, plant and equipment | (306,404) | (643,484) |
| Proceeds from sale of property, plant and equipment | 68,922 | 47,787 |
| Deposit on purchase of a business | (1,000,000) | |
| | <u>(4,237,482)</u> | <u>(595,697)</u> |
| Cash Used In Investing Activities | (4,237,482) | (595,697) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Reduction in short-term debt, net | (154,175) | (1,055,367) |
| Proceeds from long-term debt | 367,913 | 291,972 |
| Repayment of long-term debt | (630,856) | (784,316) |
| | <u>(417,118)</u> | <u>(1,547,711)</u> |
| Net Cash Used in Financing Activities | (417,118) | (1,547,711) |
| EFFECT OF CHANGES IN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS | (284,247) | 18,048 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 599,867 | (550,858) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 1,120,054 | 1,670,912 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | <u>\$ 1,719,921</u> | <u>\$ 1,120,054</u> |
| INTEREST PAID | \$ 116,030 | \$ 168,424 |
| TAXES PAID | \$ 313,272 | \$ 161,572 |

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

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:

Pursuant to the agreement signed on February 28, 2005 to acquire the business of Rizzo Inc. (doing business as Owen Mills Company), On March 18, 2008 and on May 1, 2007, the Company issued 123,839 shares and 74,074 shares of its common stock, respectively, having a fair value of \$40,000 each, at the date of issuance, to the former shareholders of Rizzo Inc.

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On December 31, 2008, the Company signed an agreement to purchase an additional 240 management shares and 801,360 ordinary shares of Achidatex Nazareth Elite (1977) Ltd. held by minority shareholders and 1,050,000 shares of common stock of the Company for an aggregate purchase price of \$1,200,000, to paid by the Company during the first quarter of 2009 (see also Note 1).

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

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

NOTE 1 **DESCRIPTION OF BUSINESS**

Defense Industries International, Inc. and subsidiaries (the Company) is a manufacturer and global provider of personal military and civilian protective equipment and supplies. The Company's products are used by military, law enforcement, border patrol enforcement, and other special security forces, corporations, non-governmental organizations and individuals throughout the world.

The Company's main products include body armor, bomb disposal suits, bullet proof vests and jackets, ballistic wall coverings, bullet proof ceramic and polyethylene panels, V.I.P. car armoring and lightweight armor kits for vehicles, personal military equipment, dry storage systems, liquid logistic products, tents and other camping and travel gear.

Defense Industries International, Inc. is a holding company whose wholly owned subsidiaries include Export Erez USA, Inc., Rizzo Inc.(doing business as Owen Mills Company), Export Erez, Ltd. (Export Erez), Mayotex, Ltd. (Mayotex), Dragonwear Trading Ltd. (Dragonwear), and Achidatex Nazareth Elite (1977) Ltd. (Achidatex).

On December 31, 2008, the Company signed an agreement to purchased all the minority shares of Achidatex (240 management shares and 801,360 ordinary shares) and 1,050,000 shares of common stock of the Company for an aggregate price of \$1,200,000. Following the completion of the transaction the Company owned 100% of Achidatex. The Company allocated \$252,000 of the purchase price or \$0.24 per share to the purchase of the Company's common stock. The \$0.24 per share represented the best measurement of fair value and was the closing price of the Company's common stock on December 31, 2008. The remaining purchase price of \$948,000 was allocated to the purchase of the Achidatex minority interest. The excess of the liability to minority over the fair value assigned by management of \$153,076 was allocated to shareholders equity. Payment by the Company to the minority shareholders under this agreement were scheduled to be paid during the first quarter of 2009 and accordingly, the liability to the minority shareholders pursuant to this agreement are recorded as current liabilities.

NOTE 2 **SIGNIFICANT ACCOUNTING POLICIES**

(A) Principles of Consolidation

The consolidated financial statements include the accounts of Defense Industries International, Inc. and its wholly owned subsidiaries, Export Erez, USA, Inc., Export Erez, Mayotex, Dragonwear, Owen Mills Company and Achidatex (assets and liabilities - 100% and 76% as of December 31, 2008, and 2007, respectively, and operations - 76% in 2008 and 2007).

All significant inter-company accounts and transactions have been eliminated in consolidation.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

(B) Foreign Currency Translation and Transactions

The accompanying consolidated financial statements are presented in United States dollars. The functional currency of Export Erez, Mayotex and Achidatex is the New Israeli Shekel (NIS). The financial statements of entities with functional currency different than United States dollar are translated into United States dollars at year-end exchange rates for assets and liabilities and average exchange

rates in the year for revenues and expenses. Capital accounts are translated at their historical exchange rates when the capital transactions occurred.

Foreign currency transaction gains or losses from transactions denominated in currencies other than NIS are recognized in net income in the period the gain or loss occurs. During 2008 and 2007, a gain of \$280,350 and a loss of \$129,729, respectively, are included in financial expense, net in the accompanying consolidated statements of operations.

(C) Comprehensive Income

The foreign currency translation gains (losses) resulting from the translation of the financial statements of the Company's subsidiaries expressed in NIS to United States dollars are reported as Accumulated Other Comprehensive Gain (Loss) in the statements of changes in shareholders' equity.

(D) Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that effect the reported amounts of assets and liabilities and disclose the nature of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

(E) Fair Value of Financial Instruments

The Company's financial instruments are principally non-derivative assets and non-derivative liabilities (non-derivative assets include cash and cash equivalents, deposits in banks and other financial institutions, marketable securities, trade accounts receivable, other assets; non-derivative liabilities include short-term debt, trade accounts payable, and other current liabilities). Because of the nature of these financial instruments, fair value generally equals or approximates the amounts presented in the consolidated financial statements. The carrying amount of the Company's long-term debt approximates quoted market prices or current rates offered to the Company for debt of the same remaining maturities.

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**DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007**

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standard No. 157, Fair Value Measurements (SFAS 157), which establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements.

SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. SFAS 157 also requires disclosure about how fair value is determined for assets and liabilities and establishes a hierarchy for which these assets and liabilities must be grouped, based on significant levels of inputs, as follows:

Level 1 Quoted prices in active markets for identical assets or liabilities;

Level 2 Quoted prices in active markets for similar assets and liabilities and inputs that are observable for the asset or liability; or

Level 3 Unobservable inputs, such as discounted cash flow models or valuations.

The Company's trading securities and bank deposits are measured at fair value based on quoted market prices in active markets for identical assets (Level 1).

The Company funds in respect to employees' rights upon retirement are measured at fair value based upon unobservable inputs (Level 3).

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The effect of the first-time adoption of this statement had no material impact on the Company's financial position and results of operations.

In February 2007, the FASB issued Statement of Financial Accounting Standard No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. This statement became effective for the Company as of the year beginning January 1, 2008, and in accordance with SFAS 159, the Company decided not to apply SFAS 159 to its financial assets and liabilities. Therefore the adoption of SFAS 159 has had no impact on the Company's financial position and results of operations.

(F) Concentrations of Credit Risk

At December 31, 2008 and 2007, the Company held cash and cash equivalents, in the aggregate amount of \$1,719,921 and \$1,120,054, respectively, and most of these amounts were deposited with Israeli banks. Under Israeli law, the Bank of Israel insures all bank deposits without limits on the amount. Therefore, the Company does not anticipate losses in respect to these items.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

Part of the Company's sales are made to government institutions and private industry in Israel. Consequently, the exposure to credit risks relating to these trade receivables is limited. Export sales are made primarily with a letter of credit by the buyer or under controlled credit with specific accredited customers, so the receivable is collectible. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. An appropriate allowance for doubtful accounts is included in trade accounts receivable.

(G) Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with a maturity of three months or less to be cash equivalents.

(H) Trading Securities

The Company invests in mutual funds and common stock in Israel and in common stock in the United States.

All trading securities as of December 31, 2008 and 2007 are carried at their fair market value based upon quoted market prices of those investments at year end. Net realized and unrealized gains and losses on trading securities are included in net earnings in other income.

(I) Inventories

Inventories are valued at the lower of cost or market value.

Inventories allowances are provided to cover risks arising from obsolete and slow-moving items, discontinued products and excess inventories according to revenue forecasts. As of December 31, 2008 and 2007, inventories allowances were \$371,800 and \$380,675, respectively.

(J) Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of three to twenty-five years.

Leasehold improvements are amortized using the straight line method over the period of the lease contract, provided that this period does not exceed the useful life of the asset.

Fixed assets not in use, held for resale, are stated at the lower of net cost or estimated realizable value.

Expenditures for maintenance and repairs are charged to expense as incurred, while renewals and betterment of a permanent nature are capitalized.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

(K) Impairment of Long-lived assets

In accordance with the provisions of Financial Accounting Standard Board (FASB) Statement No. 144, Accounting for the Impairment or Disposal of Long-lived Assets , the Company reviews long-lived assets, including equipment, for impairment whenever events or changes in business circumstances indicate that the carrying amounts of the assets may not be fully recoverable. Under Statement No 144, an impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of the assets and its eventual disposition is less than its carrying amount. Impairment, if any, is measured as the amount by which the carrying amount of long-lived assets exceeds its fair value. As of December 31, 2007, the cost of sales includes \$30,875 with respect to impairment of certain equipment of Owen Mills Company. No impairment charges were recorded in 2008.

(L) Revenue Recognition

Revenues from sales of products are recognized under the completed contract method upon shipment to customers. The contracts are short term, generally under two months. In accordance with Staff Accounting Bulletin (SAB) No.101 Revenue Recognition in Financial Statements (as updated by SAB 104) revenue is recognized when delivery has occurred, persuasive evidence of an agreement exists, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

The Company provides a warranty on goods ranging from three to four years on certain products. Based upon historical experience of no warranty claims, the Company has not established a reserve at December 31, 2008 and 2007.

(M) Accounts Receivable

Accounts receivables are recognized and carried at the original invoice amount less an allowance for any uncollectible amounts. An estimate for doubtful accounts is made when collection of the full amount is no longer probable.

Provisions are made for doubtful accounts on a specific basis that, in management's opinion, appropriately reflect the loss inherent in collection of the receivable. This provision is made by management based on its assessment of the risk of the receivable. This assessment involves reviewing, and relying on, information in its possession regarding the financial position of its customers, the scope of their activities and evaluation of any security the Company has received.

Bad debts are written off as incurred. The allowance for doubtful accounts was \$298,354 and \$208,464 at December 31, 2008 and 2007, respectively.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(N) Treasury shares

Treasury shares are presented as a reduction of shareholders' equity, at their cost to the Company.

(O) Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

FASB Statement No. 109 Accounting for Income Taxes, requires the establishment of a valuation allowance to reflect the likelihood of the realization of deferred tax assets. Significant management judgment is required in determining provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against net deferred tax assets. The Company evaluates the weight of all available evidence to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. During year 2008 and 2007, the Company recorded a valuation allowance for the full amount of deferred tax assets generated in the United States (US) due to uncertainties surrounding the ability to utilize US deferred tax assets. If related to US operations the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the deferred tax assets would increase net income in the period such determination is made. In the event that actual results differ from these estimates or the Company adjusts these estimates in future periods, the Company may need to adjust its valuation allowance.

Deferred taxes were not created for taxes to be imposed on earnings distributed by subsidiaries, as it is the Company's policy not to distribute taxable dividends in the foreseeable future.

As for the effect of the adoption of FASB Interpretation 48 Accounting for Uncertainty in Income Taxes as of January 1, 2007, see Note 11.

(P) Per Share Data

Basic net income per share of common stock is computed based on the weighted average number of shares of common stock outstanding during the year. Diluted net income per share of common stock is computed based on the weighted average number of shares of common stock and common stock equivalents outstanding during the year. Common stock equivalents to purchase 202,500 shares of common stock were not included in diluted loss per share because their effect was anti dilutive, in the years ended December 31, 2008 and 2007.

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**DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(O) Shipping and Handling Fees

The Company includes shipping and handling fees billed to customers as revenues and the related costs as cost of sales. Such fees and costs are primarily comprised of outbound freight. Included in revenues in the accompanying consolidated statements of income are shipping and handling fees of \$236,572 and \$148,314 for the years ended December 31, 2008 and 2007, respectively.

(R) Advertising Costs

The Company expenses advertising costs as incurred. Advertising expenses included in selling expenses were \$71,378 and \$62,901 for the years ended December 31, 2008 and 2007, respectively.

(S) Research and Development Costs

Expenditures relating to the development of new products and processes, including significant improvements to existing products, are expensed as incurred. Research and development expenses were \$120,608 and \$115,000 for the years ended December 31, 2008 and 2007, respectively.

(T) Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statement No. 87, 88, 106 and 132(R), (FAS 158). This Standard requires recognition of the funded status of a benefit plan in the statement of financial position. The Standard also requires recognition in other comprehensive income certain gains and losses that arise during the period but are deferred under pension accounting rules, as well as modifies the timing of reporting and adds certain disclosures. FAS 158 provides recognition and disclosure elements to be effective as of the end of the fiscal year after December 15, 2006 and measurement elements to be effective for fiscal years ending after December 15, 2008. The Company does not expect the remaining elements of this Statement to have a material impact on the company's financial condition, results of operations, cash flows when adopted.

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In December 2007, the FASB issued SFAS No. 141 (Revised 2007) Business Combinations, a revision of the original SFAS No. 141. This statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces the original Statement 141, cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. The Company is required to adopt the revised SFAS No. 141 on January 1, 2009. The Company is currently evaluating the potential impact of the revised SFAS No. 141 on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160 Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51. This statement establishes accounting and reporting standards for noncontrolling interests in subsidiaries and for the deconsolidation of subsidiaries and clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS No. 160 also required expanded disclosures that clearly identify and distinguish the interests of the parent owners and the interests of the noncontrolling owners of a subsidiary. The Company is required to adopt SFAS No. 160 on January 1, 2009. The Company is currently evaluating the potential impact of this Statement on the Company's consolidated financial statements.

In March 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 161 (SFAS 161), Disclosures about Derivative Instruments and Hedging Activities. SFAS 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 Accounting for Derivative Instruments and Hedging Activities and how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is currently evaluating the potential impact that SFAS 161 will have on the Company's consolidated financial statements.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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In December 2008, the FASB issued FSP FAS 132R-1, Employers' Disclosures about Post retirement Benefit Plan Assets (FSP FAS 132R-1), which provides additional guidance on employers' disclosures about the plan assets of defined benefit pension or other postretirement plans. The disclosures required by FSP FAS 132R-1 include a description of how investment allocation decisions are made, major categories of plan assets, valuation techniques used to measure the fair value of plan assets, the impact of measurements using significant unobservable inputs and concentrations of risk within plan assets. The disclosures about plan assets required by this FSP must be provided for fiscal years ending after December 15, 2009. For the Company, FSP FAS 132R-1 will be effective for the fiscal year ending December 31, 2009, and will result in additional disclosures related to the assets of defined benefit pension plans in notes to the Company's consolidated financial statements.

NOTE 3 **RESTRICTED BANK DEPOSITS**

Restricted bank deposits consist of bank deposits in US dollars, bear no interest, with maturities dates of February 12, 2009, March 31, 2009 and June 16, 2009. The bank deposits are restricted to secure the Company's liabilities to its banks.

NOTE 4 **TRADING SECURITIES**

A reconciliation of original cost to fair market value for trading securities held at December 31, 2008 and 2007 consisted of the following:

| | <u>2008</u> | <u>2007</u> |
|---|---------------------|---------------------|
| Trading securities, at cost | \$ 2,391,408 | \$ 3,014,852 |
| Unrealized loss on trading securities | (6,681) | (63,248) |
| Trading securities at fair market value | <u>\$ 2,384,727</u> | <u>\$ 2,951,604</u> |

NOTE 5 **INVENTORIES**

Inventories at December 31, 2008 and 2007 consisted of the following:

| | <u>2008</u> | <u>2007</u> |
|-------------------|---------------------|---------------------|
| Raw materials (1) | \$ 3,527,373 | \$ 2,036,470 |
| Work in progress | 754,932 | 994,580 |
| Finished goods | 1,091,322 | 667,828 |
| | <u>\$ 5,373,627</u> | <u>\$ 3,698,878</u> |

(1) Includes advanced payment to purchase inventory for \$513,447 as of December 31, 2008.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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NOTE 6 **PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment at December 31, 2008 and 2007 consisted of the following:

| | <u>2008</u> | <u>2007</u> | <u>Estimated Useful Life</u> |
|---------------------------------|------------------|------------------|------------------------------|
| Leasehold improvements | \$ 620,696 | \$ 611,583 | 10 Years |
| Motor vehicles | 696,074 | 615,110 | 5-7 Years |
| Office equipment and furniture | 477,663 | 441,740 | 3-14 Years |
| Equipment | 4,518,702 | 4,440,259 | 5 Years |
| | <u>6,313,135</u> | <u>6,108,692</u> | |
| Less - Accumulated depreciation | (4,104,734) | (3,623,268) | |

| | <u>2008</u> | <u>2007</u> | Estimated Useful Life |
|--------------------------|---------------------|---------------------|-----------------------------|
| | 2,208,401 | 2,485,424 | |
| Less - impairment charge | (30,875) | (30,875) | |
| | <u>\$ 2,177,526</u> | <u>\$ 2,454,549</u> | |

Depreciation expense for the years ended December 31, 2008 and 2007 were \$580,255 and \$484,907, respectively.

NOTE 7 SHORT-TERM DEBT

Short-term debt at December 31, 2008 and 2007 consisted of the following:

| | <u>Interest Rates</u> | <u>2008</u> | <u>2007</u> |
|--|--|-------------------|---------------------|
| Overdraft credit | 3.4% - 7.4% (average rate of 5.6%) | \$ 604,597 | \$ 473,796 |
| Short-term bank loans | 6% - 7.5% (average rate of 7%) | | 261,266 |
| Current portion of long-term debt (see note 9) | | 352,204 | 529,731 |
| | | <u>\$ 956,801</u> | <u>\$ 1,264,793</u> |

The overdraft credit is a revolving credit facility due on demand.

The maximum available and the average amounts of overdraft credit during the year ended December 31, 2008 were \$2,000,000 and \$560,747, respectively.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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To secure its short-term liabilities and long-term loans (see Note 9), the Company has a blanket floating lien in favor of several Israeli banks on all assets, securities, notes and other trade instruments that are deposited with the banks.

NOTE 8 OTHER CURRENT LIABILITIES

Other current liabilities at December 31, 2008 and 2007 consisted of the following:

| | <u>2008</u> | <u>2007</u> |
|--|-------------|-------------|
| Government institutes | \$ 54,873 | \$ 54,873 |
| Employees and institutions for payroll and related taxes | 519,256 | 649,515 |
| Advances from customers | 621,461 | 321,328 |

| | 2008 | 2007 |
|------------------|-----------------------------|-----------------------------|
| Accrued expenses | 58,421 | 122,554 |
| Income taxes | 688,706 | 937,265 |
| | <u> </u> | <u> </u> |
| | \$ 1,887,844 | \$ 2,085,535 |
| | <u> </u> | <u> </u> |

NOTE 9 LONG-TERM DEBT

Consists of:

| | 2008 | 2007 |
|------------------------------------|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Loan to acquire Owen Mills Company | \$ 50,698 | \$ 82,834 |
| Loans from banks | 856,550 | 1,065,573 |
| | 907,248 | 1,148,407 |
| Less – current maturities | (352,204) | (529,731) |
| | <u> </u> | <u> </u> |
| | \$ 555,044 | \$ 618,676 |
| | <u> </u> | <u> </u> |

On February 28, 2005, the Company acquired all the outstanding shares of Rizzo Inc. (doing business as Owen Mills Company) for an aggregate of \$372,401, consisting of a note payable of \$172,401 and \$200,000 in shares of common stock of the Company, both of which are to be paid over five years. As of December 31, 2008 the balance of the note was \$50,698, of which \$40,000 is included in the current portion of long term debt (See also Note 13). On May 31, 2004, the Company obtained two loans of \$105,208 each with interest at a fluctuating rate based on the Bank of Israel's prime rate +1.2% (5.2% at December 31, 2008). The terms are 56 monthly payments commencing June 1, 2004 with each payment consisting of a fixed principal along with accrued interest. As of December 31, 2008 the balance of each loan was \$2,185, all of which is included in the current portion of long-term debt.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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On April 18, 2005, the Company borrowed \$26,525 with interest at a fluctuating rate based on the Bank of Israel's prime rate (4% at December 31, 2008). The terms are 48 monthly payments commencing May 21, 2005 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$2,547, all of which is included in the current portion of long-term debt.

On April 18, 2005, the Company borrowed \$35,718 with interest at a fluctuating rate based on the Bank of Israel's prime rate (4% at December 31, 2008). The terms are 48 monthly payments commencing May 21, 2005 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$3,196, all of which is included in the current portion of long-term debt.

On April 10, 2006, the Company borrowed \$526,039 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1.4% (5.4% at December 31, 2008). The terms are 60 monthly payments commencing May 10, 2006 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$269,453 of which \$109,203 is included in the current portion of long-term debt.

On May 24, 2006, the Company borrowed \$210,416 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1% (5% at December 31, 2008). The terms are 36 monthly payments commencing June 24, 2006 with each payment consisting of a fixed amount of

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principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$32,255, all of which is included in the current portion of long-term debt.

On May 17, 2006, the Company borrowed \$43,292 with interest at a fluctuating rate based on the Bank of Israel's prime rate +0.5% (3.5% at December 31, 2008). The terms are 48 monthly payments commencing Jun 1, 2006 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$16,393 of which \$11,298 is included in the current portion of long-term debt.

On April 11, 2007, the Company borrowed \$263,019 with interest at a fluctuating rate based on the Bank of Israel's prime rate +2% (6% at December 31, 2008). The terms are 60 monthly payments commencing May 11, 2007 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$186,277 of which \$51,116 is included in the current portion of long-term debt.

On July 3, 2007, the Company borrowed \$26,302 with interest at a fluctuating rate based on the Bank of Israel's prime rate +0.5% (4.5% at December 31, 2008). The terms are 36 monthly payments commencing August 3, 2008 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$14,459 of which \$8,976 is included in the current portion of long-term debt.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

On December 5, 2007, the Company borrowed \$26,302 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1% (5% at December 31, 2008). The terms are 36 monthly payments commencing January 5, 2008 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$18,163 of which \$8,802 is included in the current portion of long-term debt.

On July 23, 2008, the Company borrowed \$39,453 with interest at a fluctuating rate based on the Bank of Israel's prime rate (4% at December 31, 2008). The terms are 36 monthly payments commencing August 23, 2008 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$34,003 of which \$13,162 is included in the current portion of long-term debt.

On July 31, 2008, the Company borrowed \$263,019 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1.1% (5.1% at December 31, 2008). The terms are 60 monthly payments commencing August 31, 2008 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$241,101 of which \$52,604 is included in the current portion of long-term debt.

On March 18, 2008, the Company borrowed \$44,713 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1% (5% at December 31, 2008). The terms are 36 monthly payments commencing April 18, 2008 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2008, the balance of the loan was \$34,333 of which \$14,675 is included in the current portion of long-term debt.

The Company's long-term debt with its banks is collateralized by a floating guarantee on essentially all of the Company's assets (See Note 7).

Required principal payments (including current maturities) on long-term debt as of December 31, 2008 were as follows:

| <u>Year</u> | <u>Amount</u> |
|-------------|---------------|
| 2009 | \$ 352,204 |
| 2010 | 285,459 |
| 2011 | 165,343 |
| 2012 | 73,556 |

| | |
|-----------------------|-------------------|
| 2013 | 30,686 |
| | <u>907,248</u> |
| Less: current portion | (352,204) |
| | <u>\$ 555,044</u> |

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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NOTE 10 **LIABILITY AND FUNDS FOR EMPLOYEE RIGHTS UPON RETIREMENT**

Under the Israeli Severance Pay Law, the Company is required to make severance payments to terminated employees who have been employed at least one year. The calculation is based on the employee's latest salary and the period employed whereby the employee is entitled to one month of severance pay for each year employed based on the last month's salary. For certain employees, including officers, the obligation for severance pay is discharged by payment of premiums to insurance companies under approved plans.

Certain classes of the Company's employees are included in a comprehensive defined contribution pension plan for industrial workers. The Company is contributing to a pension fund in order to secure a pension for such employees. The Company contributes 6% of the employee's salary each month to the pension fund, covering 72% of its obligation. Contributions charged to operations were \$166,754 and \$192,217 in 2008 and 2007, respectively.

For employees other than those referred to above, and for the remaining 28% not subject to the pension plan, the Company's obligation under the Israeli Severance Pay Law is covered by regular payments to severance payment funds. The funds presented in the consolidated balance sheets include Company contributions, profits and losses and interest in the fund accumulated to the consolidated balance sheet date. These funds amounted to \$646,905 and \$751,609 at December 31, 2008 and 2007, respectively. The amounts deposited may be withdrawn only after fulfillment of the obligations under the Severance Pay Law as discussed above. The liability for these employee rights upon retirement amounted to \$821,909 and \$734,652 at December 31, 2008 and 2007, respectively.

NOTE 11 **INCOME TAXES**

The parent company and its United States subsidiary company file consolidated tax returns. Each Israeli subsidiary files separate tax returns. For 2008, the Company's Israeli subsidiaries were taxed in Israel at a corporate tax rate of 27% and are subject to the Israel Income Tax Law (Inflation Adjustment) of 1985. Under this law, results of operations for income tax purposes are measured in real terms in accordance with the changes in the Israeli Consumer Price Index. The inflation adjustment is expressed as financing costs or income and is applied as an adjustment to book income for purposes of computing income taxes.

In February 2008, the Israeli Parliament passed an amendment to the Income Tax (Inflationary Adjustment) Law, 1985, which limits the scope of the law starting in 2008 and thereafter. Beginning in 2008, the results for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Consumer Price Index carried out in the period up to December 31, 2007. The amended law includes, inter alia, the elimination of the inflationary additions and deductions and the additional deduction for depreciation starting in 2008.

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On July 25, 2005, the Israeli Parliament, approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2005 - 34%, in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109, (FIN 48), which clarifies the accounting for uncertain income tax positions. This interpretation prescribes a financial statement recognition threshold and measurement attribute for any tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Effective January 1, 2007, the Company adopted FIN 48. Upon adoption, the Company determined that there were no unrecognized income tax benefits or liabilities. The Company recognizes accrued interest and penalties related to uncertain tax positions in income tax expense.

Unrecognized tax benefits are the difference between a tax positions that is taken, or expected to be taken in a tax return, and the benefit recognized for accounting purposes pursuant to FIN 48.

A reconciliation of the beginning and ending amount of recognized provision is as follow:

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

| | <u>2008</u> | |
|--|---------------|---------------|
| Balance at January 1, 2007 | \$ | |
| Additions for tax positions of prior years | 334,608 | |
| Settlements with tax authorities | (273,294) | |
| Exchange rate differences | 4,209 | |
| | <u>65,523</u> | |
| Balance at January 1, 2008 | 65,523 | |
| Additions for tax positions | 23,970 | |
| Exchange rate differences | (592) | |
| | <u>88,901</u> | |
| Balance at December 31, 2008 | \$ | <u>88,901</u> |

As of December 31, 2008, income tax returns filed by the Company's Israeli subsidiaries with the Israeli tax authorities prior to 2003, were no longer subject to examination by the Israeli tax authorities. As of December 31, 2008, the Company's US entities tax returns for the years ended December 31, 2001 through 2008 are subject to examination.

During 2006, the Israeli tax authorities commenced an examination of certain of the Company's Israeli subsidiaries' income tax returns for the years 2003 through 2005. During 2007, the Israeli tax authorities proposed certain adjustments to the subsidiaries' tax positions related to the allocation of costs within the group and management fees made by the Company. During the year ended December 31, 2007, Mayotex and Export Erez reached a settlement with the Israeli tax authorities regarding their tax positions from 2003 through 2005 for an aggregate of \$273,294 (including accumulated interest) related to the allocation of costs and management fees within the group. As a result of these tax settlements and based upon the enforcement of Israeli statutory tax regulations, the Company recognized a tax expense of \$23,970 and \$61,314 in 2008 and 2007, respectively, and a current tax liability of \$88,901 and \$61,314 at December 31, 2008 and 2007, respectively (including anticipated interest), since it is more likely than not that the settlement achieved will be sustained by the Israeli Tax Authorities with respect to the Company's other subsidiaries in Israel and for all the Israeli subsidiaries for 2006 through 2008.

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Certain Israeli subsidiaries have been elected to file their tax returns of the claiming tax benefits under the Law for the Encouragement of Capital Investments, 1959, as amended on April 1, 2005 (the Law) for Beneficiary Enterprise status, under the Law. Pursuant to the provision of the Law income derived from the Beneficiary Enterprise is tax exempt for 10 years from 2007 the year elected by the subsidiaries to of commence the program (the election year).

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the Law, regulations published there under. In the event of failure to comply with these conditions, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2008, management believes that the Company is meeting all of the aforementioned conditions.

The tax-exempt income attributable to the Beneficiary Enterprise can not be distributed to shareholders without imposing tax liability on the Company other than in complete liquidation. As of December 31, 2008, there is approximately \$1,259,825 tax-exempt income earned by the Company s Beneficiary Enterprise .

If the retained tax-exempt income is distributed to shareholders, it would be taxed at the corporate tax rate applicable to such profits as if the Company had not elected to utilized benefits under the Law, currently - 27%.

Income from sources other than the Beneficiary Enterprise during the benefit period will be subject to tax at the effective standard corporate tax rate in Israel.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

Income tax expense (benefit) for the years ended December 31, 2008 and 2007 was as follows:

| | 2008 | 2007 |
|----------------------------|------------|--------------|
| Current year - Israel | \$ 154,282 | \$ 1,330,379 |
| Current year – U.S. | | |
| Deferred – U.S. and Israel | (27,278) | (66,098) |
| | \$ 127,004 | \$ 1,264,281 |

The actual tax expense differs from the expected tax expense for the years ended December 31, 2008 and 2007 (computed by applying United States statutory rate (34%) and the Israeli tax rate (27%) to income before taxes) as follows:

| | 2008 | 2007 |
|--|------------|------------|
| Computed “expected” tax expense | \$ 227,260 | \$ 852,154 |
| Non-tax deductible expenses | 9,370 | 11,549 |
| Changes in income tax estimate from prior year (*) | (288,177) | 128,921 |
| State income tax | 800 | 800 |
| Inflationary adjustment | (5,035) | (36,840) |
| FIN 48 reserve | 23,970 | 61,314 |
| Israeli audit settlement | | 273,294 |
| Revenues tax exempt or taxable at different rate | (54,611) | (93,908) |

| | 2008 | 2007 |
|---|-------------------|-------------------|
| Valuation allowance due to operating loss carry forwards in respect to US operation | 21,268 | 77,452 |
| Effect of change in tax rates on deferred taxes | 158,219 | |
| Other | 33,940 | (10,455) |
| | <u> </u> | <u> </u> |
| | \$ 127,004 | \$ 1,264,281 |
| | <u> </u> | <u> </u> |

(*) In 2008 consists of tax benefit for a Beneficiary Enterprise in the previous year.

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The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31, 2008 and 2007 were as follows:

| | 2008 | 2007 |
|---|-------------------|-------------------|
| | <u> </u> | <u> </u> |
| Deferred taxes asset – current: | | |
| Allowance for doubtful accounts | \$ 67,951 | \$ 74,872 |
| Trading securities | 18,978 | 17,763 |
| Reserve for vacation pay | 81,302 | 73,267 |
| | <u> </u> | <u> </u> |
| Total deferred tax assets - current | \$ 168,231 | \$ 165,902 |
| | <u> </u> | <u> </u> |
| Deferred taxes asset, net - non current: | | |
| Depreciable fixed assets | \$ 19,122 | \$ 19,013 |
| Net operating loss carry forward | 285,380 | 264,112 |
| Liability for employee rights upon retirement | 43,751 | 17,352 |
| | <u> </u> | <u> </u> |
| | 348,253 | 300,477 |
| Less – valuation allowance due to losses carry forward in respect of U.S. operation | (285,380) | (264,112) |
| | <u> </u> | <u> </u> |
| Total deferred tax assets - non-current | \$ 62,873 | \$ 36,365 |
| | <u> </u> | <u> </u> |

At December 31, 2008, the US parent company and its US subsidiary had net operating loss carryforwards of approximately \$722,000 for income tax purposes, available to offset future taxable income expiring in 2023. The consolidated financial statements include a valuation allowance for such loss carry forwards, in the amount of \$285,380 and \$264,112 for the years ended December 31, 2008 and 2007, respectively. The net change in the total valuation allowance for the years ended December 31, 2008 and 2007 was an increase of \$21,268 and \$77,452, respectively. Significant management judgment is required in determining the valuation allowance recorded against net deferred tax assets. The Company assesses the likelihood that its deferred tax assets will be recovered from future taxable income and to the extent recovery is believed unlikely, establishes a valuation. For the Company and its US subsidiary deferred taxes are

computed at a rate of 34% for federal taxes, plus 6% for state taxes. For the Israeli subsidiaries, deferred taxes are computed at rates of 25% - 26% which are the expected rates to be in effect when the deferred tax assets and liabilities are realized.

NOTE 12 **COMMITMENTS AND CONTINGENCIES**

(A) Operating Lease Agreements

The Company's executive offices are located at 8 Brisel Street, Industrial Zone Sderot, Israel. The Company's manufacturing, production and distribution facilities are located in six locations in Israel and in the US, under non-cancelable operating leases with expiration dates through April 2012. Four of the operating leases are with affiliated parties. The monthly rental range is approximately \$605 to \$17,754.

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Future minimum lease payments under the terms of the operating leases were as follows at December 31, 2008:

| <u>Year</u> | <u>Related Party</u> | <u>Unrelated Party</u> | <u>Total</u> |
|-------------|----------------------|------------------------|----------------|
| 2009 | \$ 298,067 | 53,874 | 351,941 |
| 2010 | | 29,006 | 29,006 |
| 2011 | | 29,006 | 29,006 |
| 2012 | | 9,669 | 9,669 |
| | <u>\$ 298,067</u> | <u>121,555</u> | <u>419,622</u> |

Total rent expense under the operating leases for the years ended December 31, 2008 and 2007 was \$569,970 and \$446,385, respectively.

(B) Contingencies

The Company has an employment agreement with its President, pursuant to which the President is entitled to additional compensation of 1.5% of the growth in the Company's total sales since 2002. The President, at his option, may receive shares of common stock in lieu of cash. For the year ended December 31, 2007, the President was entitled to bonus compensation of \$129,921. The cash bonus compensation of \$129,921 was accrued and included in other current liabilities in 2007, and paid during 2008. For the year ended December 31, 2008, there was no bonus entitlement due from Company.

(C) Israeli Gaza Strip Operations:

During 2004, the Israeli Government decided to evacuate the Erez Industrial Zone in the Gaza Strip where part of the Company's operations were located. The Company had owned facilities, leased other facilities and maintained equipment and inventory within this area. In 2005, the Company moved its light cut and sew operation from the Erez Industrial Zone to Sderot as well as some of its webbing equipment to Nazareth. In August 2005, the Company evacuated its remaining operations and abandoned the buildings owned and leased in the Erez Industrial Zone. In 2005, the Company recorded a receivable from the Israeli government of \$217,477 related to the direct cost to move and loss on abandoned properties.

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The Israeli Government's decision to evacuate the Gaza Strip was supported by certain resolutions, as well as the Evacuation Compensation Law that was adopted by the Israeli Parliament, to compensate the Israeli Gaza Strip settlers as well as business and property owners in the Gaza Strip and in the Erez Industrial Zone. In February 2006, three subsidiaries, Export Erez, Mayotex and Achidatex filed claims for compensation pursuant to the Evacuation Compensation Law.

In 2006, the Company was notified that it would receive advance payments aggregating \$523,000. The Company applied this payment against the receivable established in 2005 and recorded the excess payment of \$240,658, net of 5% taxes withheld, as extraordinary gain.

On February 18, 2008 Export Erez, Mayotex and Achidatex signed definitive agreements with SELA Agency, a government agency, established pursuant to the Evacuation Compensation Law, for compensation of approximately \$6 million, net of advanced payments of approximately \$523,000, received by the Company during 2007. The net compensation payments of \$4,827,280 were recognized as extraordinary gain, net of 5% related taxes during 2008.

(D) Guarantees and liens:

- (1) As of December 31, 2008, guarantees in the amount of approximately \$460,273 were issued by banks on behalf of the Company's Israeli subsidiaries, mainly for performance in different projects, and to guarantee Mayosar Technologies Ltd. liability under the agreement with Isorad Ltd. (see note 16).
- (2) To secure liabilities to its principal banks, the Company's Israeli subsidiaries have registered unlimited, floating, and first priority liens on all their assets, with no limitations as to the amounts, and also committed not to conduct certain actions, without informing the banks such as selling assets under the unlimited liens.

NOTE 13 SHAREHOLDERS EQUITY

Effective February 28, 2005, the Company acquired all of the outstanding shares of Rizzo Inc. (doing business as Owen Mills Company). Under the terms of the agreement, the Company purchased all of the outstanding shares of Owen Mills Company in consideration for a \$200,000 note payable and shares of the Company's common stock having a value of \$200,000, based on the average closing price per share of the Company's common stock for the ten trading days preceding the issuance of such shares. The Company agreed to pay the \$400,000 of aggregate consideration as follows: (i) \$3,333.33 each month commencing on March 31, 2005 and thereafter on the last business day of each successive month until the Company has paid the former shareholder of Owen Mills Company a total of \$200,000; the present value of the remain cash payments as of December 31, 2008 is \$50,698 (ii) \$40,000 in the form of shares of common stock of the Company payable within fifteen (15) business days from the date of the agreement (On April 27, 2005 the Company issued 36,463 shares of common stock having a fair value of \$40,000 to the former shareholder of Owen Mills Company); and (iii) four annual payments of \$40,000 in the form of the Company's common stock payable to the former shareholder of Owen Mills Company through February 2009. On April 3, 2006, the Company issued 123,077 shares of common stock having a fair value of \$40,000. On May 1, 2007, the Company issued 74,074 shares of common stock having a fair value of \$40,000. On March 18, 2008, the Company issued 123,839 shares of common stock having a fair value of \$40,000. As of December 31, 2008, \$40,000 is reflected on the Consolidated Balance Sheet as a liability for common stock to be issued.

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**DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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Securities Purchase Agreement:

In 2005, the Company executed a Securities Purchase Agreement (the Agreement) with a group of investors for a private placement of its common stock. The Company agreed to issue 1,833,334 shares of its common stock to the investors at a price of \$0.60 per share and received net proceeds of \$761,441, net of issuance costs. The Company also agreed to issue the investors 365,000 warrants to purchase its common stock at an exercise price of \$0.94 per share, exercisable until June 30, 2007, and 182,500 warrants at an exercise price of \$2.40 per share, exercisable until June 30, 2010. In addition, the Company agreed to issue 82,133 shares of its common stock, as well as 60,000 warrants at an exercise price of \$0.94 per share (exercisable until June 30, 2007) and 20,000 warrants at an exercise price of \$2.40

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per share (exercisable until June 30, 2010) as a finder's fee for services provided in connection with the transaction. In accordance with the provisions of the agreement, on June 16, 2006 the Company issued to the investors and to the finder an additional 1,368,191 shares of its common stock, since its share price decreased below \$0.60 per share.

The Company accounted for the warrants issued based on guidance from SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities and Emerging Issues Task Force (EITF) No. 00-19, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's Own Stock. Accordingly, the warrants were treated as derivatives and classified as a liability with a fair value of \$171,597 at the transaction date of the warrants. The warrants fair value, computed based on the Black-Scholes pricing model, was revalued each reporting period with the change in fair value recorded as other income (expenses).

The Company adopted as of January 1, 2007, FSP EITF 00-19-2, Accounting for Registration Payment Arrangements (FSP), which addresses an issuer's accounting for registration payment arrangements. This FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. This FSP further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles (GAAP) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

As a result of the Company's adoption of the FSP, the Consolidated Financial Statements include a cumulative-effect adjustment to the opening balance of shareholders' equity in the amount of \$123,654, as of January 1, 2007.

As of December 31, 2008, warrants to purchase 202,500 shares of common stock were outstanding. These warrants have a remaining life of 1.5 years and an exercise price of \$2.40.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

Stock Purchase Program:

On October 30, 2008, the Company's board of directors authorized a stock purchase program, which authorizes the Company to repurchase up to \$450,000 of shares of its common stock over a period of six months. As of December 31, 2008, the Company has not repurchased any shares of common stock according to this stock purchase program.

NOTE 14 **RELATED PARTIES**

(A) Transactions with Related Parties

The Company is a party to lease agreements with its controlling shareholder. The Company's subsidiaries, Achidatex and Export Erez, have signed lease agreements with a company owned by former minority shareholders of Achidatex.

(B) Income and (Expenses) Transactions with Related Parties

| | 2008 | 2007 |
|---|------------|------------|
| Lease and rent expenses, see Note 12 (A) | \$ 386,740 | \$ 271,084 |
| Purchase of materials and maintenance costs * | 275,460 | 208,983 |

(C) Balances with Related Parties

| | 2008 | 2007 |
|--|------|------|
|--|------|------|

| | 2008 | 2007 |
|--|-------------|----------|
| Accounts receivable * | \$ | \$ 1,113 |
| Accounts payable controlling shareholder | (66,743) | (21,839) |
| Accounts payable ** | (1,514,354) | (28,609) |

* The controlling shareholder and chairman of the Board of the Company is a principal shareholder of this affiliate.

** The payable amount includes \$1,200,000 to be paid to the former minority shareholders of Achidatex (see Note 1) and amounts due for the purchase of materials and maintenance costs, during the ordinary course of business from an affiliate company, owned by the former minority shareholders.

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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NOTE 15 **SEGMENT INFORMATION AND CONCENTRATIONS**

During 2008 and 2007, the Company operated and managed two strategic business units: production for the civilian market and the military market. These operational segments are further broken down between Israel (local) and other (export) sales in order to better analyze trends in sales and profit margins. The Company does not allocate assets between segments because assets are used in more than one segment and any allocation would be impractical.

(A) Sales and Income from Operations:

| | <u>Civilian</u> | | <u>Military</u> | | <u>Consolidated</u> |
|-------------------------------|-----------------|---------------|-----------------|---------------|---------------------|
| | <u>Local</u> | <u>Export</u> | <u>Local</u> | <u>Export</u> | |
| December 31, 2008 | | | | | |
| Revenue from sales | \$ 3,741,228 | \$ 1,004,042 | \$ 6,226,225 | \$ 7,199,013 | \$ 18,170,508 |
| Gross Profits | 1,022,154 | 55,630 | 1,393,866 | 1,604,983 | 4,076,633 |
| Corporate unallocated costs | | | | | 3,361,761 |
| Income from operations | | | | | 714,872 |
| December 31, 2007 | | | | | |
| Revenue from sales | \$ 2,453,886 | \$ 1,894,276 | \$ 9,706,945 | \$ 5,207,821 | \$ 19,262,928 |
| Gross Profits | 1,283,611 | 283,016 | 3,091,285 | 1,547,240 | 6,205,152 |
| Corporate unallocated costs | | | | | 3,167,019 |
| Income (loss) from operations | 669,725 | (36,069) | 1,566,065 | 838,412 | 3,038,133 |

(B) Geographic Areas - revenues

| | <u>Year ended December 31,</u> | |
|-----------------|--------------------------------|---------------|
| | <u>2008</u> | <u>2007</u> |
| Israel | \$ 9,967,453 | \$ 12,285,178 |
| South America | 2,242,477 | 1,511,891 |
| North America | 1,655,495 | 2,506,695 |
| Europe and Asia | 1,533,500 | 2,366,150 |
| Australia | | 349,720 |

| | Year ended December 31, | |
|--------|-----------------------------|-----------------------------|
| | 2,771,583 | 243,294 |
| Africa | <u> </u> | <u> </u> |
| Total | <u>\$ 18,170,508</u> | <u>\$ 19,262,928</u> |

(C) Single Customer Exceeding 10% of Sales:

| | <u>2008</u> | <u>2007</u> |
|--|--------------|--------------|
| Sales | | |
| Israeli Ministry of Defense and Government of Israel | \$ 5,585,355 | \$ 9,367,382 |
| Accounts receivable balance | | |
| Israeli Ministry of Defense and Government of Israel | \$ 1,907,498 | \$ 2,021,433 |

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DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES
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NOTE 16 **SUBSEQUENT EVENTS****(A) Purchase of a business**

On December 17, 2008, Mayotex entered into investment agreement with Sarino Crystal Technologies Ltd. and Sarino Optronics Ltd. (Sarino) to cooperate in the manufacture of optical grade Germanium crystals and sales of optical and infra-red night vision products utilizing the germanium crystals (the Sarino Agreement).

Pursuant to the Sarino Agreement:

- (1) Mayotex and Sarino agreed to incorporate Mayosar Technologies Ltd. (Mayosar), to be held 50.1% by Mayotex and 49.9% by Sarino .
- (2) In consideration to the above, Mayotex will pay Sarino up to \$1 million, out of which, \$300,000 is non refundable to Mayotex and \$700,000 will be refundable to Mayotex, unless Mayosar achieve \$10 million in sales during the 36 consecutive months following the commencement of operations. As of December 31, 2008 the Company paid \$1 million reflected in the financial statements as a deposit for purchase of a business.
- (3) Mayotex agreed to provide Mayosar with a loan of up to \$2 million, as required by the board of directors of Mayosar. Such loan bears interest at the rate of Libor + 2%, payable from profits that will be generated by Mayosar.

On January 1, 2009, Mayosar purchased through its wholly owned subsidiary Isorad IR Optics Ltd., (Optronics) the Germanium Crystals Business of Isorad Ltd. (Isorad), consisting of certain know-how, equipment, inventories and production activities of Germanium Crystals for lenses used in infra-red night vision system applications (Isorad Agreement). Pursuant to the Isorad Agreement, Optronics committed to pay royalties of 3% out of sales for a period of 15 years commencing January 1, 2009, with a minimum amount of approximately \$131,000 payable per a year during the first 18 months following the effective date of the Isorad Agreement; or the date of completion the transfer of the site of the Germanium Crystals Business, which ever earlier and approximately \$50,000 per year during the following years of the royalties payment period.

Pursuant to the Isorad Agreement, Isorad was granted the right to acquire during the 24 months beginning January 1, 2009, 5% of the share capital of Optronics on a fully diluted basis for their nominal value. If the Israeli Government does not approve the 5% purchase of

the Optronics shares by Isorad prior to December 31, 2009, the right to acquire the shares will expire and Isorad will be entitled to a payment of \$75,000.

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It was agreed by the parties to Sarino Agreement that:

(1) In the event Isorad acquires the 5% interest in Optronics, Mayosar will issue to Mayotex additional shares of Mayosar on a prorata basis in order for Mayotex to retain a 50.01% indirect interest in Optronics share capital.

(2) Mayosar will have the right during four years following the date of the purchase agreement, to redeem and purchase from Isorad its 5% holdings and to cancel its commitment to make royalty payments for a fixed payment of \$750,000, less all royalties paid to Isorad by Mayosar through that date.

The activity of Mayosar, including the acquired Germanium Crystals Business will be consolidated with the Company's financial statements as of January 1, 2009, the date of acquisition. The acquisition will be accounted for using the purchase method of accounting as determined in Statement of Financial Accounting Standard (SFAS) No. 141R, Business Combinations, and accordingly, the purchase price will be allocated to the assets acquired and the liabilities assumed based on the estimated fair value on the date of acquisition.

(B) Litigation

On February 11, 2009, a lawsuit was filed in the Jerusalem District Court against our Achidatex subsidiary, its chief executive officer, Mr. Avraham Hazor, and our subsidiary Export Erez USA Inc. The suit alleges that Achidatex materially breached its agreement with the plaintiff, dated February 22, 2000, relating to the development of inflatable mine-field crossing enabling sandals, because Achidatex allegedly failed to register patents for the technology worldwide and only registered patents in the United States. The plaintiff further claims that the defendants, jointly and severally, committed a breach of trust. The plaintiff is seeking damages in the amount of NIS 10 million (approximately \$2.6 million). Contemporaneously with the filing of the claim, the plaintiff also filed a motion seeking an exemption from payment of the requisite court filing fee, and stated that he would withdraw the lawsuit if the motion is not granted. On March 12, 2009, Achidatex filed a request to respond to the motion and requested a 30 day extension to file its statement of defense. The Company believes that it is likely that the plaintiff's motion for an exemption from payment of the court filing fee will be granted and that the lawsuit will therefore proceed. The Company believes that the plaintiff's claim is unfounded and intends to vigorously defend against the claim. Due to the preliminary stage of the claim, management and its legal advisors cannot currently assess the outcome or possible adverse effect on its financial position or results of operations, however, management believes the Company has substantial legal arguments to oppose the allegations.

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