

DEFENSE INDUSTRIES INTERNATIONAL INC  
Form 10-K  
March 31, 2010

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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, 2009

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.)

12 Hamefalsim Street, Petach Tikva  
Israel  
(Address of principal executive offices)

49514  
(Zip Code)

Registrant's telephone number (011) 972-3-7168383

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

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

| Title of each class                        | Name of each exchange on which registered |
|--|---|
| 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

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.

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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: \$2,158,883

The number of the registrant’s common shares (par value \$0.0001 per share) outstanding as of March 31, 2010 was 28,150,535 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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## 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. On July 8, 2002, we changed our corporate domicile from the State of Utah to the State of Nevada, through a merger with our then wholly owned subsidiary, Defense Industries International, Inc., or Defense Industries, a Nevada corporation organized on July 1, 2002. As part of the reincorporation, we changed our 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.

#### Organization

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

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 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. Mayotex is held by us through Export Erez. In December 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 2008, Mayotex entered into an investment agreement, or the Sarino Agreement, with Sarino Crystal Technologies Ltd. and Sarino Optronics Ltd., together Sarino, to form an entity which will cooperate in the manufacture of optical grade germanium crystals and the sale of lenses to be used in 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. The Sarino Agreement has not yet been consummated. For further details please see below under Item 6, "Pending Acquisition".

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 the three minority shareholders, pursuant to which we purchased the remaining minority interest in Achidatex in consideration for \$948,000. As a result of this purchase we now own 100% of Achidatex. In addition, we purchased an aggregate of 1,050,000 shares of our common stock (3.62% of the then outstanding shares) at an allocated price per share of \$0.24 from the three former minority shareholders of Achidatex.



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 the products we manufacture in Israel.

### Strategy

We believe that current international tensions, the continuing war on terrorism and 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. We intend 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., or Optics, a company that will manufacture lenses made from germanium crystal, based on the know how and equipment it purchased from an Israeli governmental entity, for the use, by third parties in the production of infra-red night vision systems. For further details please see below under Item 6, "Pending Acquisition".
- 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 (both international and local): the 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.

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

| 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                         | International       |
| 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.

#### 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 was 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 Elite. 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 Disengagement Plan Law, 5765 – 2005 (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 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.

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 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 2009, 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.

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 2009, 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.

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 2010.

#### 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 our marketing consultant works almost exclusively for us, we do not have a formal written relationship with him. 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, South America, Africa and Asia. In 2009 and 2008, we sold approximately 38.8% and 45.1%, respectively, of our products to our international customers with 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.

**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.

**Local Military Market.** During 2009, the demand for our products increased significantly, mainly due to the effect of the war between Israel and the Hamas in Gaza, which took place in December 2008 and January 2009. In 2009, sales to the Israeli Ministry of Defense increased to \$7,121,326 from \$5,585,355 in 2008, accounting for 43.2% and 30.7% of our sales, respectively.

During the years 2008 and 2009 our military business grew as a result of increased demand for our dry storage systems products, bulletproof vests and other military gear. As of March 15, 2010, we had a backlog of firm orders from the Israeli Ministry of Defense of approximately \$2.3 million, including orders of approximately \$0.7 million that we received subsequent to December 31, 2009. We shipped approximately \$1.0 million in orders to the Israeli Ministry of Defense during the first quarter of 2010.

**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 2009 and in 2008, we had sales of \$1,946,546 and \$2,242,477 in South America, sales of \$258,047 and \$651,453 in North America, sales of \$1,203,367 and \$1,533,500 in Europe and Asia, \$1,848,346 and \$2,771,583 in Africa, respectively.

Since 2003, we have increased our export efforts and 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, 2009:

|                                    | Year Ended<br>December 31, |                    |
|------------------------------------|----------------------------|--------------------|
|                                    | 2009                       | 2008               |
| Sales to South America             | \$1,946,546                | \$2,242,477        |
| Sales to North America             | 258,047                    | 651,453            |
| Sales to Europe and Asia           | 1,203,367                  | 1,533,500          |
| Sales to Africa                    | 1,848,346                  | 2,771,583          |
| <b>Total Export Military Sales</b> | <b>\$5,256,306</b>         | <b>\$7,199,013</b> |

Local Civilian Market. Our product range to the civilian market is diversified. In 2009, due to the global economic crisis, our local market business decreased compared to 2008. We expect a modest increase in this market in 2010 and in the future.

#### Backlog

We had approximately \$5.3 million of unfilled customer orders at December 31, 2009, as compared to approximately \$6.7 million of unfilled customer orders at December 31, 2008. Of our \$5.3 million of unfilled customer orders at December 31, 2009, approximately \$1.2 million was attributable to orders from military customers in South America, approximately \$0.1 million was attributable to orders from military customers in Europe and Asia, approximately \$0.5 million was attributable to orders from military customers in Africa, approximately \$0.7 million was attributable to local civilian market, approximately \$0.1 million was attributable to the U.S. civilian market and approximately \$2.7 million was attributable to the Israeli Ministry of Defense.

#### Regulation

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, 2009 and 2008, we spent approximately \$19,302 and \$120,608, respectively, on research and development, which expenses have been charged to operations. Our research and development expenses during 2009 were lower than we initially anticipated since certain research and development projects to evaluate and test new products that were scheduled to be performed during 2009 were postponed to 2010. We have not as yet finalized our research and development budget for 2010.

#### 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, 2009, we had 183 full-time employees, all of whom are in Israel. 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, 2009 and 2008, the Israeli Ministry of Defense accounted for \$7,121,326 and \$5,585,355 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, 38.8% of our sales in the year ended December 31, 2009, and 45.1% of our sales in the year ended December 31, 2008 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:

- 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 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.

The death of our former Chairman and Chief Executive Officer could have a material adverse effect on our business.

Our success has been significantly dependent on the services of our former chairman and chief executive officer, Joseph Fostbinder. Mr. Fostbinder passed away in June 2009 and we appointed Mrs. Meira Fostbinder to succeed him as the chairman of our board of directors and Mr. Baruch Tosh, our then President, was appointed as Chief Executive Officer. Mr. Tosh was released from his duties on January 1, 2010 and Mr. Uri Nissani was appointed Chief Executive Officer, President and a member of the Board of Directors effective January 1, 2010. The death of Mr. Joseph Fostbinder could have a material adverse effect on our business.

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.

A significant portion of our revenues is derived from the sale of products to military markets. These revenues, on a consolidated basis, totaled \$12,724,098, or 77.1%, of our revenues for the year ended December 31, 2009 and \$13,425,238, or 73.9%, of our revenues for the year ended December 31, 2008. 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 43.2% of our revenues for the year ended December 31, 2009. In the fiscal year ended December 31, 2008, the Israeli Ministry of Defense accounted for 30.7% 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.

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 car 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. Furthermore, we may have to divert our management's attention and our financial and other resources from other areas of our business to potential new businesses. 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 may 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.

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, which could have an adverse effect on our financial results and the market price of our ordinary shares.

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 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 resources. Section 404 of the Sarbanes-Oxley Act requires us to provide management's annual review and evaluation of our internal control over financial reporting and in future years a statement by management that its independent registered public accounting firm has issued an attestation report on our internal control over financial reporting, in connection with the filing of our Annual Report on Form 10-K for each fiscal year. The rules governing the standards that must be met for management to assess our internal control over financial reporting are complex and require significant documentation, testing and possible remediation to meet the detailed standards under the rules. During the course of its testing, our management may identify material weaknesses or significant deficiencies, which may not be remedied prior to the deadline imposed by the Sarbanes-Oxley Act. If we fail to maintain the adequacy of our internal controls, we may not be able to ensure that we can conclude on an ongoing basis that we have effective 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,

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investor confidence in our reported financial information, and the market price of our ordinary shares.



### 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 stockholders to sell their securities in the secondary market.

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 stockholders to sell their securities in the secondary market.

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.

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#### Dividend policy

We have not declared or distributed dividends in the past and do not currently have a dividend distribution policy. The declaration of dividends is subject to the discretion of our Board of Directors and 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 security conditions in Israel directly influence us. 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 in degree and intensity, 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 unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2009. 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 January 2009, Israel attacked Hamas strongholds in the Gaza strip, in reaction to rockets that were fired from Gaza and which landed in Israel. In addition, Iran has threatened to attack Israel numerous times, and is widely believed to be developing nuclear weapons. Ongoing violence between Israel and the Palestinians as well as tension between Israel and other countries in the Middle East may have a material adverse effect on our business, financial condition and results of operations.

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 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.

Item 1B.

Unresolved Staff Comments.

None.



Item 2.

Properties.

Our executive offices are located at 12 Hamefalsim Street, Petach Tikva, Israel. 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, 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 1,080,003 NIS (\$274,628) in 2009. The lease will expire in December 31, 2011.

Achidatex leases approximately 300 square meters of office space for its executive offices in Petach-Tikva at an annual rental expense of 116,365 NIS (\$29,590) in 2009. The lease will expire in April 30, 2012.

Mayotex leases 1,000 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 213,000 NIS (\$54,163) in 2009. The lease for 500 square meters will expire on June 30, 2010. The lease for an additional 500 square meters will expire on December 31, 2010.

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 285,904 NIS (\$72,701) in 2009. The lease will expire on December 31, 2010.

Mayotex leases approximately 1,734 square meters of industrial space in the Alon Tavor Industrial Zone near Afula, at an annual rental expense of 342,814 NIS (\$87,172) in 2009. The lease will expire on June 30, 2012.

Owen Mills leases approximately 9,000 square feet of space in Van Nuys, California for its operations, at an annual rental expense of \$54,378 in 2009. The lease will expire on April 1, 2010.

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.

On February 11, 2009, a lawsuit was filed at the Jerusalem District Court (the "Court") against our subsidiary, Achidatex, its chief executive officer, Mr. Avraham Haztor, and our subsidiary Export Erez USA Inc. The plaintiff has recently filed a petition to add Export Erez to the claim. Export Erez has not yet responded to the above petition. 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, by failing to register patents for the technology, underlying the sandals, 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). Achidatex filed a statement of defense rejecting the plaintiff's claims and a claim against the plaintiff and others for a declaratory judgment that the plaintiff has breached his contractual undertakings towards Achidatex.

Achidatex's petition to consolidate its claim with the plaintiff's claim was ordered by the Court and the claims are now being heard together. Achidatex also filed a petition to remove the claim against Mr. Haztor and Export Erez USA Inc. based on the assertion that there is no contractual or any other kind of privity between the plaintiff and Mr. Haztor

and Export Erez USA Inc. and, therefore, no cause of action against them exists. This petition is pending.

We intend to vigorously defend against the claim. Due to the preliminary stage of the above claims, we and our legal advisors cannot currently assess the outcome or possible adverse effect on our financial position or results of operations.

## PART II

Item 4. (Removed and Reserved).

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.

|                                     | Price Range |         |
|-------------------------------------|-------------|---------|
|                                     | High        | Low     |
| Fiscal Year Ended December 31, 2009 |             |         |
| First Quarter                       | \$ 0.28     | \$ 0.15 |
| Second Quarter                      | 0.33        | 0.19    |
| Third Quarter                       | 0.28        | 0.19    |
| Fourth Quarter                      | 0.25        | 0.14    |
| Fiscal Year Ended December 31, 2008 |             |         |
| First Quarter                       | \$ 0.41     | \$ 0.26 |
| Second Quarter                      | 0.45        | 0.26    |
| Third Quarter                       | 0.33        | 0.21    |
| Fourth Quarter                      | 0.28        | 0.14    |

The closing price for our common stock on March 30, 2010, as reported on the OTCBB, was \$0.19.

## Holders of Record

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 15, 2010, there were 28,150,535 shares of our common stock outstanding and we had 32 shareholders of record.

## 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.

### 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, March 18, 2008 and June 8, 2009, 36,463 shares, 123,077 shares, 74,074 shares, 123,839 shares and 209,424 shares of our common stock, respectively, each issuance having a fair market value of \$40,000. We have no further obligation to issue any shares of common stock.

On June 15, 2005, we executed a securities purchase agreement, with Gov Financial Holdings, Avshalom Hershcovich, 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.

### 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 Davidovitz, 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 \$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 continuing war on terrorism and conflicts in Iraq and Afghanistan 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.

#### Material Trends

**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 2009 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 2010. 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, 2009 the U.S. dollar depreciated against the NIS by approximately 0.71%, 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.



Pending acquisition

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

On December 21, 2008, Mayosar Ltd., or Mayosar, which was incorporated by Mayotex and Sarino, through its wholly owned subsidiary Isorad IR Optics Ltd., or Optics, entered into an agreement, or the Isorad Agreement, to purchase the Germanium Crystals Business of Isorad Ltd., an Israeli governmental company, or Isorad. The Isorad Agreement provided for the purchase of certain know-how, equipment, inventories and production activities of Germanium Crystals for lenses used in infra-red night vision system applications. As of December 31, 2009, Isorad has not met certain conditions precedent set out in the Isorad Agreement and therefore, based on legal advice received, we are of the opinion that the Isoard Agreement has not been consummated.

Pursuant to the Sarino Agreement and subject to the approval of the Isorad Agreement:

- Mayotex and Sarino agreed to incorporate Mayosar, with Mayotex being the majority shareholder owning 50.1% and Sarino owning 49.9%. As majority shareholder, Mayotex will have operational control of Mayosar.
- In consideration of the above, Mayotex will pay Sarino \$1 million, out of which, \$300,000 will be non-refundable to Mayotex upon 24 months following the execution of the Isorad Agreement, and the remaining \$700,000 will be earned by Sarino based on 10% of sales over \$3 million and up to \$10 million during the first 36 months of operations. Amounts not earned are to be refunded to Mayotex, including interest of Libor + 2% per annum. The refundable consideration is secured by Sarino's interest in Mayosar and personal guarantees provided by Sarino Crystal Technologies Ltd.'s controlling shareholders.
- Mayotex agreed to provide Mayosar with a loan in the aggregate amount of \$2 million under a timetable to be determined by Mayosar's board of directors. Such loan will bear interest at the rate of Libor + 2%, and is payable from profits generated by Mayosar.

As of December 31, 2009, Mayotex provided loans of \$1 million to Sarino and \$0.9 million to Mayosar. Such payments are recognized as refundable deposits pending resolution of the Isorad Agreement.

Pursuant to the Isorad Agreement, Optics is to pay annual royalties of 3% out of sales for a period of 15 years commencing the effective date of the Isorad Agreement, or the Effective Date, with a minimum amount of approximately \$133,000 payable per year during the first 18 months or until the date of completion of the transfer of the site of the Germanium Crystals Business, whichever is earlier (this payment includes a reimbursement of costs for the usage of the site and equipment in this initial period), and approximately \$53,000 per year during the following years of the royalties payment period.

Pursuant to the Isorad Agreement, Isorad was granted the right to acquire 5% of the share capital of Optics on a fully diluted basis for their nominal value during the 24 month period beginning on the Effective Date. If the Israeli Government does not approve the 5% purchase of the Optics shares by Isorad within twelve (12) months of the Effective Date, the right to acquire the shares will expire and Isorad will be entitled to a payment of \$75,000.

In the event of an allotment of shares to Isorad, representing 5% of Optics' share capital, Mayosar will issue to Mayotex additional shares of Mayosar on a pro rata basis, in order for Mayotex to retain a 50.01% indirect interest in Optics' share capital.

Optics has the right during the four year period following the Effective Date to redeem its commitment to pay royalties under the Isorad Agreement in consideration of a fixed payment of \$750,000, less all royalties paid to Isorad through that date.

Our management is currently assessing our Company's legal position. Our management is of the opinion, based on legal advice received, that the amounts paid under the Sarino and Isorad agreements should be fully refunded to us in the event that the Isorad Agreement is not consummated.

### 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 2009 and 2008, 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 under the completed contract method upon shipment to customers. We provide a warranty on goods ranging from three to four years on certain products. 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, 2009 and December 31, 2008. 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 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.** At December 31, 2009 and 2008, we held cash and cash equivalents, in the aggregate amount of \$3,783,631 and \$1,719,921, 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.

A significant portion 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.

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, 2009 and 2008 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, 2009 and 2008.

**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 stated 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, 2009 and 2008, inventories allowances were \$539,794 and \$371,800, respectively.

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 effect on our financial position or results of operations.

**Property Plant and Equipment.** Fixed assets are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets of three to sixteen 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 Financial Accounting Standard Board (“FASB”) Accounting Standards Codification (“ASC”) No. 815 “Accounting for Registration Payment Arrangements,” (formerly FSP EITF 00-19-2), or ASC 815, which addresses an issuer’s accounting for registration payment arrangements. The ASC 815 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 ASC 450 (formerly Statement of Financial Accounting Standards (“SFAS”) No. 5), Accounting for Contingencies. The ASC 815 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 ASC 815, 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.

## 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. 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, 2009 Compared with Year Ended December 31, 2008

Net Revenues and Gross Profit Margin. Net revenues for the year ended December 31, 2009 decreased to \$16,503,104 from \$18,170,508 in the year ended December 31, 2008, a decrease of 9.2%. The decrease is primarily attributable to a decrease of approximately \$1.9 million in our sales to the export military market segment, a decrease of approximately \$1.1 million in our sales to the local civilian market segment and the appreciation of the average exchange rate of the U.S. dollar, which was offset in part by an increase of approximately \$1.2 million in the local military market segment. The increase in revenues in our local military market segment is attributable to a general increase in orders from the Israeli Ministry of Defense.

The following table sets forth the breakdown of sales by segment for the years ended December 31, 2009 and December 31, 2008.

|                                    | Year Ended December 31, |              |
|------------------------------------|-------------------------|--------------|
|                                    | 2009                    | 2008         |
| Sales to the local civilian market | \$2,625,347             | \$3,741,228  |
| Sales to export civilian market    | 1,153,659               | 1,004,042    |
| Sales to the local military market | 7,467,792               | 6,226,225    |
| Sales to export military market    | 5,256,306               | 7,199,013    |
| Total                              | \$16,503,104            | \$18,170,508 |

In the year ended December 31, 2009, Export Erez accounted for \$10,752,729, or 65.2% of our revenues, Achidatex accounted for \$4,596,716, or 27.8% of our revenues, and Owen Mills accounted for \$1,153,659, or 7.0% of our revenues. 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.

Gross Profit. Gross profit for the year ended December 31, 2009 was \$3,388,488 compared to \$4,076,633 for the year ended December 31, 2008. This decrease in gross profit in 2009 is primarily attributable to the decrease in revenues, higher overhead expenses, higher labor costs due to currency fluctuations and a large sale bearing a lower margin. In the year ended December 31, 2009, Export Erez, Achidatex and Owen Mills accounted for 47%, 47.8%, and 5.2%, of our gross profit, respectively. In the year ended December 31, 2008, Export Erez, Achidatex and Owen Mills accounted for 61.2%, 37.4% and 1.4%, of our gross profit, respectively.

Our gross profit margin for the year ended December 31, 2009 was 20.5% compared to 22.4% for the year ended December 31, 2008. The decline is primarily attributable to the decrease in revenues, higher overhead expenses, higher labor costs due to currency fluctuations, and the large lower margin sale. Export Erez's gross margin for the year ended December 31, 2009 was 13.6% compared to 17.5% for the year ended December 31, 2008, primarily due to a decrease in revenues. Achidatex's gross margin for the year ended December 31, 2009 was 22.7% compared to 20.1% for the year ended December 31, 2008, primarily due to an increase in revenues. Owen Mills' gross margin was 15.3% for the year ended December 31, 2009 compared to 5.5% for the year ended December 31, 2008, mainly due to an increase in revenues.

Selling Expenses. Selling expenses for the year ended December 31, 2009 decreased by 18.5% to \$945,968 from \$1,160,734 for the year ended December 31, 2008. The decrease in our selling expenses was attributable primarily to a decrease in export sales and commissions paid on export sales, as well as less usage of external consultants for selling transactions in 2009. Export Erez's selling expenses for the year ended December 31, 2009 were \$451,880 compared to \$620,369 for the year ended December 31, 2008. Achidatex's selling expenses for the year ended December 31, 2009

were \$387,510 compared to \$521,551 for the year ended December 31, 2008. Owen Mills selling expenses for the year ended December 31, 2009 were \$105,442 compared to \$18,814 for the year ended December 31, 2008. Defense Industries selling expenses for the year ended December 31, 2009 were \$1,136 compared to \$0 for the year ended December 31, 2008.

**General and Administrative Expenses.** General and administrative expenses for the year ended December 31, 2009 decreased by 13.6% to \$1,902,410 from \$2,201,027 for the year ended December 31, 2008, primarily due to a decrease in professional fees and due to currency fluctuations.

**Compensation for War Damages.** Export Erez and Mayotex received \$50,909 and \$165,129, respectively, as compensation from the Israeli Government, under the "Property tax and compensation payments for war damages" Regulations, for the loss of employment days and potential revenues during the last two years due to the security and military situation in the area in which Export Erez and Mayotex were located. This \$216,038 of compensation has been recorded as a reduction to our operating expenses in 2009.

**Financial Expenses.** We had net financial expenses for the year ended December 31, 2009 of \$73,212 as compared to net financial income of \$228,676 for the year ended December 31, 2008. This is mainly due to the change in the U.S. dollar exchange rate versus the NIS, which resulted in an expense of \$66,396 for the year ended December 31, 2009 compared to income of \$280,350 for the year ended December 31, 2008, offset mainly by a decrease in bank interest expenses due to a decrease in short term credit and loans in the year ended December 31, 2009 compared to the year ended December 31, 2008.

**Other Income (Expense), Net.** We had other income, net for the year ended December 31, 2009 of \$304,002 as compared to other expense, net of \$129,713 for the year ended December 31, 2008. Our other income in 2009 is attributable primarily to realized and unrealized gains on trading securities and gains due to changes in the fair market value of investments allocated to funds invested in respect of employee rights upon retirement. 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, 2009 was \$464,672 as compared to income tax expense of \$127,004 for the year ended December 31, 2008. In 2009 and 2008, we did not record a tax benefit related to the loss incurred by our U.S. operation due to our deferred tax valuation allowance. In 2008 we recorded a tax benefit in respect of Beneficiary Enterprise in the previous year, which reduced our tax expense. In 2009 we recorded a deferred tax liability in respect of taxes on tax-exempt income derived from a Beneficiary Enterprise of \$235,947. Export Erez's income tax expense for the year ended December 31, 2009 was \$274,801 compared to \$43,216 (offset by income of \$273,103 from changes in our income tax estimate from a prior year) for the year ended December 31, 2008. Achidatex's income tax expense for the year ended December 31, 2009 was \$189,871 compared to \$82,988 for the year ended December 31, 2008. Owen Mills' income tax expense for the year ended December 31, 2009 was \$0 compared to income tax expense of \$800 for the year ended December 31, 2008.

**Net Income Before Extraordinary Income.** Our consolidated net income before extraordinary income was \$522,266 in the year ended December 31, 2009 compared to net income before extraordinary income of \$686,831 in the year ended December 31, 2008. Export Erez's net income for the year ended December 31, 2009 was \$255,061 compared to net income of \$909,395 for the year ended December 31, 2008. Achidatex's net income for the year ended December 31, 2009 was \$495,952 compared to net income of \$188,558 for the year ended December 31, 2008. Owen Mills' net loss for the year ended December 31, 2009 was \$170,642 compared to a net loss of \$282,376 for the year ended December 31, 2008. Defense Industries' net loss for the year ended December 31, 2009 was \$58,105 compared to a net loss of \$128,746 for the year ended December 31, 2008.

**Extraordinary Income.** We did not record any extraordinary income for the year ended December 31, 2009. 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.

Net Income Attributable to Noncontrolling Interest. For the year ended December 31, 2009, we did not record any income attributable to noncontrolling interest, compared to net income of \$25,094 attributable to noncontrolling interest for the year ended December 31, 2008, with respect to Achidatex, which subsidiary is now wholly-owned.

Net Income. In the year ended December 31, 2009 our consolidated net income attributable to controlling interest was \$522,266, compared to \$5,489,017 for the year ended December 31, 2008. Our 2008 net income was mainly attributable to the net extraordinary income of \$4,827,280 we recorded as a result of the compensatory payments we received from the Israeli government.

## Liquidity and Capital Resources

As of December 31, 2009, we had \$3,783,631 in cash and cash equivalents, \$2,312,048 in trading securities and working capital of \$10,102,545 as compared to \$1,719,921 in cash and cash equivalents, \$2,384,727 in trading securities and working capital of \$10,088,528 at December 31, 2008.

| Cash Flows  | Years ended          |                      |
|---|----------------------|----------------------|
|   | December<br>31, 2009 | December<br>31, 2008 |
| Net cash provided by operating activities           | \$1,503,984          | \$5,538,714          |
| Net cash provided by (used in) investing activities | 1,961,761            | (4,237,482)          |
| Net cash used in financing activities               | (1,557,843)          | (417,118)            |
| Net increase in cash and cash equivalents           | 2,063,710            | 599,867              |
| Cash and cash equivalents at beginning of year      | 1,719,921            | 1,120,054            |
| Cash and cash equivalents at end of year            | 3,783,631            | 1,719,921            |

Operating activities. Net cash provided by operating activities was \$1,503,984 for the year ended December 31, 2009 as compared to \$5,538,714 provided by operating activities in the year ended December 31, 2008. The decrease in net cash provided by operating activities was primarily attributable to the extraordinary income of \$4,827,280 we received in 2008, net of tax. In 2009, our cash flow from operating activities reflected net income of \$522,266, a decrease in inventories of \$1,251,844, a decrease in trading securities of \$215,407, and depreciation and amortization of \$556,086, offset by a decrease in accounts payable of \$305,859 and a decrease in other current liabilities of \$822,100. Net cash provided by operating activities in the year ended December 31, 2008 was primarily attributable to net extraordinary income of \$4,827,280 from payments by the Israeli government, net income (less extraordinary income) of \$686,831, a decrease in trading securities of \$632,050 and depreciation and amortization of \$580,255, offset by a \$1,701,140 increase in inventory and a decrease in other liabilities of \$208,055.

Investing activities. Net cash provided by investing activities was \$1,961,761 for the year ended December 31, 2009 as compared to net cash used in investing activities of \$4,237,482 in the year ended December 31, 2008. During the year ended December 31, 2009, \$3,000,000 was provided from the redemption of restricted bank deposits, \$938,666 was used for a refundable deposit for the purchase of a business and \$99,573 (net of sales of fixed assets in the amount of \$58,662) was used to purchase fixed assets. During the year ended December 31, 2008, \$3,000,000 was deposited in restricted bank deposits, \$1,000,000 was used for a refundable deposit for the purchase of a business and \$237,482 (net of sales of fixed assets in the amount of \$68,922) was used to purchase fixed assets.

Financing activities. Net cash used in financing activities was \$1,557,843 for the year ended December 31, 2009 as compared to \$417,118 net cash used in financing activities for the year ended December 31, 2008. During the year ended December 31, 2009, we paid \$1,200,000 to the former minority shareholders of Achidatex and repaid \$20,504 of short-term debt and \$337,339 of long-term debt. During the year ended December 31, 2008, we repaid \$154,175 of short-term debt and \$630,856 of long-term debt, offset by proceeds of \$367,913 from new long-term debt.

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.

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, 2009.

| Contractual Obligations                                   | Total       | Payments due by Period |            |            |                   |
|---|-------------|------------------------|------------|------------|-------------------|
|   |             | less than 1 year       | 2 -3 years | 4 -5 years | more than 5 years |
| Long-term debt obligations                                | \$561,672   | \$293,422              | \$237,344  | \$30,906   | -                 |
| Estimated interest payments on long-term debt obligations | 40,944      | 24,604                 | 15,692     | 648        | -                 |
| Operating lease obligations                               | 1,012,595   | 552,509                | 460,086    | -          | -                 |
| Total   | \$1,615,211 | \$870,535              | \$713,122  | \$31,554   | -                 |

## Recent Accounting Pronouncements

See “New Accounting Pronouncements” set forth in Note 1 of the Notes to the Consolidated Financial Statements under Item 8 of this Annual Report on Form 10-K, for information pertaining to recently adopted accounting standards or accounting standards to be adopted in the future.

## 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, 2009, the inflation rate in Israel was 3.91% and the NIS appreciated in relation to the U.S. dollar at a rate of 0.71%, from NIS 3.802 per \$1 on December 31, 2008 to NIS 3.775 per \$1 on December 31, 2009. In the period ending in December 31, 2008 inflation in Israel was 3.8% while the NIS appreciated in relation to the U.S. dollar at a rate of 1.14%. 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, 2009.



### 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, 2009 and 2008, we held cash and cash equivalents, in the aggregate amount of \$3,783,631 and \$1,719,921, 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, 2009 we held \$2,312,048 of trading securities compared to \$2,384,727 as of December 31, 2008. Such securities are subject to market risk, and in 2009 we recorded recognized and unrecognized gains of \$220,003 with respect to our holdings due to the incline 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 \$8,448.

### 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-0

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

None.

Item Controls and Procedures.  
9A(T).

Disclosure Controls and Procedures

Management is responsible for establishing and maintaining effective disclosure controls and procedures. At the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-14. 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.

Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective (1) to provide reasonable assurance that information required to be disclosed by the Company in the reports filed or submitted by it under the Securities Exchange Act was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) to provide reasonable assurance that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow for timely decisions regarding required disclosure.

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, 2009. 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 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, 2009.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the fourth quarter of 2009 that materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

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.

### 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.

| Name             | Age | Position Held   |
|------------------|-----|---|
| Meira Fostbinder | 63  | Chairman of the Board of Directors, Vice President of Finance, Secretary and Treasurer              |
| Uri Nissani      | 55  | Chief Executive Officer, President and Director   |
| Gil Fostbinder   | 26  | Assistant General Manager of Mayotex Ltd., a wholly-owned subsidiary of the Registrant and Director |
| Tsippy Moldovan  | 53  | Chief Financial Officer and Director  |
| Motti Hassan     | 59  | Director  |

Joseph Fostbinder, our former Chief Executive Officer and Chairman of the Board of Directors passed away during 2009. Baruch Tosh, our former president was released from his duties on January 1, 2010, and Dan Zarchin resigned as a director on January 7, 2010.

Meira Fostbinder has served as the Chairman of the Board of Directors since June 23, 2009 and our vice president of finance and a director of Export Erez since 1996. Mrs. Fostbinder is the controlling shareholder of our company and has been involved in the management of our company since 1996. Mrs. Fostbinder's experience with our company provides our board of directors with significant knowledge about our company and its operations.

Uri Nissani was appointed Chief Executive Officer, President and a member of the Board of Directors effective January 1, 2010. From January 15, 2007 until December 15, 2009, Mr. Nissani served as the Head of Business Development of S.D.S (Star Defense Systems) Ltd., and Star Night Technologies Ltd., each of which are Israeli companies listed on the Tel Aviv Stock Exchange. Star Night Technologies Ltd. is a holding company holding a controlling stake in S.D.S (Star Defense Systems) Ltd. S.D.S (Star Defense Systems) Ltd. manufactures and markets products mainly for the defense industry and operates through three divisions: (i) a night vision solutions division; (ii) a safety and rescue products division; and (iii) an avionic systems division. Mr. Nissani also served as a director of S.D.S. (Star Defense Systems) Ltd. from October 1, 2006 until December 31, 2008. Mr. Nissani has significant experience in managing companies engaged in the defense industry and his background enhances the breadth of experience of our board of directors.

Gil Fostbinder has served as a director and Assistant General Manager of Mayotex Ltd., our wholly-owned subsidiary, effective June 23, 2009, where he had been employed as a project manager and in the marketing department since October 2004. Mr. Fostbinder has been employed by our company since 2004 and enhances the

knowledge of our board of directors about the operations of Mayotex.

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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. Mrs. Moldovan's significant experience with our company and accounting background enhance the breadth of experience of our board of directors.

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. Mr. Hassan's significant experience in the military and his engineering background enhance the breadth of experience of our board of directors.

#### Family Relationships

Meira Fostbinder and Gil Fostbinder are mother and son.

#### 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 SEC 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 year 2009 all of our executive officers and directors subject to these reporting requirements filed the required reports on a timely basis.

#### 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](http://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, 2009, 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   |                             | Total     |
|---|--------|-------------|------------|-------------------|--------------------|------------------------|-----------------------------|-----------|
|   |        |             |            |                   |                    | Plan Compensation (\$) | All Other Compensation (\$) |           |
| Joseph Fostbinder – former Chief Executive Officer and Chairman of the Board of Directors | 2009 * | \$96,935    | -          | -                 | -                  | -                      | -                           | \$96,935  |
|   | 2008   | \$73,240    | -          | -                 | -                  | -                      | -                           | \$73,240  |
| Baruch Tosh - former President  | 2009   | \$109,197   | -          | -                 | -                  | -                      | -                           | \$109,197 |
|   | 2008   | \$112,102   | -          | -                 | -                  | -                      | -                           | \$112,102 |

\* For the period until June 2009.

The aggregate value of all other perquisites and other personal benefits furnished to each of these executive officers was less than \$10,000 for the years ended December 31, 2009 and 2008.

## Grants of Plan-Based Awards for 2009

We did not award any stock options to our executive officers during the fiscal year ended December 31, 2009.

## 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, 2009.

## 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 in 2009.

| Name                 | Fees<br>Earned or<br>Paid in<br>Cash (\$) | Stock<br>Awards<br>(\$) | Option<br>Awards<br>(\$) | Non-Equity<br>Incentive<br>Plan<br>Compensation<br>(\$) | Nonqualified<br>Deferred<br>Compensation<br>(\$) | All Other<br>Compensation<br>(\$) | Total (\$) |
|----------------------|---|-------------------------|--------------------------|---|--|-----------------------------------|------------|
| Joseph<br>Fostbinder | -   | -                       | -                        | -   | -  | \$ 96,935 (1)                     | \$96,935   |
| Meira Fostbinder     | -   | -                       | -                        | -   | -  | \$ 20,399 (2)                     | \$20,399   |
| Gil Fostbinder       | -   | -                       | -                        | -   | -  | \$ 37,240 (3)                     | \$37,240   |
| Dan Zarchin          | -   | -                       | -                        | -   | -  | \$ 120,525 (4)                    | \$120,525  |
| Tsippy<br>Moldovan   | -   | -                       | -                        | -   | -  | \$ 35,412 (5)                     | \$35,412   |

(1) Mr. Fostbinder earned \$96,935 in consideration for his employment as our Chief Executive Officer prior to his death on June 13, 2009.

(2) Ms. Fostbinder earned \$20,399 in consideration for her employment as our vice president of finance, secretary and treasurer.

(3) Mr. Fostbinder earned \$37,240 in consideration for his employment as Assistant General Manager of Mayotex Ltd., our wholly-owned subsidiary.

(4) Mr. Zarchin, who resigned as a director effective January 7, 2010, earned \$120,525 in consideration for his consulting services to us in 2009.

(5) Ms. Moldovan earned \$35,412 in consideration for her employment as our chief financial officer.

## Employment Agreements

Mr. Uri Nissani was appointed CEO, President and a member of the board of directors of the Company effective January 1, 2010. The annual compensation cost for Mr. Nissani is approximately \$144,000, plus use of a company car and the customary Israeli social benefits. Subject to the execution of an option agreement and approval of our shareholders (if necessary) Mr. Nissani has been granted options to purchase 7,088,259 shares of our common stock, par value \$0.0001 each. Options to purchase 4,252,960 shares will vest in ten quarterly installments beginning March 31, 2010. The remaining 2,835,299 options will vest upon achievement of certain milestones with respect to our performance in 2010 and 2011, as shall be agreed by the parties in the Option Agreement.



## 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 15, 2010 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, 2009; 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<br>Shares of<br>Common<br>Stock<br>Beneficially<br>Owned (2) | Percentage<br>of<br>Outstanding<br>Shares of<br>Common<br>Stock (3) |   |
|---|--|---|---|
| The Estate of Joseph Fostbinder (4)               | 19,440,212   | 69.05   | % |
| Uri Nissani (6)                                   | -  | -   |   |
| Meira Fostbinder (4) (5)                          | 9,788  | *   |   |
| Gil Fostbinder (5)                                | -  | -   |   |
| Tsippy Moldovan                                   | 55,000   | *   |   |
| Motti Hassan                                      | -  | -   |   |
| All officers and directors as a group (5 persons) | 19,515,000   | 69.32   | % |

\* Less than 1% percent

(1) The addresses of Estate of Joseph Fostbinder, Uri Nissani, Meira Fostbinder, Gil Fostbinder, Tsippy Moldovan and Motti Hassan are c/o Defense Industries International, Inc., 12 Hamefalsim Street, Petch Tikva, 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 28,150,535 shares of common stock outstanding.

(4) The late Joseph Fostbinder was the spouse of Meira Fostbinder who is the sole heir of Mr. Fostbinder's shares.

(5) Gil Fostbinder is the son of Meira Fostbinder.

(6) As for the option agreement with Mr. Nissani, see Item 11. Executive Compensation – Employment Agreements.

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 the estate of Mr. Joseph Fostbinder. 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 \$274,628 rental expense in 2009 was allocated between the two subsidiaries. The lease will expire on December 31, 2011. 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.

Mayotex leases approximately 1,219 square meters of space in the Industrial Area of Sderot from the estate of Mr. Joseph Fostbinder, primarily for its cut and sew operations. The annual rental expense for this space was \$72,701 in 2009. The lease will expire on December 31, 2010.

Mayotex leases 1,000 square meters of industrial space and additional 1,280 square meters of outdoor space in the Industrial Area of Ashkelon from a company owned by the estate of Mr. Joseph Fostbinder for its car armor installations. The annual rental expense for this space was \$54,163 in 2009. The lease for 500 square meters will expire on June 30, 2010. The lease for an additional 500 square meters will expire on December 31, 2010.

## 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 registered public accounting firm, Baker Tilly Virchow Krause, LLP during 2009 and 2008. All of such fees were pre-approved by our Board of Directors.

| Services Rendered | Year Ended December 31, |              |
|-------------------|-------------------------|--------------|
|                   | 2009<br>Fees            | 2008<br>Fees |
| Audit (1)         | \$ 69,281               | \$ 93,028    |
| Audit-related     | --                      | --           |
| Tax fees (2)      | 20,728                  | 45,000       |
| Total             | \$ 90,009               | \$ 138,028   |

(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 consents letters for SEC registration statements.

(2) Tax fees relate to the completion of our 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 2009. 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-0

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.

| Exhibit<br>Number | Description  |
|-------------------|--|
| 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 (4)   |
| 4.4               | Form of Warrant A dated June 15, 2005 (4)  |
| 4.5               | Form of Warrant B dated June 15, 2005 (4)  |
| 21.1              | Subsidiaries of the Company  |
| 31.1              | Certification of Chief Executive Officer pursuant to Rule 13a-14(a)<br>of the Securities Exchange Act, as amended.                               |
| 31.2              | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)<br>of the Securities Exchange Act, as amended.                               |
| 32.1              | Certification of Chief Financial Officer pursuant to Rule 13a-14(a)<br>of the Securities Exchange Act, as amended.                               |
| 32.2              | Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350,<br>as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of<br>2002. |
| 99.1              | Engagement letter between the registrant and Mr. Uri Nissani dated<br>December 31, 2009 (5)  |

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(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 99.1 to the Registrant's Report on Form 8-K dated filed January 1, 2010.

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SIGNATURES

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

DEFENSE INDUSTRIES INTERNATIONAL, INC.

Date: March 31, 2010

/s/ Uri Nissani  
Name: Uri Nissani  
Title: Chief Executive Officer and  
President

In accordance with the Securities Exchange Act of 1934, this report has been signed below on March 31, 2010 by the following persons on behalf of the Registrant and in the capacities indicated.

/s/ Meira Fostbinder  
Name: Meira Fostbinder  
Title: Chairman of the Board of  
Directors and Vice President of  
Finance

/s/ Uri Nissani  
Name: Uri Nissani  
Title: Chief Executive Officer and  
President and Director

/s/ Tsippy Moldovan  
Name: Tsippy Moldovan  
Title: Chief Financial Officer and  
Director

/s/ Gil Fostbinder  
Name: Gil Fostbinder  
Title: Director

/s/ Motti Hassan  
Name: Motti Hassan  
Title: Director

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, 2009 and 2008, 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, 2009 and 2008 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/ Baker Tilly Virchow Krause, LLP

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

Minneapolis, Minnesota  
March 31, 2010

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

|  | Note     | December<br>31,<br>2009 | December<br>31,<br>2008 |
|--|----------|-------------------------|-------------------------|
| <b>ASSETS</b>  |          |                         |                         |
| <b>CURRENT ASSETS</b>  |          |                         |                         |
| Cash and cash equivalents  |          | \$3,783,631             | \$1,719,921             |
| Restricted bank deposits   | 3        | ---                     | 3,000,000               |
| Accounts receivable, net of allowance for doubtful accounts of \$343,629 and \$298,354, respectively |          | 3,352,751               | 3,449,852               |
| Inventories  | 5        | 4,124,141               | 5,373,627               |
| Trading securities   | 4        | 2,312,048               | 2,384,727               |
| Deferred taxes   | 11       | 148,710                 | 168,231                 |
| Other current assets   |          | 225,112                 | 178,825                 |
| <b>Total Current Assets</b>  |          | <b>13,946,393</b>       | <b>16,275,183</b>       |
| <b>PROPERTY, PLANT AND EQUIPMENT, NET</b>  | <b>6</b> | <b>1,741,594</b>        | <b>2,177,526</b>        |
| <b>OTHER ASSETS</b>  |          |                         |                         |
| Fund in respect of employee rights upon retirement   | 10       | 780,960                 | 646,905                 |
| Deferred taxes   | 11       | 25,659                  | 62,873                  |
| Refundable deposits on purchase of a business  | 17       | 1,993,696               | 1,000,000               |
| <b>Total Other Assets</b>  |          | <b>2,800,315</b>        | <b>1,709,778</b>        |
| <b>TOTAL ASSETS</b>  |          | <b>\$18,488,302</b>     | <b>\$20,162,487</b>     |

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

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

|   | Note | December 31,<br>2009 | December 31,<br>2008 |
|---|------|----------------------|----------------------|
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |      |                      |                      |
| <b>CURRENT LIABILITIES</b>  |      |                      |                      |
| Accounts payable  |      | \$ 1,408,741         | \$ 1,720,913         |
| Accounts payable - related parties  | 14   | 462,968              | 1,581,097            |
| Short-term debt   | 7    | 876,554              | 956,801              |
| Common stock to be issued   |      | ---                  | 40,000               |
| Other current liabilities   | 8    | 1,047,771            | 1,887,844            |
| <b>Total Current Liabilities</b>  |      | <b>3,796,034</b>     | <b>6,186,655</b>     |
| <b>LONG-TERM LIABILITIES</b>  |      |                      |                      |
| Long-term portion of debt   | 9    | 268,250              | 555,044              |
| Deferred taxes liabilities  | 11   | 229,191              | -                    |
| Liability for employee rights upon retirement   | 10   | 911,440              | 821,909              |
| <b>Total Long-Term Liabilities</b>  |      | <b>1,408,881</b>     | <b>1,376,953</b>     |
| <b>TOTAL LIABILITIES</b>  |      | <b>5,204,915</b>     | <b>7,563,608</b>     |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |      |                      |                      |
|   | 12   |                      |                      |
| <b>SHAREHOLDERS' EQUITY</b>   |      |                      |                      |
|   | 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 ; 29,200,535 shares issued and 28,150,535 shares outstanding in 2009 ; and 28,991,111 shares issued and 27,941,111 shares outstanding in 2008 |      | 2,920                | 2,899                |
| Additional paid-in capital  |      | 2,997,370            | 2,957,391            |
| Treasury stock (1,050,000 shares at cost)   |      | (252,000 )           | (252,000 )           |
| Retained earnings   |      | 10,176,352           | 9,654,086            |

|   |                      |                      |
|---|----------------------|----------------------|
| Accumulated other comprehensive gain              | 358,745              | 236,503              |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>                 | <b>13,283,387</b>    | <b>12,598,879</b>    |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$ 18,488,302</b> | <b>\$ 20,162,487</b> |

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

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

|  | Year ended December 31, |               |
|--|-------------------------|---------------|
|  | 2009                    | 2008          |
| NET REVENUES   | \$ 16,503,104           | \$ 18,170,508 |
| COST OF SALES  | 13,114,616              | 14,093,875    |
| GROSS PROFIT   | 3,388,488               | 4,076,633     |
| OPERATING EXPENSES   |                         |               |
| Selling  | 945,968                 | 1,160,734     |
| General and administrative   | 1,902,410               | 2,201,027     |
| Compensation from government (Note 16)   | (216,038 )              | ---           |
| Total Operating Expenses   | 2,632,340               | 3,361,761     |
| INCOME FROM OPERATIONS   | 756,148                 | 714,872       |
| OTHER INCOME (EXPENSES)  |                         |               |
| Financial expense  | (811,793 )              | (1,324,876 )  |
| Financial income   | 738,581                 | 1,553,552     |
| Other income (expenses), net   | 304,002                 | (129,713 )    |
| Total Other Income   | 230,790                 | 98,963        |
| INCOME BEFORE INCOME TAXES   | 986,938                 | 813,835       |
| Income tax expenses (Note 11)  | 464,672                 | 127,004       |
| NET INCOME BEFORE EXTRAORDINARY INCOME   | 522,266                 | 686,831       |
| Extraordinary income, net of tax (Note 16)   | ---                     | 4,827,280     |
| NET INCOME   | 522,266                 | 5,514,111     |
| Net income attributable to noncontrolling interest   | ---                     | 25,094        |
| NET INCOME attributable to controlling interest  | \$ 522,266              | \$ 5,489,017  |
| Net income per share attributable to controlling interest from continuing operations – basic and diluted | 0.019                   | 0.027         |
| Net extraordinary income per share attributable to controlling interest – basic and diluted              | ---                     | 0.163         |
| Net income per share attributable to controlling interest - basic and diluted                            | \$ 0.019                | \$ 0.190      |

|   |            |            |
|---|------------|------------|
| Weighted average number of shares outstanding - basic and diluted | 28,059,306 | 28,964,719 |
|---|------------|------------|

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

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

|   | Common Stock |         | Treasury Stock |             | Additional  | Retained    | Accumulated | Total       | Total        |
|---|--------------|---------|----------------|-------------|-------------|-------------|-------------|-------------|--------------|
|   | Shares       | Dollars | Shares         | Dollars     | Paid-In     |             | Other       |             |              |
|   |              |         |                |             | Capital     | Earnings    | Income      | Income      | Equi         |
|   |              |         |                |             |             |             | (Loss)      | (loss)      |              |
| Balance as of<br>January 1, 2008  | 28,867,272   | \$2,886 | -              | \$-         | \$2,764,328 | \$4,165,069 | \$488,808   |             | \$7,421,     |
| Common stock<br>issued to<br>acquire Rizzo<br>Inc (1)   | 123,839      | 13      | -              | -           | 39,987      | -           | -           |             | 40,000       |
| Purchase of<br>treasury stock<br>(2)  | -            | -       | 1,050,000      | (252,000)   | -           | -           | -           |             | (252,000)    |
| Excess of fair<br>value over<br>consideration<br>for the<br>purchase of<br>Achidatex<br>Nazereth Elite<br>(1977) Ltd.<br>shares (2) | -            | -       | -              | -           | 153,076     | -           | -           |             | 153,076      |
| Comprehensive<br>income (loss):   |              |         |                |             |             |             |             |             |              |
| Net income  | -            | -       | -              | -           | -           | 5,489,017   | -           | \$5,489,017 | 5,489,017    |
| Foreign<br>currency<br>translation loss   | -            | -       | -              | -           | -           | -           | (252,305)   | (252,305)   | (252,305)    |
| Total<br>comprehensive<br>income  |              |         |                |             |             |             |             | \$5,236,712 |              |
| Balance as of<br>December 31,<br>2008   | 28,991,111   | \$2,899 | 1,050,000      | \$(252,000) | \$2,957,391 | \$9,654,086 | \$236,503   |             | \$12,599,291 |

|  |            |         |           |             |             |              |           |           |              |
|--|------------|---------|-----------|-------------|-------------|--------------|-----------|-----------|--------------|
| Common stock issued to acquire Rizzo Inc (1) | 209,424    | 21      | -         | -           | 39,979      | -            | -         |           | 40,000       |
| Comprehensive income:                        |            |         |           |             |             |              |           |           |              |
| Net income                                   | -          | -       | -         | -           | -           | 522,266      | -         | \$522,266 | 522,266      |
| Foreign currency translation gain            | -          | -       | -         | -           | -           | -            | 122,242   | 122,242   | 122,242      |
| Total comprehensive income                   |            |         |           |             |             |              |           | \$644,508 |              |
| Balance as of December 31, 2009              | 29,200,535 | \$2,920 | 1,050,000 | \$(252,000) | \$2,997,370 | \$10,176,352 | \$358,745 |           | \$13,280,000 |

(1) See Note 13

(2) See Note 1

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



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

|   | Year ended December 31, |             |
|---|-------------------------|-------------|
|   | 2009                    | 2008        |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                         |             |
| Net income attributable to controlling interest   | \$522,266               | \$5,489,017 |
| Noncontrolling interest in income of subsidiary   | -                       | 25,094      |
| Net income  | 522,266                 | 5,514,111   |
| Less – extraordinary income, net of tax   | -                       | (4,827,280) |
|   | 522,266                 | 686,831     |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                         |             |
| Items not effecting cash:   |                         |             |
| Depreciation and amortization   | 556,086                 | 580,255     |
| Gain from sale of property, plant and equipment   | (20,135 )               | (36,271 )   |
| Provision for doubtful accounts   | 41,666                  | 141,946     |
| Deferred taxes  | 276,055                 | (28,078 )   |
| Net unrealized (gain) loss on trading securities  | (129,268 )              | 4,869       |
| Accrued interest and exchange rate differences of long-term debt                            | (1,507 )                | (3,763 )    |
| Accrued interest on payments for the purchase of a business                                 | 55,030                  | -           |
| Accrued interest and exchange rate differences on deposits                                  | (177,778 )              | -           |
| Changes in assets and liabilities:  |                         |             |
| Decrease in accounts receivable   | 69,687                  | 64,386      |
| Decrease (increase) in inventories  | 1,251,844               | (1,701,140) |
| Decrease in trading securities  | 215,407                 | 632,050     |
| Increase in related parties accounts  | 76,230                  | 347,505     |
| (Increase) decrease in other current assets   | (59,698 )               | 14,608      |
| (Increase) decrease in funds in respect of employee rights upon retirement                  | (124,242 )              | 120,174     |
| (Decrease) increase in accounts payable   | (305,859 )              | 12,659      |
| Decrease in other current liabilities   | (822,100 )              | (208,055 )  |
| Increase in liability for employee rights upon retirement                                   | 80,300                  | 83,458      |
| Net Cash Provided By Operating Activities   | 1,503,984               | 711,434     |
| Cash provided by extraordinary items  | -                       | 4,827,280   |
|   | 1,503,984               | 5,538,714   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                         |             |
| Investment in short-term restricted bank deposits   | -                       | (3,000,000) |
| Redemption of restricted bank deposits  | 3,000,000               | -           |
| Purchases of property, plant and equipment  | (158,235 )              | (306,404 )  |
| Proceeds from sale of property, plant and equipment   | 58,662                  | 68,922      |
| Refundable deposit for purchase of a business   | (938,666 )              | (1,000,000) |
| Net Cash Provided by (Used In) Investing Activities   | 1,961,761               | (4,237,482) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                         |             |
| Reduction in short-term debt, net   | (20,504 )               | (154,175 )  |
| Proceeds from long-term debt  | -                       | 367,913     |
| Repayment of long-term debt   | (337,339 )              | (630,856 )  |
| Redemption of related parties creditors   | (1,200,000)             | -           |

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|  |             |             |
|--|-------------|-------------|
| Net Cash Used in Financing Activities                            | (1,557,843) | (417,118 )  |
| EFFECT OF CHANGES IN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS | 155,808     | (284,247 )  |
| NET INCREASE IN CASH AND CASH EQUIVALENTS                        | 2,063,710   | 599,867     |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR                   | 1,719,921   | 1,120,054   |
| CASH AND CASH EQUIVALENTS AT END OF YEAR                         | \$3,783,631 | \$1,719,921 |
| INTEREST PAID  | \$112,550   | \$116,030   |
| TAXES PAID   | \$940,013   | \$313,272   |

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

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

SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:

Pursuant to an agreement signed on February 28, 2005 to acquire the business of Rizzo Inc. (doing business as Owen Mills Company), on June 8, 2009 and on March 18, 2008, the Company issued 209,424 shares and 123,839 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.

On December 31, 2008, the Company signed an agreement to purchase the minority interest in Achidatex Nazereth Elite (1977) Ltd. and 1,050,000 shares of common stock of the Company for an aggregate purchase price of \$1,200,000, paid by the Company during the first and second quarters of 2009 (see also Note 1).

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

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

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) (“Owen Mills”), 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 purchase the minority interest in Achidatex 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. Payments by the Company to the minority shareholders under this agreement were paid during the first and second quarters of 2009.

During 2009, Dragonwear ceased its operations and was dissolved and deleted from the Register of Companies on March, 14, 2010. Dragonwear had no operational activities, therefore, its discontinuance had no impact for measurement and disclosure purposes in all reported periods.

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

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 and Achidatex (in respect of assets and liabilities - 100% as of December 31, 2009 and 2008, and in respect of operations – 100% and 76% in 2009 and 2008, respectively).

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

(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 2009 and 2008, a loss of \$66,396 and a gain of \$280,350, 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.

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

(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 current 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.

Effective January 1, 2008, the Company adopted Financial Accounting Standard Board ("FASB") Accounting Standards Codification ("ASC") No. 820 "Fair Value Measurements and Disclosures" (formerly Statement of Financial Accounting Standards ("SFAS") No. 157), which establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements.

FASB ASC 820 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. FASB ASC 820 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).

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

(F) Concentrations of Credit Risk

At December 31, 2009 and 2008, the Company held cash and cash equivalents, in the aggregate amount of \$3,783,631 and \$1,719,921, 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.

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, 2009 and 2008 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 stated 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, 2009 and 2008, inventories allowances were \$539,794 and \$371,800, respectively.

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

(J) Property, Plant and Equipment

Property, plant and equipment are stated at cost, net of 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.

(K) Impairment of Long-lived assets

In accordance with the provisions of FASB ASC 360 "Accounting for the Impairment or Disposal of Long-lived Assets" (formerly SFAS No. 144) ("FASB ASC 360"), 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 FASB ASC 360 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. No impairment charges were recorded in 2009 and 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 FASB ASC 980 "Revenue Recognition in Financial Statements" (formerly Staff Accounting Bulletin ("SAB") No.101 (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 immaterial warranty claims, the Company has not established a reserve at December 31, 2009 and 2008.



DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

(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 \$343,629 and \$298,354 at December 31, 2009 and 2008, respectively.

(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.

FSAB ASC 740 "Accounting for Income Taxes" (formerly SFAS No. 109), 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 2009 and 2008, 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.

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

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 tax liability resulted from distribution of tax exempt revenues derived from "Beneficiary Enterprise" status under the Law for the Encouragement of Capital Investments, 1959, as amended on April 1, 2005, 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 income per share because their effect was anti-dilutive, in the years ended December 31, 2009 and 2008.

(Q) 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 \$166,894 and \$236,572 for the years ended December 31, 2009 and 2008, respectively.

(R) Advertising Costs

The Company expenses advertising costs as incurred. Advertising expenses included in selling expenses were \$42,347 and \$71,378 for the years ended December 31, 2009 and 2008, 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 \$19,302 and \$120,608 for the years ended December 31, 2009 and 2008, respectively.

(T) Subsequent Events

The Company evaluates events occurring after the date of the financial statements for events requiring recording or disclosure in the financial statements.

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

(U) Recent Accounting Pronouncements

Following are summaries of accounting pronouncements that were either recently adopted or may become applicable to the Company's consolidated financial statements. It should be noted that effective with the year ended December 31, 2009, titles and references to accounting standards have been updated to reflect Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) and Accounting Standards Update (ASU) references, where applicable.

Recently Adopted Pronouncements

The provisions of FASB ASC Topic 810 - "Consolidation" (formerly SFAS No. 160 - "Noncontrolling Interests in Consolidated Financial Statements") establishes new accounting and reporting requirements for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest is included in consolidated net income on the face of the income statement. The standard clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this standard requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated.

Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. The standard also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. The Company adopted this standard as of January 1, 2009. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

FASB ASC Topic 805 - "Business Combinations" (formerly known as SFAS No. 141(R)) requires the acquirer in a business combination to recognize the assets acquired, the liabilities assumed, contractual contingencies, and contingent consideration at their fair values as of the acquisition date. Additionally, this standard requires acquisition costs to be expensed as incurred, restructuring costs to be expensed in the period subsequent to the acquisition date, and changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date to impact tax expense. The acquirer in an acquisition implemented in stages is required to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values. This standard was effective for business combinations with an acquisition date after December 31, 2008. The adoption of this standard did not have an impact on the Company's consolidated financial statements.

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The provisions of FASB ASC Topic 805 - "Business Combinations" (formerly FASB Staff Position (FSP) No. FAS 141(R)-1 - "Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies") amends and clarify previously existing rules and requires an acquirer to recognize at fair value, at the acquisition date, an asset acquired or liability assumed in a business combination that arises from a contingency if the fair value can be determined during the measurement period. If an acquisition date fair value cannot be determined during the measurement period, it must still be recognized if it is probable the asset existed or a liability had been incurred and it can be reasonably estimated. This standard also increases the disclosure requirements of the acquirer to include the nature and the financial effects of the contingencies on its financial statements. This standard was effective for assets or liabilities arising from contingencies in business combinations with an acquisition date after December 31, 2008. The adoption of this standard did not have an impact on the Company's consolidated financial statements.

The provisions of FASB ASC Topic 260 - "Earnings Per Share" (formerly FSP No. EITF 03-6-1 - "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities") applies to the calculation of earnings per share ("EPS") for share-based payment awards with rights to dividends or dividend equivalents. Unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and should be included in the computation of EPS pursuant to the two-class method. This standard was effective for the Company beginning January 1, 2009 with retrospective adjustment to previously reported EPS data for comparative purposes. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

The provisions of FASB ASC Topic 320 - "Investments - Debt and Equity Securities" (formerly FSP No. FAS 115-2 and FAS 124-2 - "Recognition and Presentation of Other-Than-Temporary Impairments") changes the requirements for recognizing other-than-temporary impairments for debt securities, modifies the presentation of other-than-temporary losses in the income statement and expands the disclosure requirements relating to impairments of debt and equity securities. This standard specifies that if a company does not have the intent or need to sell a debt security prior to recovery, the security is not considered other-than-temporarily-impaired unless there is a credit loss. If impairment to a security is recognized because of a credit loss, a company is required to recognize the credit loss component of the impairment of the debt security in earnings and the remaining portion of the impairment loss in other comprehensive income. The standard was effective for interim and annual periods ending after June 15, 2009. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

The Company adopted the revisions to U.S. GAAP accounting standards included in ASC Topic 855 - "Subsequent Events", and the FASB amendment ASU 2010-09, which establish the accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued. This guidance did not have any impact on the Company's financial position, results of operations, or cash flows.

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Recently Issued Pronouncements

ASC Topic 810 – “Consolidation” (“ASC 810”), as amended in June 2009, is a revision to pre-existing guidance pertaining to the consolidation and disclosures of variable interest entities. Specifically, it changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity’s purpose and design and the reporting entity’s ability to direct the activities of the other entity that most significantly impact the other entity’s economic performance. This guidance will require a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity will be required to disclose how its involvement with a variable interest entity affects the reporting entity’s financial statements. This guidance will be effective at the start of a reporting entity’s first fiscal year beginning after November 15, 2009. Early application is not permitted. The Company is currently evaluating the impact of this ASU on its consolidated financial statements, if any, upon adoption.

FASB ASU No. 2009-05 - “Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value” provides additional requirements for measuring a liability at fair value. When a quoted price in an active market for the identical liability is not available, a reporting entity is required to use a valuation technique that uses the quoted price for similar liabilities traded or quoted prices for an identical liability or similar liabilities traded as an asset. An entity may also use a valuation technique that is consistent with the principles of Topic 820 such as an income or market approach. This ASU is effective for the first reporting period beginning after August 27, 2009. The Company is currently evaluating the impact of this ASU on its consolidated financial statements, if any, upon adoption.

FASB ASU No. 2009-14 - “Revenue Recognition (Topic 605) - Multiple-Deliverable Revenue Arrangements”, a consensus of the FASB Emerging Issues Task Force, addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than a combined unit. It establishes a hierarchy for determining the selling price for each deliverable. The selling price used for each deliverable should be based on vendor-specific objective evidence if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available. This ASU also clarifies existing requirements that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. This ASU is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The adoption of this ASU is not expected to have material impact on the Company’s consolidated financial statements.

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In January 2010, the FASB amended ASC 820 – “Fair Value Measurements and Disclosures” (“ASC 820”) to require new disclosures for fair value measurements and provides clarification for existing disclosures requirements. More specifically, this update will require (a) an entity to disclose separately the amounts of significant transfers in and out of Levels 1 and 2 fair value measurements and to describe the reasons for the transfers; and (b) information about purchases, sales, issuances and settlements to be presented separately (i.e., present the activity on a gross basis rather than net) in the reconciliation for fair value measurements using significant unobservable inputs (Level 3 inputs). This update clarifies existing disclosure requirements for the level of disaggregation used for classes of assets and liabilities measured at fair value and requires disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements using Level 2 and Level 3 inputs. The amendment to ASC 820 is effective for interim and annual fiscal years beginning after December 15, 2009. The Company does not anticipate that the adoption of this statement will materially expand its consolidated financial statement footnote disclosures.

NOTE 3                    RESTRICTED BANK DEPOSITS

At December 31, 2008, restricted US dollar bank deposits consisted of non-interest bearing bank deposits which matured on February 12, 2009, March 31, 2009 and June 16, 2009.

NOTE 4                    TRADING SECURITIES

A reconciliation of original cost to fair market value for trading securities held at December 31, 2009 and 2008 consisted of the following:

|  | 2009         | 2008         |
|--|--------------|--------------|
| Trading securities, at cost                  | \$ 2,158,954 | \$ 2,391,408 |
| Unrealized gain (loss) on trading securities | 153,094      | (6,681 )     |
| Trading securities at fair market value      | \$ 2,312,048 | \$ 2,384,727 |

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NOTE 5                    INVENTORIES

Inventories at December 31, 2009 and 2008 consisted of the following:

|                   | 2009         | 2008         |
|-------------------|--------------|--------------|
| Raw materials (1) | \$ 2,597,759 | \$ 3,527,373 |
| Work in progress  | 642,132      | 754,932      |
| Finished goods    | 884,250      | 1,091,322    |
|                   | \$ 4,124,141 | \$ 5,373,627 |

Includes advanced payments to purchase inventory for \$52,894 and \$513,447 at December 31, 2009 and 2008, respectively.

NOTE 6                    PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at December 31, 2009 and 2008 consisted of the following:

|                                 | 2009         | 2008         | Estimated<br>Useful Life |
|---------------------------------|--------------|--------------|--------------------------|
| Leasehold improvements          | \$ 649,325   | \$ 620,696   | 5-14 Years               |
| Motor vehicles                  | 604,386      | 696,074      | 5-7 Years                |
| Office equipment and furniture  | 495,124      | 477,663      | 3-16 Years               |
| Equipment                       | 4,607,528    | 4,518,702    | 5-14 Years               |
|                                 | 6,356,363    | 6,313,135    |                          |
| Less - Accumulated depreciation | (4,583,894)  | (4,104,734)  |                          |
|                                 | 1,772,469    | 2,208,401    |                          |
| Less - impairment charge        | (30,875 )    | (30,875 )    |                          |
|                                 | \$ 1,741,594 | \$ 2,177,526 |                          |

Depreciation expense for the years ended December 31, 2009 and 2008 were \$556,086 and \$580,255, respectively.

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NOTE 7                    SHORT-TERM DEBT

Short-term debt at December 31, 2009 and 2008 consisted of the following:

|   | Interest Rates                        | 2009       | 2008       |
|---|---------------------------------------|------------|------------|
| Overdraft credit                                  | 2.5% - 6.2% (average<br>rate of 4.2%) | \$ 583,132 | \$ 604,597 |
| Current portion of long-term debt (see<br>note 9) |                                       | 293,422    | 352,204    |
|   |                                       | \$ 876,554 | \$ 956,801 |

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, 2009 were \$1,541,723 and \$969,781, respectively.

To secure its short-term liabilities and long-term loans (see Note 9), the Company has provided 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, 2009 and 2008 consisted of the following:

|  | 2009         | 2008         |
|--|--------------|--------------|
| Government institutes                                    | \$ 56,603    | \$ -         |
| Employees and institutions for payroll and related taxes | 488,967      | 519,256      |
| Advances from customers                                  | 322,988      | 621,461      |
| Accrued expenses   | 32,714       | 58,421       |
| Income taxes   | 146,499      | 688,706      |
|  | \$ 1,047,771 | \$ 1,887,844 |



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NOTE 9                    LONG-TERM DEBT

Consists of:

|                            | 2009       | 2008       |
|----------------------------|------------|------------|
| Loan to acquire Owen Mills | \$ 19,802  | \$ 50,698  |
| Loans from banks           | 541,870    | 856,550    |
|                            | 561,672    | 907,248    |
| Less – current maturities  | (293,422)  | (352,204)  |
|                            | \$ 268,250 | \$ 555,044 |

On February 28, 2005, the Company acquired all the outstanding shares in Owen Mills for an aggregate of \$372,401, consisting of a note payable with a fair value of \$172,401 and \$200,000 in shares of common stock of the Company, both of which were to be paid over five years. As of December 31, 2009 the balance of the note was \$19,802, included in the current portion of long term debt (See also Note 13).

On April 10, 2006, the Company borrowed \$529,801 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1.4% (4.15% at December 31, 2009). 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, 2009, the balance of the loan was \$157,774, of which \$117,560 is included in the current portion of long-term debt.

On May 17, 2006, the Company borrowed \$43,602 with interest at a fluctuating rate based on the Bank of Israel's prime rate –0.5% (2.25% at December 31, 2009). The terms are 48 monthly payments commencing June 1, 2006 with each payment consisting of a fixed amount of principal along with accrued interest. As of December 31, 2009, the balance of the loan was \$4,895, included in the current portion of long-term debt.

On April 11, 2007, the Company borrowed \$264,901 with interest at a fluctuating rate based on the Bank of Israel's prime rate +2% (4.75% at December 31, 2009). 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, 2009, the balance of the loan was \$133,989, of which \$54,575 is included in the current portion of long-term debt.

On July 3, 2007, the Company borrowed \$26,490 with interest at a fluctuating rate based on the Bank of Israel's prime rate +0.5% (3.25% at December 31, 2009). 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, 2009, the balance of the loan was \$5,438, included in the current portion of long-term debt.

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On December 5, 2007, the Company borrowed \$26,490 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1% (3.75% at December 31, 2009). 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, 2009, the balance of the loan was \$9,433, included in the current portion of long-term debt.

On July 23, 2008, the Company borrowed \$39,735 with interest at a fluctuating rate based on the Bank of Israel's prime rate (2.75% at December 31, 2009). 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, 2009, the balance of the loan was \$20,983, of which \$13,252 is included in the current portion of long-term debt.

On July 31, 2008, the Company borrowed \$264,901 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1.1% (3.85% at December 31, 2009). 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, 2009, the balance of the loan was \$189,845, of which \$52,979 is included in the current portion of long-term debt.

On March 18, 2008, the Company borrowed \$45,033 with interest at a fluctuating rate based on the Bank of Israel's prime rate +1% (3.75% at December 31, 2009). 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, 2009, the balance of the loan was \$19,513, of which \$15,488 is included in the current portion of long-term debt.

The Company's long-term debt with its banks is collateralized by a blanket floating lien on all assets, securities, notes and other trade instruments that are deposited with the banks (See Note 7).

Required principal payments (including current maturities) on long-term debt as of December 31, 2009 were as follows:

| Year                      | Amount     |
|---------------------------|------------|
| 2010                      | \$ 293,422 |
| 2011                      | 163,762    |
| 2012                      | 73,582     |
| 2013                      | 30,906     |
|                           | 561,672    |
| Less: current portion     | (293,422)  |
| Long-term portion of debt | \$ 268,250 |

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NOTE 10                      LIABILITY AND FUNDS FOR EMPLOYEE RIGHTS UPON RETIREMENT

Under the Israeli Severance Payment Law, 5723-1963, 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, during which the employee was employed by the Company, whereby the employee is entitled to one month of severance payment for each year employed based on the last month's salary. For certain employees, including officers, the obligation for severance payment is discharged by payment by the Company of premiums to insurance companies or pension funds 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% or 8.33% of the employee's salary each month to the pension fund, covering 72% or 100% of its obligation, respectively. Contributions charged to operations were \$61,172 and \$58,170 in 2009 and 2008, 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 Payment 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 \$780,960 and \$646,905 at December 31, 2009 and 2008, respectively. The amounts deposited may be withdrawn only after fulfillment of the obligations under the Severance Payment Law as discussed above. The liability for these employees' rights upon retirement amounted to \$911,440 and \$821,909 at December 31, 2009 and 2008, respectively.

NOTE 11                      INCOME TAXES

The parent company and its US subsidiaries file consolidated tax returns. Each Israeli subsidiary files separate tax returns. For 2009, the Company's Israeli subsidiaries were taxed in Israel at a corporate tax rate of 26% and are subject to the Israel Income Tax Law (Inflation Adjustment) of 1985. Under this law, through 2007, 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 2009, the Israeli Parliament passed the Law for Economic Efficiency (Amended Legislation for Implementing the Economic Plan for 2009 and 2010), 2009, which provided for a further gradual reduction in the rates of the Israeli corporate tax and real capital gains tax starting in 2011 as follows: 2011 – 24%, 2012 – 23%, 2013 – 22%, 2014 – 21%, 2015 – 20%, 2016 and thereafter – 18%.

In July 2006, the FASB issued FASB ASC 740 “Accounting for Uncertainty in Income Taxes” (formerly FASB Interpretation 48 – an Interpretation of FASB Statement No. 109), (“ASC 740”), 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 ASC 740. 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 ASC 740.

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

|                              |             |
|------------------------------|-------------|
| Balance at January 1, 2008   | \$(65,523 ) |
| Additions for tax positions  | (23,970 )   |
| Exchange rate differences    | 592         |
| Balance at January 1, 2009   | (88,901 )   |
| Additions for tax positions  | (8,900 )    |
| Exchange rate differences    | (1,007 )    |
| Balance at December 31, 2009 | \$(98,808 ) |

As of December 31, 2009, income tax returns filed by the Company’s Israeli subsidiaries with the Israeli tax authorities for years prior to 2005, were no longer subject to examination by the Israeli tax authorities. As of December 31, 2009, the tax returns for the Company’s US entities for the years ended December 31, 2001 through 2009 are subject to examination.

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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 \$ 8,900 and \$23,970 in 2009 and 2008, respectively, and a current tax liability of \$98,808 and \$88,901 at December 31, 2009 and 2008, 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 all the Israeli subsidiaries for 2006 through 2009.

Certain of the Company's Israeli subsidiaries have elected to claim tax benefits under the Law for the Encouragement of Capital Investments, 5719-1959, as amended on April 1, 2005 ("the Law") for "Beneficiary Enterprise" status. Pursuant to the provision of the Law, income derived from the "Beneficiary Enterprise" is tax exempt for 10 years from election year which was 2007 ("tax holiday").

The entitlement to the above benefits is conditional upon the Company fulfilling the conditions stipulated by the Law and 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 pay income taxes on the income earned during the tax holiday, including interest. As of December 31, 2009, management believes that the Company is meeting all of the required conditions.

As a result of the Law, tax-exempt income attributable to the "Beneficiary Enterprise" will be subject to taxes upon dividend distribution or complete liquidation. As of December 31, 2009, there is approximately \$1,760,035 of tax-exempt income earned by the Company's "Beneficiary Enterprises". Of this amount, the Company has not provided for \$880,090 of the tax-exempt income as the Company believes this amount would not be taxed upon liquidation. These earnings are essentially permanently restricted from distribution. If this amount was to be taxed, it would be taxed at 26%-29%, resulting in \$245,828 of taxes which a deferred tax liability has not been recorded.

The Company has recorded a deferred tax liability of \$245,797 on remaining \$879,945 of tax-exempt income, which could not be distributed tax free in liquidation.

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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.

Income tax expense (benefit) for the years ended December 31, 2009 and 2008 was as follows:

|                            | 2009              | 2008              |
|----------------------------|-------------------|-------------------|
| Current year – Israel      | \$ 188,617        | \$ 154,282        |
| Current year – U.S.        | -                 | -                 |
| Deferred – U.S. and Israel | 276,055           | (27,278 )         |
| <b>Income tax expense</b>  | <b>\$ 464,672</b> | <b>\$ 127,004</b> |

The actual tax expense differs from the "expected" tax expense for the years ended December 31, 2009 and 2008 (computed by applying the Israeli tax rate (26% and 27%, respectively) to income before taxes) as follows:

|   | 2009              | 2008              |
|---|-------------------|-------------------|
| Computed "expected" tax expense   | \$ 256,604        | \$ 227,260        |
| Non-tax deductible expenses   | 22,928            | 9,370             |
| Changes in income tax estimate from prior year (*)                                  | (33,693 )         | (288,177)         |
| Taxes on distribution of exempt income from Beneficiary Enterprise upon liquidation | 235,947           | -                 |
| Inflationary adjustment   | (4,121 )          | (5,035 )          |
| ASC 740 reserve   | 8,900             | 23,970            |
| Revenues tax exempt or taxable at different rate                                    | (111,425)         | (54,611 )         |
| Valuation allowance due to operating loss carry forwards in respect to US operation | 124,582           | 21,268            |
| Effect of change in tax rates on deferred taxes                                     | (44,040 )         | 158,219           |
| Other   | 8,990             | 34,740            |
|   | <b>\$ 464,672</b> | <b>\$ 127,004</b> |

(\*) Related to tax benefit for a Beneficiary Enterprise in the previous years.

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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, 2009 and 2008 were as follows:

|   | 2009              | 2008              |
|---|-------------------|-------------------|
| <b>Deferred taxes asset – current:</b>  |                   |                   |
| Allowance for doubtful accounts   | \$ 76,657         | \$ 67,951         |
| Trading securities  | (14,755 )         | 18,978            |
| Reserve for vacation pay  | 63,611            | 81,302            |
| Net operating loss carry forward  | 23,197            | -                 |
| <b>Total deferred tax assets - current</b>  | <b>\$ 148,710</b> | <b>\$ 168,231</b> |
| <b>Deferred taxes asset, net - non current:</b>   |                   |                   |
| Depreciable fixed assets  | \$ 4,940          | \$ 19,122         |
| Net operating loss carry forward  | 409,962           | 285,380           |
| Liability for employee rights upon retirement   | 20,719            | 43,751            |
|   | 435,621           | 348,253           |
| Less – valuation allowance due to losses carry forward in respect of U.S. operation     | (409,962)         | (285,380)         |
| <b>Total deferred tax assets - non-current</b>  | <b>\$ 25,659</b>  | <b>\$ 62,873</b>  |
| <b>Deferred taxes liabilities, net - non current:</b>                                   |                   |                   |
| Depreciable fixed assets  | \$ (13,839 )      | \$ -              |
| Taxes on distribution of tax-exempt income from Beneficiary Enterprise upon liquidation | 245,797           | -                 |
| Liability for employee rights upon retirement   | (2,767 )          | -                 |
| <b>Total deferred tax liabilities - non-current</b>                                     | <b>\$ 229,191</b> | <b>\$ -</b>       |

At December 31, 2009, the US parent company and its US subsidiary had net operating loss carryforwards of approximately \$1,064,000 for income tax purposes, available to offset future taxable income expiring in 2024. The consolidated financial statements include a valuation allowance for such loss carry forwards in the amount of \$409,962 and \$285,380 for the years ended December 31, 2009 and 2008, respectively. The net change in the total valuation allowance for the years ended December 31, 2009 and 2008 was an increase of \$124,582 and \$21,268, 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 18% - 25% which are the expected rates to be in effect when the deferred tax assets and liabilities are realized.





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NOTE 12                    COMMITMENTS AND CONTINGENCIES

(A) Operating Lease Agreements

The Company's executive offices are located at 12 Hamefalsim Street, Petach Tikva, 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. Five of the operating leases are with affiliated parties. The monthly rental ranges from approximately \$585 to \$17,164.

Future minimum lease payments under the terms of the operating leases were as follows at December 31, 2009:

| Year | Related<br>Party | Unrelated<br>Party | Total     |
|------|------------------|--------------------|-----------|
| 2010 | \$ 417,533       | 134,976            | 552,509   |
| 2011 | 286,093          | 118,730            | 404,823   |
| 2012 | -                | 55,263             | 55,263    |
|      | \$ 703,626       | 308,969            | 1,012,595 |

Total rent expense under the operating leases for the years ended December 31, 2009 and 2008 was \$564,998 and \$556,976, respectively.

(B) Contingencies

The Company has an employment agreement with its former president, pursuant to which the former president is entitled to additional compensation of 1.5% of the growth in the Company's total sales since 2002. The former president, at his option, may receive shares of common stock in lieu of cash. For the years ended December 31, 2009 and 2008, there was no bonus entitlement due from Company.

(C) Guarantees and liens

- (1) As of December 31, 2009, guarantees of approximately \$1,553,833 were issued by banks on behalf of the Company's Israeli subsidiaries, mainly for performance in different projects and to guarantee Mayosar Technologies Ltd.'s liability under its agreement with Isorad Ltd. (see note 17).
- (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 take certain actions without informing the banks.
- (3) To secure liabilities to its principal bank, Owen Mills assigned and granted its principal bank collateral on all of its accounts with the bank.

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(D) Litigation

On February 11, 2009, a lawsuit was filed in the Jerusalem District Court against the Company's subsidiaries, Export Erez USA, Inc. and Achidatex, and Achidatex's chief executive officer, Mr. Avraham Hazor. The plaintiff recently filed a petition to add Export Erez to the claim. 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 (the "Sandals"), by failing to register the 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). The Company believes that the plaintiff's claim is unfounded and that it has substantial legal arguments to oppose the allegations and has filed a statement of defense rejecting the plaintiff's claims. In addition, Achidatex filed a claim against the plaintiff and others for a declaratory judgment that the plaintiff has breached his contractual undertakings towards Achidatex. Achidatex also filed a petition to remove the claim against Mr. Hazor and Export Erez USA, Inc. as there is no contractual or any other kind of privity between the plaintiff and Mr. Hazor and Export Erez USA, Inc. and, therefore, no cause for an action against them exists. The above petition is still pending. These claims are currently in their early stages and the Company intends to vigorously defend against the claim and to pursue the Company's counterclaim.

NOTE 13                      SHAREHOLDERS' EQUITY

Effective February 28, 2005, the Company acquired all of the outstanding shares of Owen Mills in consideration for a \$200,000 note 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 paid the owner of Owen Mills Company a total of \$200,000 (the present value of the remaining cash payments as of December 31, 2009 is \$19,802); (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 issuances of \$40,000 of the Company's common stock. 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. On June 8, 2009, the Company issued 209,424 shares of common stock having a fair value of \$40,000 and has no further obligation to issue any shares of common stock.

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Outstanding Stock Warrants:

As of December 31, 2009, warrants to purchase 202,500 shares of common stock were outstanding. These warrants have a remaining life of 0.5 years and an exercise price of \$2.40.

The Company adopted as of January 1, 2007, FASB ASC 815 "Accounting for Registration Payment Arrangements" (formerly FSP EITF 00-19-2) ("ASC 815"), which addresses an issuer's accounting for registration payment arrangements. The ASC 815 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 ASC 450 (formerly SFAS No. 5), "Accounting for Contingencies". The ASC 815 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 of December 31, 2009 and 2008, the Company has not recorded a liability for the registration payment arrangement.

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NOTE 14                    RELATED PARTIES

(A) Expenses Transactions with Related Parties

|  | 2009       | 2008       |
|--|------------|------------|
| Lease and rent expenses, see Note 12 (A) *     | \$ 401,492 | \$ 386,740 |
| Purchase of materials and maintenance costs ** | 137,314    | 275,460    |

(B) Balances with Related Parties

|  | 2009         | 2008         |
|--|--------------|--------------|
| Accounts payable controlling shareholder | \$ (129,900) | \$ (66,743 ) |
| Accounts payable **                      | (333,068)    | (1,514,354)  |

\*The Company is a party to lease agreements with its controlling shareholder and an affiliate company owned by the former minority shareholders of Achidatex and the controlling shareholder of the Company.

\*\*In 2008, the payable amount includes \$1,200,000 paid to the former minority shareholders of Achidatex in 2009 (see Note 1).

In 2009 and 2008, the payable amounts include debt for the purchase of materials and maintenance costs, during the ordinary course of business from an affiliate company, owned by the former minority shareholders and the controlling shareholder of the Company.

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NOTE 15                    SEGMENT INFORMATION AND CONCENTRATIONS

During 2009 and 2008, 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:

|                             | Civilian     |              | Military     |              | Consolidated  |
|-----------------------------|--------------|--------------|--------------|--------------|---------------|
|                             | Local        | Export       | Local        | Export       |               |
| December 31,<br>2009        |              |              |              |              |               |
| Revenue from sales          | \$ 2,625,347 | \$ 1,153,659 | \$ 7,467,792 | \$ 5,256,306 | \$ 16,503,104 |
| Gross Profits               | 709,665      | 176,552      | 1,442,258    | 1,060,013    | 3,388,488     |
| Corporate unallocated costs |              |              |              |              | 2,632,340     |
| Income from operations      |              |              |              |              | 756,148       |
| December 31,<br>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       |

(B) Geographic Areas - revenues

|                 | Year ended December 31, |               |
|-----------------|-------------------------|---------------|
|                 | 2009                    | 2008          |
| Israel          | \$ 10,093,141           | \$ 9,967,453  |
| South America   | 1,946,546               | 2,242,477     |
| North America   | 1,411,704               | 1,655,495     |
| Europe and Asia | 1,203,367               | 1,533,500     |
| Africa          | 1,848,346               | 2,771,583     |
| Total           | \$ 16,503,104           | \$ 18,170,508 |

(C) Single Customer Exceeding 10% of Sales:

|  | 2009         | 2008         |
|--|--------------|--------------|
| <b>Sales</b>   |              |              |
| Israeli Ministry of Defense and Government of Israel | \$ 7,121,326 | \$ 5,585,355 |
| <b>Accounts receivable balance</b>                   |              |              |
| Israeli Ministry of Defense and Government of Israel | \$ 1,608,806 | \$ 1,907,498 |

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NOTE 16                    COMPENSATION FROM GOVERNMENT

(A) Compensation for War Damages

Export Erez and Mayotex received \$50,909 and \$165,129, respectively, as compensation from the Israeli Government, under the "Property tax and compensation payments for war damages" Regulations, for the loss of employment days and potential revenues during the last two years due to the security and military situation in the area in which Export Erez and Mayotex were located. This \$216,038 of compensation has been recorded as a reduction to the Company's operating expenses in 2009.

(B) Company's 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 Elite. 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.

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.

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NOTE 17                      PENDING ACQUISITION

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

On December 21, 2008, Mayosar Ltd. (incorporated by Mayotex and Sarino) ("Mayosar"), through its wholly owned subsidiary Isorad IR Optics Ltd., ("Optics"), entered into an agreement to purchase the Germanium Crystals Business of Isorad Ltd., an Israeli governmental company ("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"). As of December 31, 2009, Isorad has not met certain conditions set out in the Isorad Agreement and, based on a legal advice received, this agreement has not been consummated.

Pursuant to the Sarino Agreement and subject to the approval of the Isorad Agreement:

(1) Mayotex and Sarino agreed to incorporate Mayosar, with Mayotex being the majority shareholder owning 50.1% and Sarino owning 49.9%. As majority shareholder, Mayotex will have operational control of Mayosar.

(2) In consideration of the above, Mayotex will pay Sarino \$1 million, out of which, \$300,000 will be non-refundable to Mayotex upon 24 months following the execution of the Isorad Agreement, and the remaining \$700,000 will be earned by Sarino based on 10% of sales over \$3 million and up to \$10 million during the first 36 months of operations. Amounts not earned are to be refunded to Mayotex, including interest of Libor + 2% per annum. The refundable consideration is secured by Sarino's interest in Mayosar.

(3) Mayotex agreed to provide Mayosar with a loan of up to \$2 million. Such loan will bear interest at the rate of Libor + 2%, and is payable from profits generated by Mayosar.

As of December 31, 2009, Mayotex provided loans of \$1 million to Sarino and \$0.9 million to Mayosar. Such payments are recognized as refundable deposits pending resolution of the Isorad Agreement.

Isorad Agreement (subject to approval):

Pursuant to the Isorad Agreement, Optics is to pay royalties of 3% out of sales for a period of 15 years commencing the effective date of the Isorad Agreement ( the "Effective Date"), with a minimum amount of approximately \$125,000 payable per year during the first 18 months or until the date of completion of the transfer of the site of the Germanium Crystals Business, whichever is earlier (this payment includes a reimbursement of costs for the usage of the site and equipment in this initial period), and approximately \$50,000 per year during the following years of the royalties payment period.



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Pursuant to the Isorad Agreement, Isorad was granted the right to acquire 5% of the share capital of Optics on a fully diluted basis for their nominal value during the 24 month period beginning on the Effective Date. If the Israeli Government does not approve the 5% purchase of the Optics shares by Isorad within twelve (12) months of the Effective Date, the right to acquire the shares will expire and Isorad will be entitled to a payment of \$75,000.