NOVA MEASURING INSTRUMENTS LTD
Form 20-F
June 29, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 20-F

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) or (g)
OF THE SECURITIES EXCHANGE ACT OF 1934
OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2005
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
for the transition period from _____ to _____

Commission File Number 0-030668

NOVA MEASURING INSTRUMENTS LTD.

(Exact name of Registrant as specified in its charter)

Nova Measuring Instruments Ltd.	**Israel**
(Translation of Registrant s name into English)	(Jurisdiction of incorporation or organization)

Weizmann Science Park, Building 22, 2nd Floor, Ness-Ziona 76100, Israel
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	**Name of each exchange on which registered**
None	None

Securities registered or to be registered pursuant to Section 12(g) of the Act:
Ordinary Shares, nominal value NIS 0.01 per share
Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

15,457,471 Ordinary Shares, NIS 0.01 nominal (par) value per share, as of December 31, 2005

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

Yes o **No x**

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o **No x**

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

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 o **Item 18 x**

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o **No x**

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Introduction

In this Annual Report, the Company, Nova, we or our refers to Nova Measuring Instruments Ltd. and its consolidated subsidiaries, when the context requires.

The consolidated financial statements and selected consolidated financial data as of December 31, 2001, 2002, 2003, 2004 and 2005 and for each of the years in the five-year period ended December 31, 2005 (the Consolidated Financial Statements), included in this Annual Report have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP).

Our Functional Currency

Unless otherwise indicated, all amounts herein are expressed in United States dollars (U.S. dollars, dollars, USD, US$ or $).

The currency of the primary economic environment in which we operate is the U.S. dollar, since substantially all our revenues to date have been denominated in U.S. dollars and over 50% of our expenses are in U.S. dollars or in New Israeli Shekels linked to the dollar. Transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been re-measured into dollars as required by the principles in Statement No. 52 of the Financial Accounting Standards Board (FASB) of the United States of America. All exchange gains and losses from such re-measurement are included in the net financial income when they arise.

Cautionary Statement Regarding Forward-Looking Statements

Certain information contained herein, which does not relate to historical financial information, may be deemed to constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words or phrases will likely result, are expected to, will continue, is anticipated, estimate, project, believe, plan , or similar expressions identify forward looking statement statements, including statements relating to our anticipated sales, revenues and expenses in 2006, our expectations with respect to our ability to gain market share, add additional process equipment manufacturers as partners and to develop and introduce new products, possible outcomes of the litigation in which we are involved, possible outcomes of our efforts to consummate and integrate our pending acquisition or of our efforts to identify, complete and integrate future acquisition, anticipated growth of the semiconductor industry and metrology markets and expected changes in the semiconductor industry, are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results and those presently anticipated or projected. We wish to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We cannot guarantee future results, levels of activity, performance or achievements. We also undertake no obligation to release publicly any revisions to these forward looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Among the factors that could cause our actual results in the future to differ materially from any opinions or statements expressed with respect to future periods are competitive industry conditions and the ability to forecast the needs of the semiconductor industry with respect to the very cyclical nature of the industry and the very fast pace of technology evolutions. Various other factors that could cause our actual results to differ materially are set forth in Risk Factors starting on page 3 and elsewhere herein.

PART I

Item 1. Identity of Directors, Senior Management and Advisors

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

Selected Financial Data

The following selected consolidated financial data as of December 31, 2004 and 2005 and for the years ended December 31, 2003, 2004 and 2005 have been derived from our audited Consolidated Financial Statements included elsewhere in this report. These financial statements have been prepared in accordance with U.S. GAAP, and audited by our independent registered public accounting firm. The consolidated selected financial data as of December 31, 2003, 2002 and 2001 and for the years ended December 31, 2002 and 2001 have been derived from other consolidated financial statements not included in this Form 20-F that were also prepared in accordance with U.S. GAAP and audited by our independent registered public accounting firm. The selected consolidated financial data set forth below should be read in conjunction with and are qualified by reference to Item 5, Operating and Financial Review and Prospects and the Consolidated Financial Statements and notes thereto and other financial information included elsewhere in this report on Form 20-F.

Summary of Consolidated Financial Data

	Year ended December 31,				
	2001	**2002**	**2003**	**2004**	**2005**
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Revenues	$ 21,171	$ 20,371	$ 26,688	$ 36,806	$ 30,142
Cost of revenues	16,470	13,353	16,535	21,111	19,306
Gross profit	4,701	7,018	10,153	15,695	10,836
Operating expenses:					
Research and development expenses, net	13,253	9,894	8,561	8,665	9,301
Sales and marketing expenses	6,852	6,950	6,534	6,647	6,950
General and administrative expenses	3,032	1,797	1,898	2,331	3,626
Other operating expenses (income)	1,025	1,478	(2,203)	-	-
Total operating expenses	24,162	20,119	14,790	17,643	19,877
Operating loss	(19,461)	(13,101)	(4,637)	(1,948)	(9,041)
Financing income, net	2,587	144	425	528	627
Net loss	$ (16,874)	$ (12,957)	$ (4,212)	$ (1,420)	$ (8,414)
Loss per share:					

Loss per share	$ (1.16)	$ (0.88)	$ (0.28)	$ (0.09)	$ (0.55)
Shares used in calculation of basic and diluted loss per share	14,578	14,786	14,994	15,259	15,437

	December 31,				
	2001	2002	2003	2004	2005
	(in $ thousands)				
Consolidated Balance Sheet Data:					
Working capital	45,529	34,574	30,350	25,709	14,834
Total assets	59,564	49,008	47,918	49,966	42,339
Capital stock (including additional paid-in capital)	70,747	71,851	72,709	73,379	73,682
Shareholders equity	47,006	35,677	32,336	31,581	23,444

Risk Factors

Risks Related to Our Business and Our Industry

Because substantially all our current sales are dependent on a single product line, factors that adversely affect the pricing and demand for this product line could substantially reduce our sales.

Although we have expanded our product offering, we are still currently dependent on a single integrated process control product line targeting the chemical mechanical polishing market. We expect revenues from this product line to continue to account for a substantial portion of our revenues for at least the next year. As a result, factors adversely affecting the pricing of or demand for integrated process controls for the chemical mechanical polishing equipment field, such as competition and technological change, would substantially reduce our sales.

The markets we target are highly cyclical and it is difficult to predict the length and strength of any downturn or expansion period.

The semiconductor capital equipment market and industries, which are highly cyclical, experienced in 2004 significant increases in sales and decline of more than 10% in sales in 2005. During the first quarter of 2006, however, the market and industries changed direction and exhibited the first signs of an upturn. Although we rely on market research companies, we cannot predict the length and strength of the downturns or expansions. Furthermore, we have only a limited ability to reduce expenses during any industry downturn because of the need for significant ongoing expenditures related to engineering, research and development and worldwide customer service and support operations. As a result, during future downturns, we may incur additional losses greater than those we incurred in the past.

Our inability to reduce spending during a protracted slowdown in the semiconductor industry could reduce our prospects of achieving profitability.

Historically, we have derived all of our revenues, and we expect to continue to derive all of our revenues, from sales of our products and related services to the semiconductor industry. Our business depends in large part upon capital expenditures by semiconductor manufacturers, which in turn depend upon the current and anticipated demand for semiconductors. The semiconductor industry has experienced severe and protracted cyclical downturns and upturns. During cyclical downturns, we have in the past experienced, and will likely in the future experience, material reductions in the demand for the type of capital equipment and process technology that we offer and our sales and revenues might decline again. In addition, our ability to reduce expenses in response to any downturn or slowdown in the rate of capital investment by manufacturers in these industries may be limited because of:

our continuing need to invest in research and development,

our capital equipment requirements, and

our extensive ongoing customer service and support requirements worldwide.

As a result, we may have difficulty achieving profitability.

If we do not respond effectively and on a timely basis to rapid technological change, our ability to attract and retain customers could be diminished, which would hurt our sales and ability to remain competitive.

The semiconductor manufacturing industry is characterized by rapid technological change, new product introductions and enhancements and evolving industry standards. Our ability to remain competitive and generate sales revenue will depend in part upon our ability to develop new and enhanced systems at competitive prices in a timely and cost-effective manner and to accurately predict technology transitions. Because new product development commitments must be made well in advance of sales, new product decisions must anticipate the future demand for products. If we fail to correctly anticipate future demand for products, our sales and competitive position will suffer. In addition, the development of new measurement technologies, new product introductions or enhancements by our competitors could cause a decline in our sales or loss of market acceptance of our existing products.

We may not be able to develop or market new products, which could slow or prevent our growth.

Our business plan requires the introduction of several new product lines. Our plans to introduce process control products for photolithography, etch and other processes will require development of new capabilities. Some of these projects are in the early stages of development, and we cannot be certain that we will be able to develop or bring to market these new product lines or, if we do, that these products will be well received or profitable. If we are unable to successfully introduce new product lines, our future growth could be adversely affected.

If any of our systems fail to meet or exceed our internal quality specifications, we cannot ship them until such time as they have met such specifications. If we experience significant delays or are unable to ship our products to our customers as a result of our internal processes, or for any other reason, our business and reputation may suffer.

Our products are complex and require technical expertise to design and manufacture. Various problems occasionally arise during the manufacturing process that may cause delays and/or impair product quality. We must actively monitor our manufacturing processes to ensure that our products meet our internal quality specifications. Any significant delays stemming from the failure of our products to meet or exceed our internal quality specifications, or for any other reasons, would delay our shipments. Shipment delays could harm our business, revenues and reputation in the industry.

New product lines that we may introduce in the future may contain defects, which will require us to allocate time and financial resources to correct.

Our new product lines may contain defects when first introduced. If there are defects, we will need to divert the attention of our personnel from our product development efforts to address the detection and correction of the defects. In the past, no liability claims have been filed against us for damages related to product defects, and we have not experienced any material delays as a result of product defects. However, we cannot assure you that we will not incur these costs or liabilities or experience these lags or delays in the future. Moreover, the occurrence of such defects, whether caused by our products or the products of another vendor, may result in significant customer relations problems and injury to our reputation and may impair the market acceptance of our products.

We have had a history of losses and may incur future losses.

Since our inception in 1993, we have incurred net losses in every year other than in 1998 and 2000 and may incur a net loss in 2006 or in future years. As of December 31, 2005, we had an accumulated deficit of approximately $50 million. We plan to continue similar levels of our aggregate product development, sales and marketing and administrative expenses over the next 12 months. Accordingly, to achieve profitability in 2006, we will need to significantly increase our sales. In the future, our sales may not grow and we may not achieve profitability.

Because we have a limited operating history with one product line, our historical results may not be indicative of our future results, and it is difficult to evaluate our business and prospects.

Our first system for chemical mechanical polishing applications was developed and introduced to the market in October 1995. Because this is the only product line with which we have significant manufacturing and marketing experience and because of our focus on the development and introduction of new products, our past operating results may not be indicative of our future results. Companies in an early stage of product development frequently have higher risks and encounter unexpected expenses and difficulties. These risks, expenses and difficulties apply particularly to us because the semiconductor manufacturing business is a rapidly evolving market characterized by technological advances. The uncertainty of our future performance increases the risk that the value of your investment will decline.

Our dependence on a single manufacturing facility magnifies the risk of an interruption in our production capabilities.

We have only one manufacturing facility, which is located in Ness-Ziona, Israel. Any event affecting this site, including natural disaster, labor stoppages or armed conflict, may disrupt or indefinitely discontinue our manufacturing capabilities and could significantly impair our ability to fulfill orders and generate revenues, thus negatively impacting our business.

We experience quarterly fluctuations in our operating results, which may adversely impact our stock price.

Our quarterly operating results have fluctuated significantly in the past, and we expect this trend to continue. A principal reason is that we derive a substantial portion of our revenue from the sale of a relatively small number of systems to a relatively small number of customers. As a result, our revenues and results of operations for any given quarter may decrease due to factors relating to the timing of orders by, shipments of systems and timing of recognizing these revenues. Furthermore, our quarterly results are affected by the highly cyclical nature of the semiconductor capital equipment market and industries.

We also have a limited ability to predict revenues for future quarterly periods and, as a result, face risks of revenue shortfalls. If the number of systems we actually ship, and thus the amount of revenues we are able to record in any particular quarter, is below our expectations, the adverse effect may be magnified by our inability to adjust spending quickly enough to compensate for the revenue shortfall.

We may not be able to expand our manufacturing capacity or marketing efforts quickly enough to support our future growth.

Because of our small size and our business strategy to aggressively increase our sales, we anticipate an increased demand on all of our resources. If we do not accurately estimate our need for personnel, manufacturing capacity or marketing and customer support, we may not be able to support our future growth.

We depend on a small number of large customers, and the loss of one or more of them would lower our revenues.

Our customer base is highly concentrated among a limited number of large customers, primarily because the semiconductor industry is dominated by a small number of large companies. We anticipate that our revenues will continue to depend on a limited number of major customers, although the companies considered to be our major customers and the percentage of our revenue represented by each major customer may vary from period to period. The loss of any of one of our major customers would adversely affect our sales and revenues. Furthermore, if any of our customers become insolvent or have difficulties meeting their financial obligations to us for any reason, we may suffer losses.

We operate in an extremely competitive market, and if we fail to compete effectively, our revenues and market share will decline.

Although the market for integrated process control systems used in semiconductor manufacturing is currently concentrated and characterized by relatively few participants, the semiconductor capital equipment industry is intensely competitive. We compete with Nanometrics Inc., Therma-Wave Inc. and Rudolph Technologies Inc., which manufacture and sell integrated process control systems. In addition, we compete with established manufacturers of conventional stand-alone measurement equipment, such as KLA-Tencor Corp., and original semiconductor equipment manufacturers, such as Tokyo Electron Ltd. Established companies, both domestic and foreign, compete with our product line, and new competitors are entering our market. Some of our competitors have greater financial, engineering, manufacturing and marketing resources than we do. If a particular customer selects a competitor s capital equipment, we expect to experience difficulty in selling to that customer for a significant period of time. A substantial investment is required by customers to evaluate, test, select and integrate capital equipment into a production line. As a result, once a manufacturer has selected a particular vendor s capital equipment, we believe that the manufacturer generally relies upon that equipment for the specific production line application and frequently will attempt to consolidate its other capital equipment requirements with the same vendor. Accordingly, unless our systems offer performance or cost advantages that outweigh a customer s expense of switching to our systems, it will be difficult for us to achieve significant sales from that customer once it has selected another vendor s system for an application. We believe that our ability to compete successfully depends on a number of factors both within and outside of our control, including:

- the contribution of our equipment to our customers productivity;
- our product quality and performance;
- our global technical service and support;
- the return on investment (ROI) of our equipment and its cost of ownership;
- the breadth of our product line; and
- our success in developing and marketing new products.

If we fail to compete in a timely and cost-effective manner against current or future competitors, our revenues and market share will decline.

The ongoing consolidation in our industry may harm us if our competitors are able to offer a broader range of products and greater customer support than we can offer.

We believe that the semiconductor capital equipment market is undergoing consolidation. A number of suppliers have been acquired by larger equipment manufacturers. For example, in 2005 Rudolph Technologies Inc. acquired August Technologies Inc. and in 2006 Nanometrics Inc. acquired Soluris Inc. and signed an agreement to acquire Accent Technologies. We believe that similar acquisitions and business combinations involving our competitors and customers may occur in the future. These acquisitions could adversely impact our competitive position by enabling our competitors and potential competitors to expand their product offerings and customer service, which could provide them an advantage in meeting customers needs, particularly with those customers that seek to consolidate their capital equipment requirements with a smaller number of vendors. The greater resources, including financial, marketing and support resources, of competitors involved in these acquisitions could permit them to accelerate the development and commercialization of new competitive products and the marketing of existing competitive products to their larger installed bases. Accordingly, such business combinations and acquisitions by competitors or customers could jeopardize our competitive position.

We may not be successful in our efforts to consummate and integrate our pending acquisition of HyperNex Inc. or in our efforts to identify, complete and integrate future acquisitions, which could disrupt our current business activities and adversely affect our results of operations or future growth.

On April 24, 2006 we entered into an Asset Purchase Agreement with HyperNex, Inc. and its shareholders, providing for the acquisition of substantially all the assets of HyperNex and the assumption of certain specified liabilities. The consummation of the acquisition of HyperNex is being delayed because of the refusal of a key supplier of HyperNex to consent to the assignment of its contract with HyperNex to Nova. We have commenced litigation against the key supplier generally asserting that it is unreasonably withholding its consent to the assignment, contrary to the terms of its contract with HyperNex. The proceedings are at a very early stage and we cannot predict the outcome of the litigation. Similarly, we cannot predict whether we will be able to consummate our pending acquisition of HyperNex. For more information regarding the HyperNex acquisition see Material Contracts beginning at page 55.

The pending acquisition of HyperNex and any future acquisition involve many risks, including the risks of:

diverting management s attention from our ongoing business concerns;

entering markets in which we have no direct prior experience;

improperly evaluating new services, products and markets;

being unable to maintain uniform standards, controls, procedures and policies;

being unable to integrate new technologies or personnel;

incurring the expenses of any undisclosed or potential liabilities; and

the departure of key management and employees.

If we are unable to successfully complete the acquisition or to effectively integrate HyperNex or any future acquisitions, our ability to grow our business or to operate our business effectively could be reduced, and our business, financial condition and operating results could suffer. Even if we are successful in completing acquisitions, we cannot assure you that we will be able to integrate the operations of the acquired business without encountering difficulty regarding different business strategies with respect to marketing, integration of personnel with disparate business backgrounds and corporate cultures, integration of different point-of-sale systems and other technology and managing relationships with other business partners.

Because we are small, we depend on a small number of employees who possess both executive and technical expertise, and the loss of any of these key employees would hurt our ability to implement our strategy and to compete effectively.

Because of our small size and our reliance on employees with both executive and advanced technical skills, our success depends significantly upon the continued contributions of our officers and key personnel. All of our key management and technical personnel have expertise, which is in high demand among our competitors, and the loss of any of these individuals could cause our business to suffer. We do not maintain life insurance policies for our officers and directors.

Our lengthy sales cycle increases our exposure to customer cancellations or delays in orders, which may result in obsolete inventory and volatile quarterly revenues.

Sales of our systems depend, in significant part, upon our customers adding new manufacturing capacity or expanding existing manufacturing capacity, both of which involve a significant capital commitment. We may experience delays in finalizing sales following initial system qualification while a customer evaluates and approves an initial purchase of our systems. In general, for new customers or applications, our sales cycle takes between three and 24 months to complete. During this time, we may expend substantial funds and management effort, but fail to make any sales. Lengthy sales cycles subject us to a number of significant risks, including inventory obsolescence and fluctuations in operating results, over which we have little or no control.

Because of the technical nature of our business, our intellectual property is extremely important to our business, and our inability to protect our intellectual property would harm our competitive position.

We have obtained 49 U.S. patents and have 25 U.S. patent applications pending. In addition, we have obtained 29 non-U.S. patents and have more than 60 non-U.S. patent applications pending.

We cannot assure you that:

- pending patent applications will be approved;
- any patents will be broad enough to protect our technology, will provide us with competitive advantages or will not be challenged or invalidated by third parties; or
- the patents of others will not have an adverse effect on our ability to do business.

We also cannot assure you that others will not independently develop similar products, duplicate our products or, if patents are issued to us, design around these patents. Further, because patents may afford less protection under foreign law than is available under U.S. law, we cannot assure you that any foreign patents issued to us will adequately protect our proprietary rights.

In addition to patent protection, we also rely upon trade secret protection, employee and third-party nondisclosure agreements and other intellectual property protection methods to protect our confidential and proprietary information. Despite these efforts, we cannot be certain that others will not otherwise gain access to our trade secrets or disclose our technology.

Furthermore, we may be required to institute legal proceedings to protect our intellectual property. If such legal proceedings are resolved adversely to us, our competitive position and/or results of operations could be harmed. For additional information on our intellectual property, including information regarding a patent infringement lawsuit we commenced against Nanometrics Inc., and information regarding a patent infringement lawsuit Nanometrics commenced against us, see Intellectual Property starting on page 21 of this report.

There has been significant litigation involving intellectual property rights in the semiconductor and related industries and similar litigation involving Nova could force us to divert resources to defend against this litigation or deter our customers from purchasing our systems.

We have been, and may in the future be, notified of allegations that we may be infringing intellectual property rights possessed by others. In addition, we may be required to commence legal proceedings against third parties, which may be infringing our intellectual property, in order to defend our intellectual property. In the future, protracted litigation and expense may be incurred to defend ourselves against alleged infringement of third party rights or to defend our intellectual property against infringement by third parties. Adverse determinations in that type of litigation could:

- result in our loss of proprietary rights;
- subject us to significant liabilities, including treble damages in some instances;
- require us to seek licenses from third parties, which licenses may not be available on reasonable terms or at all; or
- prevent us from selling our products.

Any litigation of this type, even if we are ultimately successful, could result in substantial cost and diversion of time and effort by our management, which by itself could have a negative impact on our profit margin, competitive position and ability to develop and market new and existing products. For additional information on our intellectual property, including information regarding a civil action we commenced against Nanometrics Inc., and information regarding a civil action Nanometrics commenced against us, see Intellectual Property starting on page 21 of this report.

We depend on a limited number of suppliers, and in some cases a sole supplier. Any disruption or termination of these supply channels may adversely affect our ability to manufacture our products and to deliver them to our customers.

We purchase components, subassemblies and services from a limited number of suppliers and occasionally from a single source. Disruption or termination of these sources could occur, and these disruptions could have at least a temporary adverse effect on our operations. To date, we have not experienced any material disruption or termination of our supply sources. A prolonged inability on our part to obtain components included in our systems on a cost-effective basis could adversely impact our ability to deliver products on a timely basis, which could harm our sales and customer relationships.

We are dependent on international sales, which expose us to foreign political and economic risks that could impede our plans for expansion and growth.

Our principal customers are located in the United States, Japan, Taiwan and South Korea and we produce our products in Israel. International operations expose us to a variety of risks that could seriously impact our financial condition and impede our growth. For instance, trade restrictions, changes in tariffs and import and export license requirements could adversely affect our ability to sell our products in the countries adopting or changing those restrictions, tariffs or requirements. This could reduce our sales by a material amount.

Because we derive a significant portion of our revenues from sales in Asia, our sales could be hurt by the instability of Asian economies.

A number of Asian countries have experienced political and economic instability. For instance, Taiwan and China have had a number of disputes, as have North and South Korea, and Japan has for a number of years experienced significant economic instability. We have a subsidiary in Taiwan and we have significant customers in Japan and South Korea. An outbreak of hostilities or other political upheaval or economic downturns in these or other Asian countries would likely harm the operations of our customers in these countries, causing our sales to suffer.

A large number of our ordinary shares continue to be owned by a relatively small number of shareholders, whose future sales of our stock, if substantial, may depress our share price.

If our principal shareholders sell substantial amounts of our ordinary shares, including shares issued upon the exercise of outstanding options, the market price of our ordinary shares may fall. As of December 31, 2005 we had 15,457,471 ordinary shares outstanding, of which 10,975,051 shares were held by nine shareholders.

Because four of our shareholders control approximately 51.6% of our ordinary shares, they can control the outcome of matters submitted to a vote of our shareholders, including the election of directors.

As of April 30, 2006, four of our shareholders controlled approximately eight million, or 51.6%, of our ordinary shares. As a result, and although we are currently not aware of any voting agreement between such shareholders, if these shareholders voted together or in the same manner, they would have the ability to control the outcome of corporate actions requiring an ordinary majority vote of shareholders as set in the Company s articles of association. Even if these four shareholders do not vote together, each has the ability to influence the outcome of corporate actions requiring the vote of shareholders as set in the Company s article of association. For additional information on our major shareholders, see Major shareholders on page 46.

Risks Related to Operations in Israel

Potential political, economic and military instability in Israel may adversely affect our growth and revenues.

Our principal offices and manufacturing facilities and many of our suppliers are located in Israel. Although most of our sales are currently being made outside Israel, political, economic and military conditions in Israel directly affect our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors. Conflicts between Israel and Palestinian militant groups have been ongoing. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. The resumption of hostilities in the region, and the on-going tension in the region, have a negative effect on the stability of the region which might have negative effect on our business and harm our growth and revenues. For further detail see Political and economic conditions in Israel starting on page 36.

Our operations may be disrupted by the obligation of key personnel to perform military service.

Some of our executive officers and employees in Israel are obligated to perform up to 36 days of military reserve duty annually. This time-period may be extended by the Military Chief of General Staff and the approval of the Minister of Defense or by a directive of the Minister of Defense in the event of a declared national emergency. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees due to military service. To date, our operations have not been materially disrupted as a result of these military service obligations, and no executive officer or key employee was recruited for any significant time period. Any disruption in our operations due to such obligations would adversely affect our ability to produce and market our existing products and to develop and market future products.

Because most of our revenues are generated in U.S. dollars, but a significant portion of our expenses is incurred in New Israeli Shekels, our profit margin may be seriously harmed by inflation and currency fluctuations.

We generate most of our revenues in U.S. dollars, but incur a significant portion of our expenses in New Israeli Shekels, commonly referred to as NIS. As a result, we are exposed to risk to the extent that the rate of inflation in Israel exceeds the rate of devaluation of the NIS in relation to the dollar or if the timing of this devaluation lags behind inflation in Israel with respect to such expenses that might increase as a result of inflation in Israel. In that event, the dollar cost of our operations in Israel will increase and our dollar measured results of operations will be adversely affected. Our operations also could be adversely affected if we are unable to hedge against currency fluctuations in the future. Accordingly, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar against the NIS. These measures, however, may not adequately protect us from material adverse effects due to the impact of inflation in Israel.

We participate in government programs under which we receive tax and other benefits. These programs impose restrictions on our ability to use the technologies developed under these programs. In addition, the reduction or termination of these programs would increase our costs.

We receive conditional grants from the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor for research and development programs that meet specified criteria. We are also eligible to receive tax benefits under Israeli law for capital investments that are designated as approved enterprises. To maintain our eligibility for these programs and tax benefits, we must continue to meet certain conditions, including paying royalties related to grants received and making specified investments in fixed assets. Some of these programs also restrict our ability to manufacture particular products and transfer particular technology, which was developed as part of the approved enterprises outside of Israel, by requiring approval of the research and development committee nominated by the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor under applicable law. Such approval may be given only if the recipient abides by all the provisions of the law and related regulations. Approval to manufacture products outside of Israel or consent to the transfer of technology, if requested, might not be granted.

If we fail to comply with these conditions in the future, the benefits received could be cancelled. We could also be required to pay increased taxes or refund any benefits previously received, adjusted for inflation and interest. In 2003, 2004 and 2005, we recorded an aggregate of $2.3 million, $1.9 million and $1.9 million, respectively, in conditional grants under Israeli government programs. As of December 31, 2005, our contingent liability to the Office of the Chief Scientist for grants received was approximately $5.7 million. See also Note 7A to our consolidated financial statements contained elsewhere in this report. From time to time, we submit requests for new grants from the Office of the Chief Scientist and for expansion of our approved enterprise programs. These requests might not be approved. The Israeli government has reduced the benefits available under these programs in recent years and has indicated that it may reduce or eliminate these benefits in the future. The termination or reduction of these grants or tax benefits could harm our business, financial condition and results of operations. In addition, if we increase our activities outside Israel due to, for example, future acquisitions, our increased activities generally will not be eligible for inclusion in Israeli tax benefit programs. Accordingly, our effective corporate tax rate could increase significantly in the future.

Any shareholder with a cause of action against us as a result of buying, selling or holding our ordinary shares may have difficulty asserting a claim under U.S. securities laws or enforcing a U.S. judgment against us or our officers, directors or Israeli auditors.

We are organized under the laws of the State of Israel, and we maintain most of our operations in Israel. Most of our officers and directors as well as our Israeli auditors reside outside of the United States and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, if you wish to enforce a judgment obtained in the United States against us, or our officers, directors and auditors, you will probably have to file a claim in an Israeli court. Additionally, you might not be able to bring civil actions under U.S. securities laws if you file a lawsuit in Israel. We have been advised by our Israeli counsel that Israeli courts generally enforce a final executory judgment of a U.S. court for liquidated amounts in civil matters after a hearing in Israel. If a foreign judgment is enforced by an Israeli court, it will be payable in Israeli currency. However, payment in the local currency of the country where the foreign judgment was given shall be acceptable, subject to applicable foreign currency restrictions.

Our shares are listed for trade on more than one stock exchange, and this may result in price variations.

Our ordinary shares are listed for trading on the Nasdaq National Market and on the Tel Aviv Stock Exchange. This may result in price variations. Our ordinary shares are traded on these markets in different currencies, U.S. dollars on the Nasdaq and New Israeli Shekels on the Tel Aviv Stock Exchange. These markets have different opening times and close on different days. Different trading times and differences in exchange rates, among other factors, may result in our shares being traded at a price differential on these two markets. In addition, market influences in one market may influence the price at which our shares are traded on the other.

We may be classified as a passive foreign investment Company and, as a result, our U.S. shareholders may suffer adverse tax consequences

Generally, if for any taxable year 75% or more of our gross income is passive income, or at least 50% of our assets are held for the production of, or produce, passive income, we may be characterized as a passive foreign investment company for U.S. federal income tax purposes. Our passive income would not include income derived from the sale of our products, but would include amounts derived by reason of a temporary investment of any cash amounts. This characterization could result in adverse U.S. tax consequences to our shareholders, including having gain realized on the sale of our shares be treated as ordinary income, as opposed to capital gain income, and having potentially punitive interest charges applied to such sales proceed. U.S. shareholders should consult with their own U.S. tax advisors with respect to the U.S. tax consequences of investing in our ordinary shares.

We believe that in 2005 we were not a passive foreign investment company. Nonetheless, because of the difficulty determining the value of our assets, there is a risk that we were a passive foreign investment company in 2005. Currently we expect that we will not be a passive foreign investment company in 2006. However, passive foreign investment company status is determined as of the end of the full tax year and is dependent on a number of factors, including the value of a corporation s assets and the amount and type of its gross income. Therefore, there can be no assurances that we will not become a passive foreign investment company for the current fiscal year ending on December 31, 2006 or any future year. For a discussion on how we might be characterized as a passive foreign investment company and related tax consequences, please see the section of this annual report entitled U.S. Taxation Passive Foreign Investment Companies.

Item 4. Information on the Company

History and Development of the Company

Nova Measuring Instruments Ltd. was incorporated in May 1993 under the laws of the State of Israel. We commenced operations in October 1993 to design, develop and produce integrated process control systems for use in the manufacture of semiconductors, also known as integrated circuits or chips. In October 1995, we began manufacturing and marketing systems for chemical mechanical polishing processes. We have since expanded our product offering to include systems designed for chemical vapor deposition, lithography and etch, and are continuing to develop new products and additional applications for our current products. These new offerings have not yet contributed a material amount to our sales.

In April 2000, we conducted an initial public offering pursuant to which we sold 3,000,000 ordinary shares for consideration of $54 million and net proceeds of $49.2 million. In connection with the public offering, our shares were listed for trading on the Nasdaq National Market.

In June 2002, we listed our shares in the Tel-Aviv Stock Exchange in Israel, pursuant to legislation which enables Israeli companies whose shares are traded on certain stock exchanges outside of Israel to be registered on the Tel Aviv Stock Exchange, while reporting, in substance, according to the provision of the relevant foreign securities law applicable to the company. The Israeli securities laws prescribe that as condition precedent to a company being eligible to register its shares for trade on the Tel Aviv Stock Exchange, the company s capital must consist of a single class of shares with equal voting rights with respect their par value. Accordingly, all of our series E shares were converted into ordinary shares in May 2002. This conversion was approved by the Tel Aviv District Court on May 2002 and our Articles of Association were amended accordingly.

We have four wholly owned subsidiaries in the U.S., Japan, Taiwan and Netherlands. These subsidiaries are engaged in marketing activities and provide technical support to our customers.

Our main office, research and development and production facilities are located in Israel at the Weizmann Science Park, Building 22, 2nd Floor, Ness-Ziona. Our telephone number at our main office is +1-972-8-938-7505. Our agent for service of process in the U.S. is Mr. David Gitlin, of Wolf, Block, Schorr and Solis-Cohen LLP, 1650 Arch Street, 22nd Floor, Philadelphia, PA 19103.

Overview

We are a worldwide leading designer, developer and producer of integrated process control metrology systems used in the manufacture of semiconductors and a leading designer, manufacturer and producer of stand-alone process control metrology systems. Metrology systems measure various thin film properties, critical circuit dimensions and layer-to-layer circuit alignment, known as overlay, during various steps in the semiconductor manufacturing process, allowing semiconductor manufacturers to increase quality, productivity and yields, lower their manufacturing costs and increase their profitability. We supply our metrology systems to major semiconductor manufacturers worldwide, either directly or through process equipment manufacturers. Of the 20 semiconductor manufacturers that had the highest capital equipment expenditures in 2005, 18 use our systems. The majority of our metrology systems are sold to process equipment manufacturers. These process equipment manufacturers integrate our metrology systems into their process equipment which is then sold to the semiconductor manufacturers. Our systems were first installed in 1995 and, since that time, we have sold more than 1,350 metrology systems.

The semiconductor manufacturing process starts with a silicon wafer that has been highly polished on one side to a mirror finish, upon which circuits are constructed. To construct the circuits, a series of layers of thin films that act as conductors, semiconductors or insulators are applied to the polished side of the wafer. During the manufacturing process, these film layers are subjected to processes which remove portions of the film layers, create circuit patterns and perform other functions. The semiconductor manufacturing process requires exacting steps and strict control of equipment performance and process sequences. Tight control can be achieved through monitoring silicon wafers and measuring relevant parameters after each process step with metrology tools such as those we produce.

Prior to the introduction of our integrated metrology systems, process control was achieved through stand-alone measurement equipment. Stand-alone measurement equipment requires semiconductor manufacturers to interrupt the manufacturing process sequence, remove sample silicon wafers from the process equipment and place the silicon wafers on the stand-alone measuring or inspection tool. In contrast, our integrated metrology approach is based upon patented measuring methods that enable us to produce optical measuring systems that are small enough to be integrated directly inside many types of semiconductor process equipment. We believe our integrated approach offers considerable advantages over the conventional stand-alone approach to metrology control, enabling manufacturers using our integrated equipment to reduce costs and to improve production efficiency, yield and quality.

We have emphasized our integrated metrology solutions in the past and intend to continue to do so. However, we also produce stand-alone metrology systems. We plan to leverage our technology, methods, metrology expertise and market position in the integrated metrology field to expand our offerings of stand-alone metrology systems. Our long-term strategy is focused on advanced metrology and process control solutions where our integrated process control products and stand alone products are compatible or complementary.

Demand for metrology systems, whether integrated or stand-alone, is driven by capital equipment purchases by semiconductor manufacturers, which in turn are driven by worldwide demand for semiconductors. Industry data indicates that the worldwide demand for semiconductors is growing. We believe that this growth in demand will drive demand for process control equipment, including metrology systems, as semiconductor manufacturers add capacity. Demand for metrology systems will also be driven by the increasing cost to manufacture semiconductors, which are becoming larger and more complex, and the demands of semiconductor manufacturers for process equipment that provides better film uniformity, increased dimensional control, tool-to-tool matching and within-tool uniformity.

Our Market

Growth of the Semiconductor Industry and the Metrology Market

The use of semiconductor devices continues to increase. Semiconductors are no longer used solely in personal computers and computer systems, but also in wireless communications, Internet infrastructure, Internet access devices, automobiles, portable electronic devices and other advanced consumer electronics. As a result of the increasing demand for semiconductors, the semiconductor industry has experienced significant growth over the past eight to 10 years, despite a severe downturn between 2000 and 2003. According to the Semiconductor Industry Association, worldwide sales of semiconductors decreased from $223 billion in 2000 to $178 billion in 2003, then increased to $220 billion in 2004 and $235 billion in 2005. Over the past decade, the increased use of semiconductors has driven demand for additional semiconductor manufacturing capacity. In turn, the addition of semiconductor manufacturing capacity, whether through new construction or refurbishment of existing manufacturing facilities, has been a driver of demand for metrology systems such as those we produce.

The increased use of semiconductors has been accompanied by in increase in their complexity. Due to the creation of new applications and markets for semiconductors, suppliers and manufacturers are faced with an increasing demand for new products that provide greater functionality and higher performance at lower prices. As a result, many new complex materials, structures and processes are being introduced to semiconductor manufacturing. New materials include copper, low- and high-k dielectrics, silicon-on-insulator, silicon-germanium, strained silicon and raised source/drain. Manufacturers are also increasingly moving toward 300 mm silicon wafers from 200 mm silicon wafers. While 300 mm wafers can yield up to twice as many integrated circuits as 200 mm wafers, larger wafers increase manufacturing challenges. For example, because 300 mm wafers can bend or bow more than twice as much as 200 mm wafers, they are more susceptible to damage. The larger area of 300 mm wafers also makes it more difficult to maintain film uniformity across the entire wafer. Semiconductors also continue to move toward smaller feature sizes and more complex multi-level circuitry. The increase in complexity of semiconductors and the resulting increase in the complexity and cost of the semiconductor manufacturing process has also been a driver of demand for metrology systems.

The ever-increasing level of complexity and the decrease in feature sizes has also significantly increased the cost and performance requirements of semiconductor fabrication equipment. The cost of wafer fabrication equipment has also increased due to the higher levels of automation being utilized by manufacturers. Thus, semiconductor manufacturers must increase their investment in capital equipment in order to sustain technological leadership, to expand manufacturing capacity and maintain profitability. According to published reports by an industry market research firm, the cost of building a state-of-the-art semiconductor manufacturing facility has grown from approximately $200 million in 1983 to over $3 billion for facilities capable of manufacturing 300 mm wafers. We believe that the process control equipment market, which includes the metrology segment, in the future will grow at a rate greater than the overall process equipment market since process control equipment is in the future expected to consume a larger portion of the overall costs of semiconductor manufacturing equipment.

While we expect that the demand for semiconductors will increase and the market for semiconductor process control equipment will expand, we cannot assure you that either will occur, that we will benefit from any increase in demand or expansion of the process control market, or that our products will be accepted in the market place. Our industry is intensively competitive and if we fail to compete effectively our revenues and market share will decline. In addition, the semiconductor industry, and the semiconductor capital equipment market in particular, are highly cyclical. Therefore, while we anticipate demand for semiconductors will increase and the market for semiconductors capital equipment will expand, it is likely that there will be periodic downturns which may be severe and protracted.

The Semiconductor Manufacturing Process

Semiconductors typically consist of transistors or other components connected by an intricate system of circuitry on flat silicon discs known as wafers. Integrated circuit manufacturing involves hundreds of individual steps, some of which are repeated several times, through which numerous copies of an integrated circuit are formed on a single silicon wafer. Typically, up to 30 very thin patterned layers are created on each wafer during the manufacturing process. At the end of the manufacturing process, the wafer is cut into individual chips or die. Because semiconductor specifications are extremely exacting, and integrated circuits are becoming more complex, requiring ever more sophisticated manufacturing processes, the process steps are constantly monitored, and critical parameters are measured at each step using metrology equipment.

Many of the manufacturing steps involve the controlled application or removal of layers of materials to or from the wafer. The application of materials to the wafer, known as deposition, involves the layering of extremely thin films of electrically insulating, conducting or semi-conducting materials. These layers can range from one-thousandth to less than one-hundred-thousandth of a millimeter in thickness and create electrically active regions on the wafer and its surface. A wide range of materials and deposition processes are used to build up thin film layers on wafers to achieve specific performance characteristics. One of the principal methods of thin film layer deposition is chemical vapor deposition (CVD). In CVD, a chemical is introduced into the chamber where the wafer is being processed and is deposited using heat and a chemical reaction to form a layer of solid material on the surface of the silicon wafer. Metrology systems monitor the thickness and uniformity of thin film layers during the deposition process.

Once the thin film has been deposited on the wafer to form a solid material, circuit patterns are created using a process known as photolithography. During this process, a light-sensitive coating called photoresist is applied to the wafer, which is then exposed to intense light through a patterned, opaque piece of glass. For the photolithography process to work properly, the thickness of the photoresist must be precise and uniform. In addition, to control the photolithography process, the film thickness, reflectivity, overlay registration and critical dimensions are all measured and verified. The exposed photoresist is developed when it is subjected to a chemical solution. The developed wafer is then exposed to another chemical solution, or plasma, that etches away any areas not covered by the photoresist to create the structure of the integrated circuit. Semiconductor manufacturers use metrology systems to verify the removal of material through the etch process and the critical dimensions of the structures created.

To meet the processing challenges posed by ever smaller feature sizes and because of the use of new materials such as copper in the manufacture of integrated circuits, manufacturers are increasingly using a process technology known as chemical mechanical polishing. Chemical mechanical polishing, or CMP, removes uneven film material deposited on the surface of the wafer from processes such as CVD and photolithography by carefully sanding the wafer with abrasives and chemicals, creating an extremely flat and even surface for the patterning of subsequent film layers. Metrology systems are used to control and verify the results of the CMP process by measuring the thin film layer to determine when the correct thickness has been achieved.

The processes described above are repeated in sequence until the last layer of structures on the wafer has been completed. Each integrated circuit on the wafer is then inspected and its functionality tested before shipment. Measurements taken by metrology systems during the manufacturing process help insure process uniformity and help semiconductor manufacturers avoid costly rework and mis-processing, thereby increasing efficiency and profitability.

The Need for Greater Overall Equipment Efficiency

We believe that one of the major challenges to achieving improvements in semiconductor manufacturing cost productivity is continuously improving equipment productivity. Overall equipment efficiency, that is, the percentage of time that processing equipment is utilized to produce wafers, is used as a metric to quantify the productivity of a processing tool. The major factors affecting productivity are equipment downtime, qualification time, mis-processing and operator skills. We believe that in order to improve cost productivity, earn an acceptable return on their investment in capital equipment and to meet the demand for improved semiconductor device performance, semiconductor manufacturers must find ways to improve overall equipment efficiency.

Process Control. The steps used to create semiconductors are an exacting processes that require strict control of equipment performance and process sequences for the resulting semiconductors to function properly. Tight control is achieved through monitoring of the in-process wafers and by measuring relevant parameters after each process step. These procedures are usually carried out on a small sample of the wafers. The monitoring may include measurement of several parameters, such as the thickness of the layers of thin film deposited, the sizes of the features that are patterned through the photolithography process, as well as the registration or alignment between two consecutive layers, known as overlay. Monitoring also includes inspection of the wafer for irregularities, defects or scratches. If parameters are out of specification or if defects or contamination are present, the manufacturer adjusts the process and measures another sample of wafers thereby allowing manufacturers to reduce costs and improve device performance.

Traditional Stand-Alone Process Control and Its Limitations. In the standard approach to semiconductor manufacturing, process control is a stand-alone operation. Stand-alone process control systems, however, impose a number of limitations on the semiconductor manufacturer. The semiconductor manufacturer must interrupt the process sequence and add extra steps in order to remove sample wafers from the fabrication process equipment and put them on a stand-alone measuring or inspection tool. The conventional stand-alone approach necessitates redundant robotic wafer handling hardware and software in both the process equipment and the stand-alone process monitoring tools, as well as additional wafer transferring automation systems between the two pieces of equipment, resulting in decreased factory efficiency and reduced productivity. In addition, removing the wafer samples from the process equipment to the metrology tool increases the risk of contamination or damage. As this removal significantly detracts from useable process time, it is not practical to make a large number of measurements, thereby compromising the accuracy of the measurement of process deviations and trends. If a measurement indicates that the process has been out of specification, the wafers made since the sample wafers were removed for inspection may have to be discarded or re-worked, actions that are increasingly costly for the manufacturer.

The Need for More Effective Process Control Tools. In addition to the inherent limitations of stand-alone process control systems, a number of technical and operational trends within the semiconductor manufacturing industry are strengthening the need for more effective process control solutions. These trends include:

Development of smaller semiconductor features. The development of smaller features, now as small as 90 nm in production, enables semiconductor manufacturers to produce larger numbers of circuits per wafer and to achieve higher circuit performance. As feature geometries decrease, manufacturing yields become increasingly sensitive to processing deviations and defects, as more integrated circuits are lost with every discarded wafer. In addition, the increased complexity and number of layers of the integrated circuits increase the chance of error during the manufacture of the wafer.

Shortening of technology life cycles. The technology life cycle of integrated circuits continues to shorten as semiconductor manufacturers strive to adopt new processes that allow a faster transition to smaller, faster and more complex devices. In the past, the technology life cycle was approximately three years; it is now only two years. The accelerating rate of obsolescence of technology makes early achievement of enhanced productivity and high manufacturing yields an even more critical component of a semiconductor manufacturer s profitability.

Transition to copper and other new materials. Copper metal layers and other new materials such as low and high k-dielectrics and silicon on insulator are increasingly replacing aluminum for advanced integrated circuits in order to increase performance and reduce the cost of integrated circuits. Copper and low-K materials make it possible to build higher speed devices using fewer layers. The use of copper and other new materials, requires new processing and metrology equipment and thus represents challenging developments for the semiconductor manufacturing industry.

Change to 300-millimeter wafers. The transition in wafer size from 200-millimeter diameter to 300-millimeter diameter that began in 1999more than doubles the number of integrated circuits per wafer. Maintaining process uniformity across these larger wafers is more difficult. Processing larger wafers also increases the cost of mistakes caused by both the larger number of integrated circuits per wafer and the greater complexity (and, therefore, cost) of processing larger wafers. Thus, with 300 mm wafers, the need for effective metrology to quickly detect and correct errors in the manufacturing process has increased. In addition, new metrology equipment is needed to accommodate the larger wafer size. It is forecasted that in 2006 80% of equipment sales will towards 300mm processing.

Increase in foundry manufacturing. As a result of the rising investment for semiconductor production and the proliferation of different types of semiconductors, semiconductor manufacturing is increasingly being outsourced to large semiconductor contract manufacturers, or foundries. A foundry typically runs several different processes and makes hundreds to thousands of different semiconductor product types in one facility, making the maintenance of a constant high production yield and overall equipment efficiency more difficult to achieve.

Increase in Automation. In an effort to achieve greater operating efficiencies, semiconductor manufacturers are increasingly relying upon automation. Automation represents the fastest growing segment of the semiconductor manufacturing industry.

In order to address the increasing costs associated with these trends, we believe semiconductor manufacturers must enhance manufacturing productivity. One way to enhance productivity is through improvements in process control, with a greater emphasis on metrology as part of process control. As part of this emphasis on metrology, manufacturers are taking more measurements to characterize each step of the semiconductor manufacturing process, new and enhanced measurement techniques are being used to provide meaningful data and the data provided is being used in new ways to enhance the manufacturing process. We believe that the demand for advanced process control systems that address the evolving needs of semiconductor manufacturers will continue to drive the growth in the market for process control systems, and integrated process control systems in particular.

We believe integrated metrology systems provide semiconductor manufacturers with the greatest opportunity to increase the productivity and yields of their equipment, thereby increasing their profitability. Therefore, we plan to continue to maintain a major focus on the integrated metrology market. However, recognizing that a significant number of semiconductor manufacturers will continue to rely upon stand-alone equipment, we intend to leverage our market leading position in the integrated metrology market and our metrology expertise to deepen our penetration of the stand-alone metrology market. Furthermore, the technological and operational trends within the semiconductor manufacturing industry that are strengthening the need for more effective process control solutions can sometimes be addressed through the use of stand-alone metrology equipment, although, we believe, that greater efficiency can be achieved through the use of integrated metrology systems.

The Nova Approach

Integrated Metrology

Our integrated metrology systems provide semiconductor manufacturers with more effective and efficient process control by measuring wafers and their properties without removing the wafer from the process equipment. All our products use our patented measuring methods that enable us to produce optical measuring systems that are small enough to be incorporated directly inside many types of equipment used in semiconductor processing. Integrated systems measure the wafer within the actual process environment, reducing labor and wafer handling as well as the risk of contamination of or damage to the wafer. In addition, we believe that our systems deliver significant increases in overall equipment efficiency through advanced process control, along with improving wafer-to-wafer uniformity, all with minimal operator intervention.

We provide our customers with flexible integrated process control solutions by offering systems that meet thin film measurement needs in critical applications in the fabrication process. Our integrated process control platform can be deployed to multiple processes and applications of semiconductor manufacturing.

Our systems can be installed directly in new equipment or used to upgrade existing equipment with minimal integration costs, extending the useful life of existing process equipment and saving significant capital costs. To our knowledge, only our metrology systems can be used to retrofit older 200 mm semiconductor manufacturing equipment, giving us a unique opportunity as manufacturers seek to increase production quickly to meet the increasing demand for semiconductors. Our pioneering approach, centered around our NovaReady integration package, later adopted by the process equipment manufacturers, allows process equipment manufacturers to prepare their equipment to accept our measurement and inspection systems, which can then be integrated with a simple plug-and-play installation.

We believe our integrated process control systems and solutions provide several important advantages to semiconductor manufacturers, enabling manufacturers to:

utilize the process equipment wafer handling system to allow measurement of the sample wafers while processing other wafers and avoid the need for the costly additional wafer handling required by stand-alone metrology systems;

perform the measurements without removing the wafer from the process equipment, increasing the efficiency of the process and decreasing the risk of contamination;

reduce capital costs of the fabrication facility by increasing overall equipment efficiency and reducing labor costs and necessary clean room area;

reduce the amount of time required to qualify process equipment that is usually idle during qualification steps, thus, minimizing costly equipment down-time;

reduce the number of test wafers; and

detect processing errors as early as possible.

We believe that as semiconductor manufacturers demand greater efficiency from their manufacturing equipment, process equipment manufacturers will increasingly seek to offer their customers integrated metrology in their tools to lower costs and increase overall efficiency. We believe the drive toward more efficient manufacturing operations in the face of increasing complexity will continue the trend of adopting integrated metrology solutions such as those we offer to multiple processes.

Stand-alone Metrology

We believe that our integrated metrology systems offer significant advantages over traditional stand-alone systems. We do, however, believe that a significant number of semiconductor manufacturers will continue to primarily use stand-alone metrology equipment for most of their manufacturing processes. In order to be able to serve all the metrology needs of our customers, whether integrated or stand-alone, we plan to leverage our position in integrated metrology to increase our offerings and market penetration for stand-alone systems.

As a result of the ever changing semiconductor manufacturing process and accompanying process control needs, we have begun to develop a new process control equipment concept. Under this concept, the same basic metrology will be used in different configurations, depending upon customer demands. For example, the same metrology module could be used as an integrated system inside the process equipment, as stand-alone systems or in metrology cluster tools. This would allow for easy customization of metrology solutions for any given process and would allow multiple metrology solutions to be combined in a single platform to answer all process needs. As we envision it, this new concept will allow semiconductor manufacturers unparalleled flexibility, upgradeability and affordability in both stand-alone and integrated forms. As technology life cycles continue to decrease, flexibility and upgradeability will become even more important. While we have not yet fully developed our new process equipment concept, we anticipate that we will begin offering new products based on the concept within the next 12 months. We cannot assure you, however, that we will be able to meet this anticipated schedule or that, if introduced, these products will be accepted by the market and purchased by customers in amounts sufficient to generate significant revenues or any profits.

Our Technology

We believe that our technological and engineering expertise and research and development capabilities allow us to develop and offer new products and technologies to meet the ever-changing demands of the semiconductor industry. We have applied our technological and engineering expertise to develop a wide range of integrated and stand-alone products for the CMP, copper CMP, etch and lithography processes. Because of our open architecture policy, our integrated metrology solutions can work with most models of CMP and etch tools made by the major process equipment manufacturers, for both 200 mm and 300 mm applications. In addition, to our knowledge, only our integrated metrology systems can be used to retrofit existing 200 mm process equipment, giving us a significant advantage over our competitors.

Our suite of technological capabilities includes:

Ellipsometry. Ellipsometry is a non-contact, non-destructive optical measuring technique used to measure very accurately the thickness and other properties of transparent thin films. When a surface is exposed to a polarized light laser, Ellipsometers measure the change in the reflected light s polarization. By using multiple light angles and multiple wavelengths, Ellipsometry can provide accurate and reliable measurement of a wide range of film thicknesses, film materials and film stacks.

Broadband Spectrophotometry. Our broadband Spectrophotometry capabilities range from deep ultraviolet to near infrared. This technology enables fast, accurate and small spot size film thickness measurement in large range of applications on a very cost effective basis, both as an integrated system and as a stand-alone system.

Scatterometry. Our Scatterometry systems are based on our broadband Spectrophotometry. These systems use fully polarized deep ultraviolet to near-infrared spectral light source. This technology enables fast and cost effective system development. Scatterometry provides two and three dimensional characterization of very fine geometries on patterned product wafers. These profiling and critical dimension capabilities are key enablers of advanced process control, allowing almost real time metrology of the most advanced design rule, down to 65 nm and below.

Imaging and image processing. This technology has three different applications: 1) navigating on product wafers to perform measurement on selected very small sites; 2) detecting defects on product wafers after critical process steps, such as lithography and etch; and 3) measurement of the accuracy of registration between two layers (overlay measurement), mostly used in lithography.

The measurement channels that we use in our metrology products are unique and protected by patented intellectual property. Our measurement channels include: polarized normal incidence spectral reflectometer/ellipsometer; multi-angle oblique incidence spectral ellipsometer; and multi-focal image overlay microscope. In addition, we are developing additional measurement channels including: multi-angle, multi-wavelength, null ellipsometer; eddy current micro-probe and phase imaging profilometer. In addition to these proprietary measurement channels, we are also seeking to acquire new measurement channels from third parties.

Throughout our history, we have been a technological leader in the integrated metrology field. We were the first to offer integrated metrology solutions for semiconductor manufacturers and are the only provider of integrated metrology solutions that can measure wafers in water, which allows for more efficient and accurate metrology. Furthermore, because our systems are small enough to fit inside wafer fabrication equipment, to our knowledge, only our metrology solutions can be used to retrofit older 200 mm systems. Our systems have also been recognized by the industry. In 2004, we received the prestigious Editors Choice Best Product Award from Semiconductor International magazine for our NovaScan 2020Cu, 3030Cu Copper CMP process monitoring.

Products

Our products include metrology systems for thin film measurement in chemical mechanical polishing and chemical vapor deposition applications; optical topography systems for use in post-copper chemical mechanical polishing applications; and optical critical dimension systems for lithography and etch applications. Our integrated thickness monitoring system for chemical mechanical polishing processing control enables wafer-to-wafer closed loop control. We offer several models of this integrated thickness monitoring systems, depending on polisher type and end-user requirements. These metrology systems address a broad range of metrology requirements of our end-user and process equipment manufacturer customers. Both our integrated and stand-alone systems incorporate patented optical scanning, dynamic auto-focus, unique pattern recognition for arbitrarily oriented wafers and proprietary algorithms for in-water measuring of two layers simultaneously. We offer several different product models that are tailored to both conventional chemical mechanical polishing equipment as well as to newer, high throughput polishers. Following is a summary of our products.

Thin Film Process Control

The NovaScan 840 combines high-speed measurement and effective handling, enabling measurement of wafers both before and after polishing. While we no longer market this system, this system and prior generations were our main revenue source in 2001 and prior years.

The NovaScan 2020 and 2040 are the second generation of integrated thickness monitoring systems with enhanced spectral range, responding to the needs of the industry for emerging chemical mechanical polishing high-end applications of thin films and complex layer stacks. The 2020 model was introduced to the market in the end of 2000, and since then has replaced the NovaScan 840 and accounted for the majority of our sales for 200 mm production lines. The NovaScan 2040 was introduced in 2002 and is the fastest integrated film thickness 200 mm measurement system in the market today.

The NovaScan 3030 and 3060 are the second generation of the 300mm measuring system, with improved optics and motion system enabling high speed measurement, and with broad spectral rage (ultraviolet to infrared) allowing accurate measurements on complex structures and thin film layers. The 3030 model was introduced to the market in 2001 and since then has replaced the NovaScan 3000 and accounts for the major portion of our sales for 300 mm production lines. The NovaScan 3060 was introduced in 2002 and is the fastest integrated film thickness 300 mm measurement system in the market today.

The NovaScan 2020Cu has the same basic platform as the NovaScan 2040, with additional hardware and software improvements, enabling the system to answer the unique requirements of copper chemical mechanical polishing monitoring. The system went through several beta tests during 2001 and 2002 and was released for sale in the beginning of 2003. This product did not generate significant revenues in 2004 or 2005, and we do not expect it to generate significant revenues in the following years.

The NovaScan 3030Cu has same basic platform as the NovaScan 3030, with additional hardware and software improvements, enabling the system to answer the unique requirements of 300 mm copper CMP monitoring. The system went through field-testing during 2002 and was released for sale in the beginning of 2003. This product generated approximately 10% of our revenues in 2005 and we currently do not expect it to generate a significantly higher portion of our revenues in the coming years.

The NovaScan 840CVD system is a 200 mm integrated metrology vacuum chemical vapor deposition measurement system, measuring different layers in the chemical vapor deposition process. Data can be fed forward to the chemical mechanical polishing process tool. Integration solutions were developed for different process equipment. The system was introduced to the market in the end of 2000 and several units have been sold. However, we do not expect to sell a significant number of these systems in the future.

The NovaScan 3090 CMP system is a scatterometry-based system for the chemical mechanical polishing metrology needs measuring thin films thicknesses in one, two or three dimensions. The system went through field-testing and was released for sale in 2005. We expect this system to account for a significant portion of our revenues in 2006.

The NovaScan 3090 CD system is a scatterometry-based system for measuring the critical dimensions (CD) and profiling lines and trenches on 200 mm and 300 mm wafers. The system went through field-testing during 2003 and was released for sale in 2004. The systems are sold as integrated metrology systems and as stand-alone systems with third-party automation modules.

The NovaScan 3090 SA is similar in performance to the NovaScan 3090 CD, providing full two and three dimension profiling capabilities in a stand-alone configuration. The systems are utilized in lithography, etch, thin film deposition and chemical mechanical polishing process. The system was released for sale in 2005.

A closed loop control option for the NovaScan systems delivers reliable, highly automated wafer-to-wafer uniformity over chemical mechanical polishing manufacturing processes. The thickness data of every processed wafer is obtained and process parameters are fed back to adjust the next wafer polish.

NovaNet is a highly sophisticated computer network, connecting all NovaScan systems on a factory floor. The network is managed by a dedicated server, running with proprietary software developed by Nova, and insuring safe recipe distribution and recipe integrity across the factory. The NovaNet also includes a report generator (NSA) that allows the creation of reports from all the systems connected and allows programmable cross sections.

While we continue to emphasize our integrated metrology solutions, we offer our products as stand-alone equipment as well, thereby significantly expanding our potential customer base. Revenues from stand-alone systems, however, were not a significant portion of our revenues in 2005. Furthermore, our revenues remain substantially dependent on sales of our CMP product line.

Research and Development

We have assembled a core team of experienced scientists and engineers who are highly skilled in their particular field or discipline. Our research and development core competencies, technologies and disciplines are in thin film metrology, and include measurement instruments, optical modeling, image acquisition, pattern recognition, equipment integration and fab automation. Our research and development staff consists of about 90 highly skilled members, including independent contractors. Our staff includes 25 scientists holding Ph.D. degrees and about 30 persons holding M.S. degrees. Since June 2003, our research and development operations have been certified as ISO9001/2000 quality standard.

The process control market is characterized by continuous technological development and product innovations. We believe that the rapid and ongoing development of new products and enhancements to our existing product line is critical to our success. Accordingly, we devote a significant portion of our technical, management and financial resources to developing new applications and emerging technologies. In 2003, 2004 and 2005, our research and development expenses, net of participation by the Office of the Chief Scientist, were $8.6 million, $8.7 million and $9.3 million, respectively, representing 32%, 24%, and 31% of our respective total revenues for those years. We anticipate that our research and development expenses, net, will be approximately $9 million in 2006.

Our research and development policy is based on a structured process of initiating new projects and on-going review of existing development projects. Our vision is to continue to be a market leader in the semiconductor process control market and our research and development policies and activities are designed to support this vision. Our launch of new development projects is based on market requirement specifications, generated through our marketing activities and research on customer needs, followed by a proposed detailed business plan, a detailed development plan with milestones, risk analysis, profit and loss model goals and required budget. Each development project is monitored through a structured process, including design reviews and project management reviews.

Intellectual Property

Our success depends in part upon our ability to protect our intellectual property. We, therefore, have an extensive program devoted to seeking patent protection for our inventions and discoveries that we believe will provide us with competitive advantages. We have been granted 49 U.S. patents and 29 non-U.S. patents and hold an exclusive license to one U. S. patent. The U.S. patents we hold have expiration dates ranging from 2014 to 2023. We also have 25 U.S. patent applications pending and more than 60 applications pending in other countries. Our patents and applications principally cover various aspects of optical measurement systems and methods, integrated process control implementation concepts, and optical, opto-mechanical and mechanical design. We have also registered four trademarks in the United States and two trademarks in countries other than the United States.

To protect our proprietary rights, we also rely on a combination of copyrights, trademarks, trade secret laws, contractual provisions and licenses. Our copyrights include software copyrights. We also enter into confidentiality agreements with our employees and some of our consultants and customers, and seek to control access to and distribution of our proprietary information, such as our proprietary algorithms.

While we attempt to protect our intellectual property through patents, copyrights and non-disclosure and confidentiality agreements, we may not be able to adequately protect our technology. Competitors may be able to develop similar technology independently or design around our patents and, despite our efforts, our trade secrets may be disclosed to others. Furthermore, the laws of countries other than the U.S. may not protect our intellectual property to the same extent as the laws in the U.S. We also cannot assure that: (i) our pending patent applications will be approved; (ii) any patents granted will be broad enough to protect our technology or provide us with competitive advantages or will not be successfully challenged or invalidated by third parties; or (iii) that the patents of others will not have an adverse effect on our ability to do business. We may also have to commence legal proceedings against third parties to protect our intellectual property, as we have done recently.

In March 2005, we filed a civil action in the United States District Court for the Northern District of California against Nanometrics Inc. seeking to enforce our United States Patent No. 6,752,689. This patent relates to an integrated optical measuring system. In the civil action, we seek an injunction against Nanometrics from infringing patent No. 6,752,689, monetary damages for willful infringement, attorneys fees and costs and expenses. Nanometrics has filed a counterclaim seeking judgment declaring the patent invalid, that Nanometrics does not infringe the patent and awarding Nanometrics costs and fees.

While we believe our patent is valid and enforceable, if the patent is invalidated, our competitors will likely be able to freely use the technology subject to the patent and our competitive position could be harmed. We cannot predict the outcome of the litigation or the extent of any harm we may suffer if our patent is declared invalid. Furthermore, we have incurred and it is likely that we will continue to incur, substantial costs which may be material. In addition, the litigation may divert management s time and attention from other matters.

In April 2006 Nanometrics filed a civil action in the United States District Court for the Northern District of California against us and our wholly-owned subsidiary, Nova Inc. alleging infringement of its United States Patent No. Re:34,783. This patent relates to measurements reflectance of materials. In the civil action, Nanometrics seeks an injunction monetary damages for willful infringement, attorneys fees, and costs and expenses. We filed our answer and counterclaim in May 2006, seeking a declaration that Nanometrics patent is invalid and unenforceable, and that neither us nor Nova Inc. infringe the patent. While we believe that Nanometrics claims are without merit and intend to aggressively defend against them, we cannot predict the outcome of the litigation. If the outcome of the litigation is adverse to us, we may become subject to significant liabilities, including treble damages; be required to seek licenses from Nanometrics or third parties, which licenses may not be available on reasonable terms or at all, or be prevented from selling our products. Any adverse outcome could be material. Furthermore, we have incurred and it is likely that we will continue to incur, substantial costs in connection with this litigation which may be material. In addition, the litigation may divert management s time and attention from other matters.

From time to time, we receive communications from others asserting that our products infringe or may infringe their intellectual property rights. Typically, our in-house patent counsel investigates these matters and, where appropriate, retains outside counsel to provide assistance. Other than the litigation with Nanometrics described above we are not presently involved in any material legal proceeds in which a third party has asserted that we have violated their intellectual property rights.If, however, we become involved in any such litigation and its outcome is adverse to us, it may result in a loss of proprietary rights, subject us to significant liabilities, including treble damages in some instances, require us to seek licenses from third parties which may not be available on reasonable terms or at all, or prevent us from selling our products. Furthermore, any litigation relating to intellectual property, even if we are ultimately successful, could result in substantial costs and diversion of time and effort by our management. This in and of itself could have an negative impact on us.

While, other than the litigation with Nanometrics described above, we are not currently involved in any material legal proceedings in which a third party has asserted that we have violated their intellectual property rights, we have become aware of a United States patent held by a competitor, which may be interpreted to cover some aspects of the products we sell in the United States. Nonetheless, we have not received any indications of intention to enforce this patent or any notice from the competitor with respect to this patent. In addition, the patent is being reexamined by the United States Patent and Trademark Office (USPTO), is unenforceable at this time, and may or may not survive the reexamination. If the USPTO decides to allow the patent to stand in some reexamined form, it is possible that the competitor could seek to enforce the patent rights against certain of our products sold in the United States, seeking damages, an injunction, or requiring us to pay royalties for a license. While we believe that we would be successful in any litigation seeking to enforce those patent rights, the ultimate outcome of any litigation or other legal proceedings cannot be predicted.

For additional information regarding our intellectual property, *see* Our Technology starting on page 18.

Our Customers, Sales and Marketing

Our two pronged, integrated sales and marketing strategy involves marketing our products directly to semiconductor manufacturers in addition to process equipment manufacturers in order to create demand for our products. We believe that the pricing structure of our NovaReady integration package enables process equipment manufacturers to increase their margins, and that the features and benefits of our systems can improve equipment yields, overall equipment efficiency and increase productivity, creating an incentive for process equipment manufacturers to promote our products to semiconductor manufacturers. At the same time, we believe that semiconductor manufacturers, eager to improve their own margins through increased factory throughput and yield improvements, will demand that the equipment they employ incorporate or use metrology systems such as those we manufacture. We believe that by marketing directly to end users as well as to process equipment manufacturers, we are able to ensure that both parties are aware of the wide range of benefits that our products can deliver, and that we are able to continuously enhance our products with functionality demanded by these two distinct types of customers.

To further enhance our marketing efforts, we have established a system of integrated sales and support activities with key process equipment manufacturers. This allows us to provide comprehensive and long-term application support directly to semiconductor manufacturers. We expect to continue to add new process equipment manufacturers as partners as we introduce new integrated process control systems that can be integrated with different types of equipment.

We also seek to establish and maintain close and mutually beneficial relationships with our customers by consistently providing them with a high level of service, support and new capabilities. We have established a global network of direct sales and marketing, customer service and applications support offices. We maintain sales, service or applications offices in Europe, Israel, Japan, Korea, Singapore, Taiwan, and the U.S., with a total staff of 70 people. These offices provide highly qualified application support specialists, training to process equipment manufacturer customers and end users, marketing, demonstrations and evaluations, spare parts hubs and sales and support engineers.

We serve all sectors of the integrated circuit manufacturing industry including logic, ASIC, foundries and memory manufactures. Our end user and process equipment manufacturer customers are located in different countries, including Japan, Korea, Singapore, Taiwan, the U.S. and various European countries.

The table below describes the distribution of our total revenues, from systems and services, according to the geographic location of the actual installation of our systems in end-user sites:

	Year ended December 31,		
	2003	2004	2005
	(in thousands)		
U.S.	$ 9,422	$ 15,943	$ 9,945
Europe	5,360	4,905	1,990
Japan	5,953	6,132	6,666
Asia-Pacific	5,953	9,826	11,541
Total	$ 26,688	$ 36,806	$ 30,142

The semiconductor industry is dominated by a small number of large companies. As a result, while our overall customer base is diverse, our sales are highly concentrated among a relatively small number of customers. The following table indicates the percentage of our total revenues derived from sales to our five largest customers and the range of these revenues from these customers for the periods indicated.

	Year ended December 31,			
	2002	2003	2004	2005
Total revenues from five largest customers	86%	87%	82%	83%
Range of revenues from five largest customers	4%-30%	3%-36%	3%-45%	2%-48%

We anticipate that our revenues will continue to depend on a limited number of major customers, although the companies considered to be our major customers and the percentage of our revenue represented by each major customer may vary from year to year. As our customer base is highly concentrated, if any of our customers becomes insolvent or has difficulties meeting its financial obligations to us, we may suffer losses that may be material in amount. A loss of any of our major customers may likewise cause us to suffer a material decrease in sales and revenue.

The highly competitive nature of the market for semiconductor capital equipment affects our ability to successfully implement our marketing and sale efforts. Competitive factors in the market for integrated process control systems include technological leadership, system performance, ease of use, reliability, cost of ownership, technical support and customer relationships. For integrated process control, an adequate business model, internal organization and unique process equipment manufacturer agreements and partnerships are also significant factors. We believe we compete favorably on the basis of these factors in the markets we serve.

Our current integrated products primarily compete with products manufactured by Nanometrics Inc. While we believe that in 2006 the successful launch of our NovaScan 3090 family of products will allow us to compete effectively, we expect our integrated products to face intense competition in 2006 and in the coming years. In the scatterometry field, which is a new application field in the semiconductor industry, used in CMP and etch processes, we face intense competition in both integrated and stand-alone metrology, from several companies.

Manufacturing

In order to leverage the relatively high volume of integrated systems we manufacture and to decrease production costs, we continue to focus our internal manufacturing activities on processes that add significant value or require unique technology or specialized knowledge and outsource others. Our manufacturing operations received the ISO 9002 quality mark by an international certification institute in October 1999. Since then, we have upgraded our quality systems to conform to ISO 9001/2000 requirements.

Our principal manufacturing activities include assembly, integration, final testing and calibration. Our production activities are conducted in our manufacturing and service facility in Israel. We rely and expect to continue to rely on subcontractors and turnkey suppliers to fabricate components, build assemblies and perform other non-core activities in a cost-effective manner. While we use standard components and subassemblies wherever possible, most mechanical parts, metal fabrications and critical components used in our products are engineered and manufactured to our specifications. A small portion of these components and subassemblies are obtained from a limited group of suppliers, and occasionally from a single source supplier.

We have the capacity to produce up to 80 systems per quarter in our current facilities. Currently, we are operating at approximately 70% of that capacity.

We have only one manufacturing facility, which is located in Ness-Ziona, Israel. Any event affecting this facility, including natural disaster, labor stoppages or armed conflict, may disrupt or indefinitely discontinue our manufacturing capabilities and could significantly impair our ability to fulfill orders and generate revenues.

Our Subsidiaries

Our subsidiaries and the countries of their incorporation are as follows:

Name of subsidiary	Country of incorporation
Nova Measuring Instruments Inc.	Delaware, USA
Nova Measuring Instruments K.K.	Japan
Nova Measuring Instruments Taiwan Ltd.	Taiwan
Nova Measuring Instruments Netherlands B.V.	Netherlands

Capital Expenditures

Our capital expenditures are primarily for network infrastructure, computer hardware and software, leasehold improvements of our facilities and system demonstration tools. None of these assets are held as collateral or guarantee other obligations. For additional information on our capital expenditures, see Liquidity and Capital Resources starting on page 34.

Properties and Equipment

Our main facilities, located in Ness-Ziona, Israel, occupy approximately 5,500 square meters, including: approximately 1,300 square meters of production facilities, approximately 3,000 square meters of research and development offices (including approximately 300 square meters of laboratories) and approximately 1,200 square meters of headquarters, sales and marketing, service and support and administration facilities. Our current lease commitment relating to our facilities in Israel expires at the end of 2007.

Our U.S. subsidiary leases approximately 400 square meters in Arizona and 300 square meters in Santa Clara for use as a pre-sale and support facility. Our Japanese and Taiwan subsidiaries lease approximately 200 and 300 square meters for use as a service and pre-sale facility, respectively. At the end of 2005 our Netherlands subsidiary closed it s offices which occupied approximately 100 square meters.

We believe that our facilities and equipment are in good operating condition and adequate for their present usage.

Government Regulation

For information relating to the impact of certain government regulations on our business, *see* Conditional Grants from the Office of the Chief Scientist starting on page 35.

Item 5. Operating and Financial Review and Prospects

Information in this Operating Review and Financial Prospects Section should be read in conjunction with our Consolidated Financial Statements and notes thereto which are included elsewhere in this report.

Executive Overview

We are a worldwide leading designer, developer and producer of integrated metrology systems for the semiconductor manufacturing industry and a leading designer, developer and producer of stand-alone metrology systems for the semiconductor industry. Our metrology systems are used to take precise measurements of semiconductors during the manufacturing process to control the manufacturing process and increase the productivity of the manufacturing equipment. We market and sell our metrology systems to semiconductor process equipment manufacturers and directly to semiconductor manufacturers.

Our business is greatly affected by the level of spending on capital equipment by semiconductor manufacturers. Capital expenditures by semiconductor manufacturers tend to be cyclical in nature and depend on numerous factors, many of which are beyond our control. Factors affecting the semiconductor industry, which are beyond our control, include general economic conditions throughout the world and the demand and perceived demand for semiconductors. In addition, demand for our products and services is affected by the timing of new product announcements and releases by us and our competitors, market acceptance of our new or enhanced products and changes or advances in semiconductor design or manufacturing processes.

In 2003, demand for semiconductors started to increase and, as a result, demand for capital equipment by semiconductor manufacturers also increased. This increased demand continued in 2004. Accordingly, our financial results for 2003 and 2004 improved. In 2005, however, demand for capital equipment decreased and the decrease is reflected in our financial results for 2005, in which we suffered steeper losses than in 2003 and 2004. As the industry began an upcycle toward the end of 2005 and current market research forecasts a growth of about 10% in the semiconductor capital equipment market for 2006, we are hopeful that we will be able to increase revenues in 2006. However, we cannot predict with certainty how long the industry upturn will last and whether we will be able to increase our sales and revenues.

We derive our revenues principally from sales of our metrology systems and services relating to our systems. In 2005, product sales produced 72.9% of our total revenues and services produced 27.1%. Presently, we have no long-term debt and continue to finance our operations mainly from the proceeds of our initial public offering in 2000. As of the end of 2005, we had working capital of $14.8 million, including cash and cash equivalents, short-term deposits and held to maturity securities of $22.8 million, and no long-term debt.

From quarter to quarter and from year to year, our revenues can vary significantly for a number of reasons. Importantly, we do not have long-term or multi-unit purchase contracts with our customers. Therefore, while most of our customers have purchased multiple systems from us and we anticipate that our customers will continue to do so, our customers can determine at any time to stop doing business with us. In addition, primarily because the semiconductor industry is dominated by a small number of large companies, our customer base is concentrated among a limited number of customers. A loss of any single customer could cause our revenues to decrease by a material amount. Furthermore, because our systems range in price from $100,000 to over $600,000, the loss of relatively few sales could also cause our revenue to decrease by a material amount. Our service revenues, which tend to be more predictable and less subject to wide fluctuations, tend to help decrease volatility in our earnings.

Our service organization is operated on a profit and loss basis and is measured as a cost center in each territory and on a global basis. The objectives of our service organization are defined and measured by: customer satisfaction; quality parameters, such as time to repair and mean time between failures; and by profit and loss criteria. The service organization provides support to all products we sell, during both the warranty period and the post warranty period.

When evaluating the performance of the Company, our management tends to focus on several financial metrics and several qualitative areas such as: warranty cost per system and warranty costs as a percentage of sale price; costs of production and costs of production as a percentage of sales; inventory as a percentage of yearly sales; days sales outstanding; and the mixture of our sales and geographical distribution of installations of our systems at end users sites compared to industry capital equipment trends. In 2005 and 2004, warranty costs amounted to approximately 10% of sale price. Factors that affect warranty costs include the number of systems installed in a specific site or territory and the maturity of the products. Costs of production include materials, labor, and write-off per product during product life time, and ranged from 34% to 44% of the sale price in 2005, depending on the product. Factors that affect cost of production include sales volume, product configuration, product maturity, and actual sale price. Our average inventory levels in 2005 and 2004 were approximately 21% and 16% of yearly sales, respectively. In 2005, average days sales outstanding for total revenues were 65, and ranged between 57 and 71 days over the four quarters of 2005. Geographical distribution analysis of installation at end users sites of our products reveals an increase in the installation of our products in Japan from 15% of sales in 2004 to 22% in 2005 and in Asia-Pacific (excluding Japan) from 32% of sales in 2004 to 38% in 2005. This trend is in line with the industry capital equipment trend of higher investments in Japan and in the Asia-Pacific region in 2004 and 2005. In 2006, the Company intends to continue to focus on these regions and seek to increase its market share in strategic accounts sites.

Significant Events in 2005 and Outlook for 2006

For Nova, the most significant event in 2005 was the release of the new NovaScan 3090 product family following a delay of about six months. As a result of the delayed introduction of the new NovaScan 3090, we lost some of our market share to a competitor and suffered a decrease in our revenue. In addition, in 2004 and 2005, our relationship and integration with a major equipment manufacturer for the etch process led to several joint evaluation processes in strategic accounts creating the potential for multiple systems sales in the etch segment in future years.

In the first half of 2005, we saw a mild slowdown in the semiconductor equipment industry. This trend, together with the loss of three strategic end user accounts to our competition, were the main reasons for our 50% revenues decline in the first quarter of 2005 compared to the fourth quarter of 2004. Recent semiconductor and industry projections, however, indicate the industry is expected to return to growth in 2006. If the industry returns to growth, we believe semiconductor manufacturers will seek to add capacity and accelerate production, resulting in increased demand for capital equipment, including metrology systems such as those we sell. We are also selling our NovaScan 3090 products in several strategic accounts and we expect to regain market share in 2006.

Other trends in the industry include the move toward more complex semiconductor devices and the adoption of more sophisticated manufacturing techniques. We believe these trends are positive developments for the semiconductor metrology market because, as semiconductors and their manufacture become more complex and sophisticated, manufacturers will increasingly look to make their operations more efficient. Metrology systems can help deliver that efficiency. For additional information on industry trends, see Item 4 Information on the Company starting on page 12.

Nova will focus in 2006 on continuing development of its current chemical mechanical polishing (CMP), copper CMP and optical critical dimension systems as well as investing in the products and technologies included in its long-term strategy. Over the next three years, Nova anticipates introducing future generations of its current products and new product to address the advancing technology trends toward feature sizes of 45 nm and below and new processes and materials. We believe that in 2006 our opportunities will most likely come from the increased need for monitoring and control resulting from decreasing feature sizes, and the accelerating move to 300 mm equipment and new materials. The main challenges and risks we see are to be on time with the right process control solutions to meet the needs of our existing customers and new customers. In order to address these risk and challenges, we are working closely with leading customers development process groups and with the leading process equipment manufacturers. The purpose of working closely with customers and process equipment manufacturers is to receive from them as early as possible information and feedback on the metrology and process needs of the upcoming new manufacturing processes and materials. We believe receiving this information as early as possible will assist us in developing metrology solutions to meet the new needs of the semiconductor industry. In tandem with this type of long term development, our ongoing marketing activity supports our current products with short term improvements to answer the customers ongoing needs and to make required changes.

Currently, our main revenue generator is our oxide CMP product line and sales of our oxide CMP product line are affected by the total number of process tools sold in this segment. In years prior to 2003, the oxide CMP represented more than 50% of the entire CMP equipment market. In 2004, this percentage decreased and we expect it to continue to decrease as copper CMP equipment is expected to dominate the CMP equipment market. We can not foresee what will ultimately be the process control needs for copper CMP, and whether the products and solutions we will bring to market for the copper CMP market will be accepted in the market.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principals generally accepted in the United States of America. We believe the following critical accounting policies, among others, affect our more significant judgments and estimates used the preparation of our Consolidated Financial Statements.

Use of estimates - General

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue recognition

We recognize revenues upon the shipment of our products to the customer or provision of support service, provided that persuasive evidence of an arrangement exists, title has transferred, the price is fixed, collection of resulting receivables is probable and there are no remaining significant obligations.In cases of arrangements with multiple deliverables, revenue is typically recognized upon shipment, if collection of the resulting receivable is probable, the fee is fixed or determinable, and vendor-specific objective evidence exists to allocate a portion of the total fee to any undelivered elements of the arrangement. Such undelivered elements in these arrangements typically consist of services and/or upgrades. If vendor-specific objective evidence does not exist for the undelivered elements of the arrangement, all revenue is deferred until such evidence does exist, or until all elements are delivered, whichever is earlier. When transactions involve newly introduced products or when customers specify acceptance criteria that cannot be demonstrated prior to the shipment, we defer the relevant revenues.

Service contracts (which sometimes include application support) generally specify fixed payment amounts for periods longer than one month, and are recognized on a straight line basis over the term of the contract. Revenue from sale of spare parts is usually recognized upon shipment of the parts.

Allowances for doubtful accounts

We review on an on-going basis the need for allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. When determining what allowance, if any, to make for doubtful accounts, we review many factors, including our history of relatively few write-offs, customer relationships and customers creditworthiness. Based on this review, we estimate the amount of accounts receivable, if any, we may be unable to collect and allowances for doubtful accounts may be required. To date, based upon management s review, no allowance for doubtful accounts was deemed necessary. If the financial condition of our customers were to deteriorate, their ability to make payments could be impaired and our estimates could prove to be inaccurate. If significant, allowances for doubtful accounts could have a material adverse effect on our financial results.

Warranty provisions

We provide for the estimated cost of product warranties at the time revenue is recognized. While we are engaged in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers, our warranty obligations are affected by product failure rates, material usage and service delivery costs incurred in correcting product failures at our locations or at customer sites. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability may be required.

Inventories write-off

We value our inventory at the lower of the actual cost or the current estimated market value of the inventory. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and production requirements for the next twelve months. As demonstrated during 2001, demand for our products can fluctuate significantly. A significant increase in the demand for our products could result in a short-term increase in inventory purchases while a significant decrease in demand could result in an increase in the amount of excess inventory quantities on hand, which could lead to losses. In addition, our industry is characterized by rapid technological change, frequent new product developments, and rapid product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. Additionally, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if our inventory is determined to be overvalued, we would be required to recognize such costs in our cost of goods sold at the time of such determination. Likewise, if our inventory is determined to be undervalued, we may have over-reported our costs of goods sold in previous periods and would be required to recognize such additional operating income at the time of sale. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results.

For a discussion of other significant accounting policies used in the preparation of our financial statements and recent accounting pronouncements, see Note 2 to our Consolidated Financial Statements contained elsewhere in this report.

Operating results

Overview

A significant portion of our revenues historically has been derived from customers in the United States of America, and we expect that this trend will continue, although we expect that U.S. sales as a percentage of total sales may decrease as our total sales and sales to other geographic areas, particularly Asia, increase. In 2003, 62% of our revenues were derived from U.S. customers, 10% were from European customers, 21% were from Japanese customers, and 7% were from Asian (other than Japanese) customers. In 2004, 67% of our revenues were derived from U.S. customers, 11% were from European customers, 18% were from Japanese customers, and 4% were from Asian (other than Japanese) customers. In 2005, 66% of our revenues were derived from U.S. customers, 11% were from European customers, 18% were from Japanese customers, and 5% were from Asian (other than Japanese) customers.

The table below describes the distribution of our total revenues, from systems and services, by geographic areas of our product installations at semiconductor manufacturing facilities. As our customers include both semiconductor manufacturers and process equipment manufactures, this distribution is different from the distribution of our revenues by customer location discussed in the immediately preceding paragraph.

	2003	2004	2005
USA	36%	41%	33%
Europe	20%	12%	7%
Japan	22%	15%	22%
Asia-Pacific	22%	32%	38%
Total	100%	100%	100%

Historically, a substantial portion of our revenues has come from a small number of customers. In 2003, 2004 and 2005, our five largest customers accounted for 87%, 82 % and 83% of our revenues, respectively. In 2003, 2004 and 2005, our single largest customer accounted for 36%, 45% and 48% of our revenues, respectively. We anticipate that our revenues will continue to depend on a limited number of major customers, although the companies considered being major customers and the percentage of our revenue represented by each major customer may vary from period to period. Therefore, the loss of any one of our major customers could materially and adversely affect us.

The sales cycle for our systems typically ranges from three to 24 months and depends upon the status of our system s integration with a particular manufacture and model of process equipment, the evaluation criteria of our customers, and the technology or application of the process. Additionally, the rate and timing of customer orders may vary significantly from month to month as a function of the introduction of a new type of system to a production line. We have a relatively low backlog. Accordingly, if sales of our products do not occur when we expect or we are unable to adjust our estimates on a timely basis, our expenses and inventory levels may fluctuate relative to revenues and total assets. In 2005, our inventory levels at the end of each quarter ranged from $5.8 million to $6.9 million. We planned our 2005 inventories for sales of 200 mm systems and 300 mm systems according to our expectation that approximately 70% of equipment sales would be for 300 mm equipment and that the NovaScan 3060 would account for most of our sales of 300 mm systems. Actual sales in 2005 were similar to this plan. In 2006, we anticipate proliferation of the new NovaScan 3090 product series for the 300 mm market, and expect that 50% of our 300 mm sales will derive from NovaScan 3090 products and 50% from NovaScan 3060 products. If our actual sales are significantly different from our expectations, we may have to write-off some of our inventory.

We schedule production of our systems based upon order backlog and customer forecasts. We include in backlog only those orders to which the customer has assigned a purchase order number and for which delivery has been specified within 12 months. As of December 31, 2005 we had an insignificant backlog. In general, because shipment dates may be changed and customers may cancel or delay orders with little or no penalty, our backlog as of any particular date may not be a reliable indicator of actual sales for any succeeding period. We do not maintain any reserves for cancellations or variations in our customers orders because historically cancellations and variations have been insignificant. In addition, if a cancellation occurs, we may be able to sell the equipment to other customers.

Our revenues decreased 18% in 2005 following 38% increase in 2004 and 31% increase in 2003.

The following table shows the relationship, expressed as a percentage, of the listed items from our consolidated statements of operations to our total revenues for the periods indicated:

	Percentage of Total Revenues Year ended December 31,		
	2003	2004	2005
Revenues from products sale	79.3%	79.5%	72.9%
Revenues from services	20.7%	20.5%	27.1%
Total revenues	100.0%	100.0%	100.0%
Cost of products sale	38.5%	39.1%	37.9%
Cost of services	23.5%	18.3%	26.2%
Total cost of revenues	62.0%	57.4%	64.1%
Gross profit	38.0%	42.6%	35.9%
Operating expenses:			
Research and development expenses, net	32.1%	23.5%	30.8%
Sales and marketing expenses	24.5%	18.1%	23.1%
General and administrative expenses	7.1%	6.3%	12.0%
Other operating income	(8.3)%		
Total operating expenses	55.4%	47.9%	65.9%
Operating loss	(17.4)%	(5.3)%	(30.0)%
Financing income, net	1.6%	1.4%	2.1%
Net Loss	(15.8)%	(3.9)%	(27.9)%

Comparison of Years Ended December 31, 2005 and 2004

Revenues. Our revenues in 2005 decreased by $6.7 million, or 18.1%, compared to 2004, with revenues attributable to product sales accounting for $22.0 million, a decrease of $7.3 million, or 24.9%, compared to 2004, and services accounting for $8.2 million, an increase of $0.6 million, or 8.3%, compared to 2004. The decrease in product sales revenue in 2005 was attributed to the competition in the 300 mm integrated metrology market, including the delay in introduction of our NovaScan 3090 product series during 2004, and also to the general slowdown in the semiconductor industry in the first half of 2005. Revenues from services accounted for 27.1% of total revenues in 2005, as compared to 20.4% of total revenues in 2004. The increase in the percentage of our revenues from services is attributed mainly to an increase in service contracts revenues and a decrease in revenues from product sales.

We expect that sales from our main integrated process control product line targeting the CMP market, including dielectric and copper, will continue to account for a substantial portion of our revenues for at least the next year, and that the new product lines sales (integrated and stand-alone process control systems for etch) will gradually become more significant following wider market adoption of integrated metrology for etch. As our revenues are largely dependent upon the sale of systems for CMP processing, any decrease in demand for our CMP products would have a material adverse affect on us. In 2006, we expect service revenue to increase relative to 2005 as the warranty periods for additional systems will expire and we expect customers to buy service contracts for these systems.

Cost of Revenues and Gross Profit. Cost of revenues consists of the labor, material and overhead costs of manufacturing our systems, and the costs associated with our worldwide service and support infrastructure. It also consists of inventory write-offs and provision for estimated future warranty costs for systems we have sold. Our cost of revenues attributable to product sales in 2005 was $11.4 million, a decrease of $3.0 million, or 20.8%, compared to 2004. This decrease is attributable mainly to the decreased volume of systems sold. As a percentage of total revenues, our cost of revenues attributable to product sales in 2005 decreased to 37.9% from 39.1% in 2004. This decrease is attributable to the mixture of products sold. Inventory write-down did not have significant affect on our cost of goods sold in 2005 or in 2004. Our cost of revenues attributable to services in 2005 was $7.9 million, an increase of $1.2 million, or 17.5%, compared to 2004. This increase is attributable to an increase in labor and material costs relating to service contracts and installations at new customer sites.

Our gross profit decreased by 31.2% to $10.8 million in 2005 from $15.7 million in 2004. Our gross profit represented 35.9% and 42.6% of our total revenues in 2005 and 2004, respectively. Our gross profits decrease from 2004 to 2005 is attributable mainly to the lower volume of systems sold.

Research and Development expenses, Net. Research and development expenses, net, consist primarily of salaries and related expenses and also include consulting fees, subcontracting costs, related materials and overhead expenses, after offsetting conditional grants received or receivable from the Office of the Chief Scientist. Our research and development expenses, net, increased 7.3% from $8.7 million in 2004 to $9.3 million in 2005, after offsetting conditional grants received or receivable from the Office of the Chief Scientist of $1.9 million in 2005 and 2004, each. In 2005 research and development expenses, net, represented 30.9% of our revenues compared to 23.5% of our revenues in 2004, due to the significant decrease in our revenues in 2005.

Approximately $5 million of our research and development expenses, net, in 2005, resulted from our research and development efforts relating to the introduction of new NovaScan 3090 models for the next manufacturing technology nodes and creating a new technology infrastructure for scatterometry based metrology solutions. We believe that meeting the needs of semiconductor manufacturers with respect to the manufacture of semiconductors with features ranging from 90 nm to below 45 nm will allow us to maintain our position as a market leader in integrated process control equipment. The balance of the research and development expenses, net, was related to current products activities, such as engineering improvements, new versions of software and application support and developments, as well as to new software products for scatterometry based metrology and also to developing a technology infrastructure for next generation metrology tools, both for stand-alone and for integrated metrology market segments.

Sales and Marketing. Sales and marketing expenses are comprised of salaries and related costs for sales and marketing personnel, related travel expenses, and overhead. They also include commissions to our representatives and sales personnel and royalties. Our sales and marketing expenses increased by 6% from $6.6 million in 2004 to $7.0 million in 2005. Sales and marketing expenses represented 23.1% and 18.1%, respectively, of our revenues in 2005 and 2004. This increase as a percentage of revenue is related to lower volume of revenues in 2005.

General and Administrative. General and administrative expenses are comprised of salaries and related expenses and other non-personnel related expenses. Our general and administrative expenses increased 55.6% from $2.3 million in 2004 to $3.6 million in 2005. This increase is attributed mainly to increase of legal expenses of about $0.6 million mainly due to Nanometrics IP infringement law suit and executives retirement payments of about $0.3 million. General and administrative expenses represented 6.3% and 12.0% of our revenues in 2004 and 2005, respectively. The increase in general and administrative expenses as a percentage of revenues from 2004 to 2005 is a result of a decrease in our revenues in 2005 and the increase of our general and administration expenses as described above.

Comparison of Years Ended December 31, 2004 and 2003

Revenues. Our revenues in 2004 increased by $10.1 million, or 37.9%, compared to 2003, with revenues attributable to product sales accounting for $29.3 million, an increase of $8.1 million, or 38.4%, compared to 2003, and services accounting for $7.5 million, an increase of $2.0 million, or 36.1%, compared to 2003. The increase in product sales revenue in 2004 was attributed mainly to the general growth in the semiconductor industry and also to a moderate increase in revenues from our new product for copper CMP. Revenues from services accounted for 20.5% of total revenues in 2004, as compared to 20.7% of total revenues in 2003.

Cost of Revenues and Gross Profit. Cost of revenues consists of the labor, material and overhead costs of manufacturing our systems, and the costs associated with our worldwide service and support infrastructure. It also consists of inventory write-offs and provision for estimated future warranty costs for systems we have sold. Our cost of revenues attributable to product sales in 2004 was $14.4 million, an increase of $4.1 million, or 40.2%, compared to 2003. This increase is attributable mainly to the increased volume of systems sold. As a percentage of total revenues, our cost of revenues attributable to product sales in 2004 increased to 39.1% from 38.5% in 2003. Inventory write-down did not have significant affect on our cost of goods sold in 2003 and in 2004. Our cost of revenues attributable to services in 2004 was $6.7 million, an increase of $0.4 million, or 7.2%, compared to 2003.

Our gross profit increased by 54.6% to $15.7 million in 2004 from $10.2 million in 2003. Our gross profit represented 42.6% and 38.0% of our total revenues in 2004 and 2003, respectively. Our gross profits increase from 2003 to 2004 is attributable to the higher volume of systems sold and higher average sales price.

Research and Development expenses, Net. Research and development expenses, net, consist primarily of salaries and related expenses and also include consulting fees, subcontracting costs, related materials and overhead expenses, after offsetting conditional grants received or receivable from the Office of the Chief Scientist. Our research and development expenses, net, increased 1.2% from $8.6 million in 2003 to $8.7 million in 2004, after offsetting conditional grants received or receivable from the Office of the Chief Scientist of $2.3 million and $1.9 million in 2003 and 2004, respectively. The grants increased from 2003 to 2004 due to additional development programs initiated in 2004 which were approved by the Office of the Chief Scientist. While our 2004 research and development expenses, net, were at levels similar to 2003, they represented 23.6% and 32.1% of our revenues in 2004 and 2003, respectively, due to the significant increase in our revenues in 2004.

Approximately $5.5 million of our research and development expenses, net, in 2004, resulted from our research and development efforts relating to the introduction of new products and new models of the NovaScan systems for the next manufacturing technology nodes. We believe that meeting the needs of semiconductor manufacturers with respect to the manufacture of semiconductors with features ranging from 90 nm to below 45 nm will allow us to maintain our position as a market leader in integrated process control equipment (According to the International Technology Roadmap for Semiconductors, ITRS, semiconductor manufacturers began high volume manufacturing of semiconductors with 90 nm features in 2004, and 90 nm manufacturing is expected to be adopted widely in 2005 and 2006. ITRS also indicates that high volume manufacturing of semiconductors with 65 nm features is expected to begin in 2006). The balance of the research and development expenses, net, were related to current products activities, such as engineering improvements, new versions of software and application support and developments.

Sales and Marketing. Sales and marketing expenses are comprised of salaries and related costs for sales and marketing personnel, related travel expenses, and overhead. They also include commissions to our representatives and sales personnel and royalties. Our sales and marketing expenses increased 1.7% from $6.5 million in 2003 to $6.7 million in 2004. Sales and marketing expenses represented 18.1% and 24.5%, respectively, of our revenues in 2004 and 2003. This decrease as a percentage of revenue is related to higher volume of revenues in 2004.

General and Administrative. General and administrative expenses are comprised of salaries and related expenses and other non-personnel related expenses. Our general and administrative expenses increased 22.8% from $1.9 million in 2003 to $2.3 million in 2004. This increase is attributed mainly to increase of legal expenses and increased operation levels of the company. General and administrative expenses represented 7.1% and 6.3% of our revenues in 2003 and 2004, respectively. The decrease in general and administrative expenses as a percentage of revenues from 2003 to 2004 is a result of an increase in our revenues in 2004.

Other Operating Income. During the fourth quarter of 2003, the Office of the Chief Scientist approved the Company s request to allocate $2.2 million from the grants provided by the Office of the Chief Scientist to a specific lithography project, to be repaid as royalties only from sales of specific lithography products. As a result, the Company canceled in 2003 a royalty provision, made mainly in prior years, in the total amount of $2.2 million. The other income in the year 2003 represents this cancellation.

Liquidity and Capital Resources

As of December 31, 2005 we had working capital of $14.8 million compared to working capital of $25.7 million as of December 31, 2004. This decrease is attributed primarily to decrease in cash and cash equivalents during 2005 and to the increase in trade account payables and other liabilities during 2005. Cash and cash equivalents, short-term and long-term deposits and securities held to maturity as of December 31, 2005 were $22.8 million compared to $30.8 million as of December 31, 2004.

Trade accounts receivable decreased slightly from $6.85 million as of December 31, 2004 to $6.84 million as of December 31, 2005. Inventories increased from $6.4 million as of December 31, 2004 to $6.6 million as of December 31, 2005.

Operating activities in 2005 used cash of $7.4 million compared to $1.8 million in 2004. Operating activities in 2005 used more cash relative to 2004 mainly due to the increased operational losses in 2005. Financing activities generated $0.5 million of cash in 2004, compared to $0.3 million in 2003.

The following table describes our investments in capital expenditures during the last three years:

	2005		2004		2003	
	Domestic	Abroad	Domestic	Abroad	Domestic	Abroad
	(in dollar thousands)					
Electronic equipment	1,176	41	844	78	310	22
Office furniture and equipment	13	2	230	3	6	9
Leasehold improvements	48	2	79	8	6	11
Total	1,237	45	1,153	89	322	42

The investment in capital expenditures was financed mainly from the cash reserves of the Company. The increase in capital expenditures for electronic equipment in 2004 and 2005 was due to our investments in information systems improvements (software and hardware), electronic equipment used in our research and development labs and systems for our demonstration centers and application development. Although we currently have no significant capital commitments, we expect to spend approximately $1.5 million on capital expenditures in the next 12 months, mainly for information systems improvements (software and hardware), electronic equipment used in our research and development labs and manufacturing clean room facilities in Israel.

Our principal liquidity requirements are expected to be for working capital, research and development, capital expenditures and lease payments for our worldwide facilities. We believe that our current cash reserves and expected cash flow will be adequate to fund our activities for at least the next 12 months.

Our long-term capital requirements will be affected by many factors, including the success of our current products, our ability to enhance our current products and our ability to develop and introduce new products that will be accepted by the semiconductor industry. We plan to finance our long-term capital needs with the remaining net proceeds of our initial public offering, together with cash flow from operations, if any. If these funds are insufficient to finance our activities, we will have to raise additional funds through the issuance of additional equity or debt securities, through borrowing or through other means. We cannot assure you that additional financing will be available on acceptable terms.

Presently, we have no long-term debt, nor any readily available source of long-term debt financing such as a line of credit.

With regard to usage of hedging financial instruments and the impact of inflation and currency fluctuations, see Quantitative and Qualitative Disclosures About Market Risk starting on page 65.

Off-balance sheet arrangements

We do not have and are not party to any off-balance sheet arrangements.

Contractual Obligation

As of December 31, 2005 we had contractual obligations as described in the following table:

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			(in dollar thousands)		
Operating Lease Obligations	2,808	1,607	1,201		
Purchase Obligations	4,507	4,507			
Other Long Term Liabilities	195	95	100		
Total	7,510	6,209	1,301		

Research and Development

For information regarding our research and development activities, see Research and Development starting on page 21.

Conditional Grants from the Office of the Chief Scientist

Under the Law for the Encouragement of Industrial Research and Development, 1984, a qualifying research and development program is eligible for conditional grants of up to 50% of the program s expenses. The program must be approved by a committee of the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor. The recipient of the conditional grants is required to return the grants by the payment of royalties on the revenues derived from using the grants. Current regulations promulgated under the law provide for the payment of royalties to the Office of the Chief Scientist ranging from 3% to 6% on the revenues derived from using the conditional grants until 100% of the grants are repaid. Conditional grants received under programs approved after January 1, 1999 will accrue interest at an annual rate of the 12-month LIBOR applicable to dollar deposits. Royalties are paid in NIS linked to the dollar at the exchange rate in effect at the time of payment. Following the full payment of such royalties and interest, there is generally no further liability for payment.

The terms of the conditional grants under the law require that we manufacture in Israel the products developed with these grants. These restrictions apply even after grants are fully repaid. Under the regulations promulgated under the law, the products may be manufactured outside Israel by us or by another entity and know-how may be transferred outside of Israel, if prior approval is received from the Office of the Chief Scientist which may be given only if we abide by all the provisions of the law and related regulations. Ordinarily, as a condition to obtaining approval to manufacture outside Israel, we would be required to pay increased royalties and as a condition to obtaining approval to transfer know-how outside Israel, ordinarily we would be required to pay a lump sum, all as defined under the relevant law. If we perform the manufacturing, the increased royalties would ordinarily be one percentage point above the otherwise applicable royalty rate. If the manufacturing is performed by an entity other than us, the rate would depend on the amount of manufacturing performed outside of Israel and the size of the conditional grants in relation to the investments made by us in the project. The total amount to be repaid to the Office of the Chief Scientist would also be adjusted to between 120% and 300% of the conditional grants, depending on the manufacturing volume that is performed outside Israel. If we wish to transfer know-how, the terms for approval shall be determined according to the character of the transaction and the consideration paid to us for such transfer. Approval of the transfer of technology may be granted only if the recipient abides by all the provisions of the law and related regulations, including the restrictions on the transfer of know-how outside of Israel and the obligation to pay royalties in an amount that may be increased. Approval to manufacture products outside of Israel or consent to the transfer of technology, if requested, might not be granted.

As of December 31, 2005 we received conditional grants from the Office of the Chief Scientist totaling $8.9 million. Because the implementation of regulations raising royalty rates to between 3% and 6% has been deferred, we are obligated to pay royalties of 3% of revenues derived from sales of products funded with these grants. As of December 31, 2005, our contingent liability to the Office of the Chief Scientist for conditional grants received was approximately $5.7 million. See also Note 7A to our consolidated financial statements contained elsewhere in this report.

The funds available for Office of the Chief Scientist conditional grants were reduced for 2004 and 2005, and the Israeli authorities have indicated that the government may further reduce or abolish Office of the Chief Scientist grants in the future. Even if these conditional grants are maintained, we might not receive Office of the Chief Scientist grants in the future and cannot presently predict the amount of any grants we might receive.

In addition to royalty-bearing grants from the Office of Chief Scientist, in 2005, we participated in two programs sponsored by the Office of Chief Scientist. In one program, we are a member of a research consortium comprised of several Israeli high technology companies, which are engaged in the development of multimedia on-line technology. In the other program, we are cooperating with a research institute in Israel for the development of advanced measurement techniques. In both programs, the Office of Chief Scientist contributes 66% of the approved research and development budget for the research consortium and the members of the research consortium contribute the remaining 34%. No royalties from this funding are payable to the Israeli government. Expenses in excess of the approved budget are borne by the consortium members. In general, any consortium member that develops technology as part of the consortium retains the intellectual property rights to the technology developed by this member, and all the members of the consortium have the right to utilize and implement such technology without having to pay royalties to the developing consortium member. As of December 31, 2005, we had received approximately $2.3 million in grants from the Office of Chief Scientist in connection with these programs.

Political and economic conditions in Israel

The Company is incorporated under the laws of Israel, and has its principal offices and manufacturing facilities in Israel. The Company is, therefore, directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel could have a material adverse effect on the Company s business, financial condition and results of operations.

Political Conditions. Since the establishment of the state of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying from time-to-time in intensity and degree, has led to security and economic problems for Israel. However, a peace agreement between Israel and Egypt was signed in 1979, a peace agreement between Israel and Jordan was signed in 1994 and, since 1993, several agreements between Israel and the Palestinian Authority representatives have been signed. As of the date hereof, Israel has not entered into any agreement with Syria or Lebanon. Currently there is stagnation in the peace process in the Middle East and ongoing hostilities between Palestinian militant groups and Israel. The resumption of hostilities in the region, which have occurred after the failure of Camp David peace talks, as well as the events of September 11, 2001, and the ongoing tension in the region, has a negative effect on the stability of the region. There can be no assurance as to whether or how the peace process will develop or what affect it or these ongoing hostilities may have upon the Company.

Beginning in 1948, nearly all Arab countries have formally adhered to a boycott of Israel and Israeli companies and, since the early 1950s, of non-Israeli companies doing business in Israel or with Israeli companies. Attempts to ensure that Arab countries are complying with this boycott have intensified due to recent hostilities between the State of Israel and the Palestinians. Despite measures to counteract the boycott, including anti-boycott legislation in the US, the boycott has had an indeterminate negative effect upon trade with and foreign investments in Israel. Although in the past such attempts did not materially affect us, there can be no assurance that restrictive laws, policies, or practices directed toward Israel or Israeli businesses will not have an adverse impact on the operation or expansion of the Company s businesses.

Due to recent presence of the Israeli military in the territories previously transferred to the control of the Palestinian authority, there were certain initiatives within the institutions of the European Union to suspend the trade agreements entered into between the State of Israel and members of the European Union. These initiatives culminated in a resolution of the European Parliament recommending that the European Union members suspend those trade agreements. It is uncertain whether such agreements will in fact be suspended, but if such agreements are suspended, it may affect the Company ability to trade with European companies.

Military Service. Generally, all male adult citizens and permanent residents of Israel under the age of 45, (doctors under the age of 49) are, unless exempt, obligated to perform up to approximately 36 days of military reserve duty annually. Generally, male adult citizens and permanent residents of Israel over the age of 45 and under the age of 54 are, unless exempt, obligated to perform up to approximately 13 days of military reserve duty annually, (doctors up to approximately 21 days). Additionally, all such residents are subject to being called to active duty at any time under emergency circumstances. Some of the Company s officers and employees are currently obligated to perform annual reserve duty. While the Company has operated effectively under these requirements since it began operations, no assessment can be made as to the full impact of such requirements on the Company s workforce or business if conditions should change, and no prediction can be made as to the effect on Company of any expansion or reduction of such obligations.

Economic Conditions. Israel s economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980s that reached an annual peak of 445%, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. In the past, the Israeli economy has been in a recession, and the Israeli government has, for these and other reasons, intervened in the economy by utilizing, among other means, fiscal and monetary policies, import duties, foreign currency restrictions and control of wages, prices and exchange rates. The Israeli government periodically changes its policies in all these areas.

Item 6. Directors, Senior Management and Employees

The following is the list of senior management and directors:

Name	Age	Position
Giora Dishon	61	President, Chief Executive Officer, Director and Co-Founder
Moshe Finarov	54	Chief Technology Officer, Director and Co-Founder
Micha Brunstein*	62	Chairman of the board
Avi Kerbs *	59	Director
Joseph Ciechanover *	72	Director
Alon Dumanis *	56	Director
Lauri Hanover */**	46	External Director
Dan Falk *	61	External Director
Dror David *	37	Chief Financial Officer, Vice President of Resources
Gabi Seligsohn *	40	Executive Vice President, Sales and Marketing

* Each one of these persons beneficially owns less than one percent of the Company s ordinary shares.

** External Director with financial expertise.

Our directors (other than the external directors) serve as such until the Company s next annual general meeting of shareholders. Our external directors, in accordance with Israeli law, serve for a three-year term, which may be renewed for only one additional three-year term. Ms. Lauri Hanover was elected in 2000 and was reelected in 2003. Mr. Dan Falk was elected in 2005.

Effective as of April 28, 2006, *Mr. Barry L. Cox* resigned from his position as Chairman and member of the Board of Directors of the Company.

Effective as of September 29, 2005, *Dr. Karey Holland* resigned from her position as a member of the Board of Directors of the Company.

Effective of June 19, 2006, Dr. Micha Brunstein was named as the chairman of the Board of Directors.

Dr. Giora Dishon is a co-founder of Nova and has served as President and Chief Executive Officer since Nova s formation in 1993. From 1989 to 1993 he served as Thin Film and Flat Panel Display Product Line Manager at Orbot Systems and Orbotech Ltd., a manufacturer of automated optical inspection equipment. From 1986 to 1988 he was a Visiting Scientist at the Microelectronics Center of North Carolina, and from 1982 to 1986 he served as the Managing Director at AVX Israel Ltd., a manufacturer of electronic devices. Dr. Dishon holds a B.Sc. in Chemistry, a MSc. and a Ph.D. in Materials Science from the Hebrew University in Jerusalem.

Dr. Moshe Finarov is a co-founder of Nova Measuring Instruments and a member of the Board of Directors. He has served as Chief Technology Officer and VP Technology since Nova s formation in 1993. From 1989 to 1993 he served as Senior Physicist at Orbotech Ltd. and from 1974 to 1988 he was employed at PULSAR and ENIMS Scientific Research Institutes in Moscow. Dr. Finarov holds a Ph.D in Semiconductor Physics and M.Sc in Microelectronics from Moscow Steel & Alloys Institute. He is named on approximately 30 US patents and published approximately 40 papers.

Dr. Micha Brunstein was elected as director of Nova during November 2003 by the other members of the board of directors, and thereafter by annual shareholders meetings. As described above, effective of June 19, 2006, Dr. Micha Brunstein was named as the chairman of the Board of Directors of Nova. During the years 1990 to 1999, Dr. Brunstein served as a Managing Director of Applied Materials Israel Ltd. Prior to that, Dr, Brunstein served as President of Opal Inc. and as a Director of New Business development in Optrotech Ltd. At present, Dr. Brunstein serves as the chairman and board member of Ham-let Ltd., a company whose stock is traded in the Tel Aviv Stock Exchange, and Valor Computerized Systems Ltd., whose stock is traded in the Frankfurt Stock Exchange. Dr. Brunstein holds B.Sc. in Mathematics and Physics from the Hebrew University, Jerusalem, and M.Sc. and Ph.D. degrees in Physics from the Tel Aviv University.

Mr. Avi Kerbs has served as a director of Nova since 1993. He serves as the president and chief executive officer of Teuza Management & Development Ltd., the management company of Teuza-A Fairchild Technology Venture Ltd., a venture capital Company and has served in this capacity since 1991. Teuza-A Fairchild Technology Venture Ltd. is a major shareholder of Nova. He serves as a director of most of the companies comprising the investment portfolio of the Teuza Fund. Mr. Kerbs holds a B.Sc. in Industrial Engineering and Management and an M.Sc. in Management, both from the Technion, Israel s Institute of Technology. Mr. Kerbs serves as a member of the Technion s Board of Governors, is a Governor of the Haifa University Board of Governors and the Chairman of the Scientific Academic Club of the Haifa University. Mr. Kerbs was originally appointed to our board of directors by Teuza.

Mr. Joseph Ciechanover has served as a director of Nova from October 1996 until December 1998 and again from February 2000 until the present. He is the founder and president of the Challenge Fund-Etgar L.P., a venture capital firm holding approximately 2% of Nova s outstanding shares, and served as chairman of the board of El-Al Israel Airlines from 1995 until 2001. He served as a chairman of Israel Discount Bank from 1986-1993 and the president and a member of the board of directors of PEC Israel Economic Corporation, a diversified investment company which merged later into Discount Investment Corp. Since 1995, Mr. Ciechanover has been a member of the board of directors of United Retail Group, Inc. and serves on the audit compensation committees. United Retail Group, Inc. s stock is publicly traded in the United States. Mr. Ciechanover holds a law degree from the Hebrew University in Jerusalem, an L.L.M. from the University of California at Berkeley and a Ph.D. in philosophy from Boston University.

Dr. Alon Dumanis, is the Chief Executive Officer of Docor International Management, a Dutch venture capital, subsidiary of The Van-Leer Group Foundation. Dr. Dumanis serves either as Chairman or as a member of the Board of Directors of various companies. Dr. Dumanis is a member of the Board of Directors of Tadiran Communications and formerly, a member of the Board of Directors at El Al Israel Airlines (TASE-LY) and Board of Directors of Inventech Investments Co. Ltd. (TASE-IVTC), a major shareholder. Previously, Dr. Dumanis was the Head of the Material Command in the Israel Air Force with the rank of Brigadier General. Dr. Dumanis currently serves as chairperson and member of several national steering committees and is the author of many papers published locally and internationally in a number of subject areas, including technology and management. Dr. Dumanis holds a Ph.D. in Aerospace Engineering from Purdue University in the United States.

Ms. Lauri Hanover has been a Director of the Company since 2000 and was appointed as the Company s external director in accordance with the provisions of Israeli law. Ms. Hanover was nominated by the Board of Directors to serve as the board member who has accounting and financial expertise. Ms. Hanover has served as Senior Vice President and Chief Financial Officer of Lumenis Ltd., a company publicly traded in the United States, since 2004. She previously served as Corporate Vice President and Chief Financial Officer of NICE Systems Ltd. from 2000 to 2004 and as Executive Vice President and Chief Financial Officer of Sapiens International Corporation N.V. from March 1997 until 2000. From 1984 to 1997, Ms. Hanover served in a variety of financial management positions, including Corporate Controller, at Scitex Corporation Ltd. Ms. Hanover holds a bachelor s degree in finance from the Wharton School of Business and a Bachelor of Arts degree from the College of Arts and Sciences, both of the University of Pennsylvania. Ms. Hanover also holds a master s degree in business administration from New York University. Ms. Hanover has served as an external director on the Board of Directors of Nur Macroprinter Ltd. since 2003. Nur Macroprinter is publicly traded in the United States.

Mr. Dan Falk was appointed as the Company s external director in accordance with the provisions of the Israeli law in 2005. Mr. Falk is a business consultant to public and private companies. During 1999 to 2000 Mr. Falk served as Chief Executive Officer and Chief Operating Officer of Sapiens International NV. Before that, Mr. Falk served as Executive Vice President and CFO of Orbotech Ltd. Mr. Falk serves as a member of various companies boards of directors such as Orbotech Ltd., Nice Systems Ltd., Ormat Technologies, Inc., Attunity Ltd., ClickSoftware Technologies, Ltd., Orad Hi-tech Systems Ltd., Jacada Ltd., Dmatek Ltd., Poalim Ventures1, Plastopil Ltd. (all of which are companies publicly traded in the United States or other countries) and Netafim Ltd.

Mr. Dror David has served as Chief Financial Officer and Vice President of Resources of Nova since August 2005. From 1998 to 2005, he served in various managerial positions in Nova including Vice President of Finance, Operations Manager, and Global Controller. From 1994 to 1998 Mr. David served as an Audit and Tax Consultant with Brightman, Almagor & Co.. Mr. David holds a B.A. in Accounting & Economics from the Bar-Ilan University and M.B.A from the Derby University of Britain.

Mr. Gabi Seligsohn was appointed Executive Vice President, Global Business Management Group, in August 2005. Having joined Nova in 1998, Mr. Seligsohn has served in several key positions in the company. From August 2002 until August 2005 he was President of Nova s US Subsidiary, Nova Inc. Previous to that he was Vice President Strategic Business Development at Nova Inc. where he established Nova s OEM group managing the Applied Materials and Lam Research accounts between the year 2000 to 2002. From 1998 to 2000 he served as global strategic account manager for the Company s five leading customers. Mr. Seligsohn joined Nova after two years service as Sales Manager for key financial accounts at Digital Equipment Corporation. Mr. Seligsohn holds an LLB from the University of Reading in England.

Voting agreement

We are not aware of any voting agreement currently valid.

Compensation

The aggregate direct remuneration paid or payable to all 13 persons partial who served in the capacity of director or executive officer during 2005 (including persons who served partial term) was approximately $1,000,000 including approximately $224,000, which was set aside for pension and retirement benefits and including amounts expended by us for automobiles made available to our executive officers and $100,000 for executives retirement payments.

External directors of the Company receive remuneration comprised of: an annual payment in the amount of NIS 30,708 (approximately $6,840) and an additional payment per meeting of NIS 1,143 (approximately $255).

The total amount paid or payable to the directors, including external directors, for 2005 was $114,000. In 2004, this amount was $105,000 and in 2003 - $122,000.

As of May 15, 2003, we entered into an agreement with Mr. Barry L. Cox according to which Mr. Cox served as chairperson of our board of directors. Under the agreement, Mr. Cox was entitled to gross annual compensation of $50,000 as well as a one-time grant of an option to purchase up to 50,000 ordinary shares of the Company, at the fair market value of the shares at the time of grant. The option vests during a three-year period so that a third of the entire amount granted to Mr. Cox shall be exercisable upon each anniversary of the grant. Mr. Cox has resigned from the Board effective April 28, 2006. On June 19, 2006 (following the recommendations of the Compensation Committee and the Audit Committee), the Board of directors approved the severance arrangements with Mr. Barry Cox continuing payment of his compensation through the end of 2006 in a total amount of $25,000. These payments have not yet been approved by our shareholders.

On May 15, 2003, the Company s Board of Directors and Audit Committee resolved (i) that the monthly gross salary of Dr. Dishon shall be increased to 44,000 NIS (approximately $9,800) for the period February 1, 2003 through July 31, 2003 and increased to 50,000 NIS (approximately $11,120) starting on August 1, 2003 and (ii) that the monthly gross salary of Dr. Finarov shall be increased to 40,000 NIS (approximately $8,900) for the period February 1, 2003 through July 31, 2003 and increased to 44,000 NIS (approximately $9,800) starting on August 1, 2003. These changes in the terms of compensation for Drs. Dishon and Finarov were approved by our shareholders on September 1, 2003.

On November 1, 2005, the Company s Audit Committee and on November 2, 2005 the Company s Board of Directors resolved (i) that the monthly gross salary of Dr. Dishon shall be increased to 57,000 NIS (approximately $12,000) starting on July 1, 2005 and (ii) that the monthly gross salary of Dr. Finarov shall be increased to 53,000 NIS (approximately $11,500) starting on July 1, 2005. In June, 2006, the Company s Audit Committee and the Company s Board of Directors approved further increases in the salaries of Drs. Dishon and Finarov as well as the allocation of additional options. These changes in the terms of compensation for Dr. Dishon and Dr. Finarov have not yet been approved by our shareholders.

During June, 2006, Dr. Micha Brunstein was named as the chairman of the Board of Directors of the Company. Following the recommendations of the Compensation Committee and the Audit Committee, the Board of Directors resolved that Dr. Brunstein will be entitled to gross annual compensation of $110,000 and to the grant of an option to acquire 100,000 of the Company s ordinary shares pursuant to the Company s Option Plan 8. Dr. Brunstein s salary and the option grant have not yet been approved by our shareholders**.**

On November 10, 2004, the Company s Board of Directors and the Company s Audit Committee, in each case after all of directors and external directors gave notification of their personal interest in such resolutions, approved the issuance of options to directors as set forth below.

Name of directors	**Position**	**# of options**
Giora Dishon	Director, CEO & President	70,000
Moshe Finarov	Director & CTO	60,000
Barry Cox	Former Chairman of the board	10,000
Micha Brunstein	Director	10,000
Avi Kerbs	Director	10,000
Joseph Ciechanover	Director	10,000
Alon Dumanis	Director	10,000
Lauri Hanover	External Director	10,000
Karey Holland	Former External Director	10,000

The options were granted in December 2004 subject to shareholder approval, which was given on September 29, 2005. The options are subject to the terms and conditions of the Company s Option Plan 7B. Subject to any permitted acceleration of vesting, the options vest over a period of between one and four years and their term may not exceed seven years from the date of grant. The exercise price of these options is $3.40 per share.

On July 30, 2005, the Company s Audit Committee (in which all directors, including both external directors, notified the Company of their personal interest in the approval of said resolution) and the Company s Board of Directors (in which all directors, including both external directors, have notified the Company of their personal interest in the approval of said resolution), approved the grant of options to directors as set forth below:

Name of directors	**Position**	**# of options**
Giora Dishon	Director, CEO & President	63,000
Moshe Finarov	Director & CTO	54,000
Barry Cox	Former Chairman of the board	9,000
Micha Brunstein	Director	9,000
Avi Kerbs	Director	9,000
Joseph Ciechanover	Director	9,000
Alon Dumanis	Director	9,000
Lauri Hanover	External Director	9,000
Karey Holland	Former External Director	9,000

These grants were approved by the shareholders on September 29, 2005. The grant of the above options is subject to the terms and conditions of the Company s Option Plan 7C. Subject to any permitted acceleration of vesting, the options vest over a period of between one and four years and their term may not exceed seven years from the date of grant. The exercise price of these options will be the fair market value of the Company s shares on the date of grant, unless otherwise determined by the Board of Directors. The grant of the above options is subject to receipt of a letter of consent from the Israeli Securities Committee, receipt of a letter of consent from the Tel-Aviv Stock Exchange and the effectiveness of a Registration Statement on Form S-8 with respect to the ordinary shares underlying the options.

On July 31, 2005, the Company s Board of Directors (in which all directors, including both external directors, notified the Company of their personal interest in the approval of said resolution) and the Company s Audit Committee (in which all directors, including both external directors, notified the Company of their personal interest in the approval of said resolution), approved the recommendation of the Company s Compensation Committee to approve a plan to accelerate the vesting of certain options outstanding as of December 29, 2005 as described below:

Last Name	First Name	Grant Date	Exercise Price $	Granted	Unvested	Vested & Exercisable
Domanis	Alon	Mar-04-Dec-04	3.4-5.15	20,000	**16,864**	3,136
Brunsten	Micha	Mar-04-Dec-04	3.4-5.15	20,000	**16,864**	3,136
Ciechanover	Joseph	Feb-03-Dec-04	2.06-5.15	30,000	**21,864**	8,136
Hanover	Lauri	Feb-03-Dec-04	2.06-5.15	30,000	**21,864**	8,136
Kerbs	Avi	Feb-03-Dec-04	2.06-5.15	30,000	**21,864**	8,136
Holland	Karey	Feb-03-Dec-04	2.06-5.15	30,000	**21,864**	8,136
Cox	Barry	May-03-Dec-04	2.68-3.4	60,000	**26,667**	33,333
Dishon	Giora	Feb-03-Dec-04	2.06-5.15	195,000	**144,682**	50,318
Finarov	Moshe	Feb-03-Dec-04	2.06-5.15	165,000	**122,818**	42,182

The acceleration of the options under Plans 6, 7A and 7B was approved by the shareholders on September 29, 2005. As a result, the options identified above vested and became fully exercisable on December 29, 2005.

On September 29, 2005, the Shareholders of the Company approved the extension of the period in which Dr. Holland may exercise her options, to a period of 180 days from the date of termination of Dr. Holland s tenure as a director and external director.

Board of Directors Committees

The Company s Board of Directors has appointed the following committees:

The *Audit Committee* is comprised of four members, but currently has only three members. The members are Lauri Hanover, Dan Falk and Joseph Ciechanover. The functions of the audit committee according to Israeli Law are to locate deficiencies in the business management of the Company, among other things, in consultation with the Company s auditors and internal auditors and to suggest to the Board of Directors the measures to be taken regarding such deficiencies. The Audit Committee is also responsible for approving related party transactions. In addition, as described under Item 16, the audit committee is responsible for the approval of all audit and non-audit services provided to the Company by Deloitte & Touche. The Audit Committee operates under a charter adopted by the Board of Directors.

The *Compensation Committee* is comprised of Joseph Ciechanover, Lauri Hanover and Dan Falk. The function of the compensation committee is described in the approved charter of the committee, and includes determining the compensation of directors, senior management and employees (subject to provisions regarding related party transactions).

The *Investment Committee* is comprised of Lauri Hanover, Avi Kerbs, Dan Falk and Joseph Ciechanover. The function of the investment committee is described in the approved charter of the committee, and includes reviewing and determining the cash investment policy of the cash reserves of the Company.

The *Nominating Committee* is comprised of Alon Dumanis, Dan Falk and Joseph Ciechanover. The function of the nomination committee is described in the approved charter of the committee, and includes reviewing the board structure and recommend nomination of new board members.

The *Strategic Committee* is comprised of Micha Brunstein, Avi Kerbs, Alon Dumanis, Dan Falk and Giora Dishon. The function of the strategic committee is described in the approved charter of the committee, and includes advising and recommending strategic and long term plans and goals for the Company.

All committees are acting according to charters that were approved by the Company Board of directors.

Employees

Set forth below is a chart showing the number of people we employed at the times indicated.

	as of December 31,		
	2003	**2004**	**2005**
Total Personnel	212	239	239
Located in Israel	150	159	156
Located abroad (mainly U.S.)	62	80	83
In operations	37	40	33
In research and development	72	82	84
In sales and marketing	24	29	29
In service and support	62	66	69
In general and administration	17	22	24

As of December 31, 2005, we employed a total of 239 persons worldwide, not including 30 independent contractors and temporary employees, of which 84 were in research and development, 33 were in operations, 69 were in service and support, and testing, 29 were in sales and marketing and 24 were in general and administration. As of December 2005, 156 of our employees were based in Israel and 83 were located abroad.

We are a member of the Industrialists Association in Israel, an employer s union. As a result of this membership, a number of collective bargaining agreements apply to us. These agreements principally concern cost of living wage increases, paid vacation and holidays, length of the workday, wage tariffs, termination and severance payments. We provide our employees with benefits and working conditions that are at least as favorable as those found in the collective bargaining agreements.

Israeli labor laws and regulations apply to all our employees employed by Nova Measuring Instruments Ltd. The laws principally concern matters such as paid vacation, paid sick days, length of the workday, payment for overtime and severance payments upon the retirement or death of an employee or termination of employment.

Share ownership

Giora Dishon, President, Chief Executive Officer and Co-Founder, and Moshe Finarov, Vice President, Director of Technology, Director and Co-Founder, beneficially owned 754,442 (including 107,500 shares held by a trustee pursuant to Israeli tax laws) and 724,541 (including 107,600 shares held by a trustee pursuant to Israeli tax laws) ordinary shares of the Company, respectively, as of April 1, 2006. All other directors, external directors and senior management each hold less than 1% of the Company s shares. The following table sets forth information regarding options held by our directors and officers as of April 1, 2006.

Name	Ordinary Shares Underlying Options	Expiration Dates	Exercise Prices ($/share)
Giora Dishon (1)	255,000	2007-2011	2.06-7.37
Moshe Finarov (1)	225,000	2007-2011	2.06-7.37
13 directors and officers as a group (1)	909,592	2006-2011	2.06-7.37

(1) All such options are currently exercisable.

(2) The vesting period of each option is between one and four years from the date of grant according to the applicable option plan.

As of December 31, 2005, options to acquire 5,730,822 ordinary shares had been issued under our options plans, of which options to acquire 1,728,567 shares have been exercised, 823,251 have been terminated and forfeited and 3,170,885 were exercisable.

As of December 31, 2005, we had eight employee share option plans that provided for the grant of options to our employees, including senior management, to purchase an aggregate of 5,080,822 ordinary shares. The existing share option plans are described below (excluding the first share option plan that was comprised of options to acquire 827,700 ordinary shares, which have been fully exercised).

Option Plan 2 - Options to purchase 650,000 shares at an exercise price per share of NIS 0.01 (approximately $.0025); as of December 31, 2005, all options under this plan were granted, 620,544 options were exercised, 4,000 options were exercisable and 25,456 options had been forfeited;

Option Plan 3 - Options to purchase 387,000 shares at an exercise price per share of $3.17; as of December 31, 2005, all options under this plan were granted, 67,277 options were exercised, 250,000 options were exercisable and 69,723 options had been forfeited;

Option Plan 4 - Options to purchase 668,350 shares at exercise price of $6.27 or $7.37 per share; originally, this plan included 1,000,000 shares, and was reduced to 668,350 shares by a decision of the Board of Directors of the Company. As of December 31, 2005, all options under this plan were granted, 5,594 options were exercised, 418,115 options were exercisable and 244,641 options had been forfeited;

Option Plan 5 - Options to purchase 746,500 shares at an exercise price of $1.13, $2.17 or $2.46, the fair market value of Nova s stock on the date of grant; as of December 31, 2005, all options under this plan were granted, 124,200 options were exercised, 464,115 options were exercisable and 150,066 options had been forfeited;

Option Plan 6 - Options to purchase 960,000 shares at an exercise prices of $2.06, the fair market value of Nova s stock on the date of grant; as of December 31, 2005, all options under this plan were granted, 49,252 options were exercised, 720,829 options were exercisable and 189,919 options had been forfeited. On September 29, 2005, our shareholders have approved amendments to the plan allowing our Board to accelerate the vesting dates and to determine an exercise price which is different from the fair market value of our shares at the date of grant;

Options to purchase 116,272 ordinary shares at an exercise price of $5.16 per share; granted in March 1999 to Mendy Erad, the Chairman of the Board at that time; as of December 31, 2005, 14,000 options were exercised and 102,272 options had been forfeited;

Options to purchase an aggregate of 75,000 ordinary shares at an exercise price of $3.69 per share granted to the members of our Board of Directors, other than our external directors; as of December 31, 2005, 20,000 options were exercised, 35,000 options were exercisable and 20,000 options had been forfeited;

Options to purchase 50,000 ordinary shares at an exercise price of $2.68 per share; granted in May 2003 to Barry Cox, the Chairman of the Board; as of December 31, 2005, 50,000 options were exercisable;

Option Plan 7A - Options to purchase 600,000 shares at an exercise prices of $4.01 and $5.15, the fair market value of Nova s stock on the date of grant; as of December 31, 2005, all options under this plan were granted, 536,054 were exercisable and 63,946 options had been forfeited. On September 29, 2005, our shareholders have approved amendments to the plan allowing our Board to accelerate the vesting dates and to determine an exercise price which is different from the fair market value of our shares at the date of grant;

Option Plan 7B - Options to purchase 650,000 shares at an exercise price of $3.40, the fair market value of Nova s stock on the date of grant; as of December 31, 2005, all options under this plan were granted, 590,500 were exercisable and 59,500 had been forfeited. On September 29, 2005, our shareholders have approved amendments to the plan allowing our Board to accelerate the vesting dates and to determine an exercise price which is different from the fair market value of our shares at the date of grant;

Option Plan 7C - Options to purchase 250,000 ordinary shares at an exercise price equal to the fair market value of Nova s stock on the date of grant; 180,000 options were approved to be granted to directors under this plan. These options have not yet been granted; and

Option Plan 8 - Options to purchase 2,500,000 ordinary shares at an exercise price equal to the fair market value of Nova s stock on the date of grant; 465,300 options were approved to be granted to employees and managers under this plan. These options have not yet been granted.

In addition to the option plans described above, in 2003, we implemented an Employee Stock Purchase Plan pursuant to which eligible employees of the Company may purchase up to 150,000 ordinary shares, subject to certain adjustments, at a discounted price. The Company issued a total of 138,505 shares under this plan.

The following table summarizes information about share options outstanding as of December 31, 2005:

Outstanding as of December 31, 2005				Exercisable as of December 31, 2005	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
(US dollars)		(in years)	(US dollars)		(US dollars)
0.0025	4,000	0.5	0.0025	4,000	0.0025
2.06	720,829	4.2	2.06	720,829	2.06
2.17-3.69	807,234	2.4	2.69	799,115	2.69
3.4	590,500	5.9	3.4	590,500	3.4
4.01	476,054	5.4	4.01	476,054	4.01
5.15	60,000	5.2	5.15	60,000	5.15
5.16	102,272	1.0	5.16	102,272	5.16
6.27-7.37	418,115	1.5	6.97	418,115	6.97
	3,179,004			3,170,885	

Item 7. Major Shareholder and Related Party Transactions

Major shareholders

The following table shows the number of ordinary shares beneficially owned by persons known by us to own beneficially more than five percent of the Company s ordinary shares, as of April 30, 2006.

Name	Number of Ordinary Shares Beneficially Owned*	Percentage of Ordinary Shares Beneficially Owned
Clal Electronics Industries Ltd. (1)	2,823,584	18.23%
Inventech Investments Co. Ltd.	833,974	5.4%
Teuza - A Fairchild Technology Venture Ltd. (2)	1,603,407	10.4%
Teuza Management & Development (1991) Ltd. (2)	1,603,407	10.4%
Austin W. Marxe & David Greenhouse (3)	2,367,837	15.4%
Tamir Fishman Ventures II, L.L.C. (4)	1,175,600	7.6%
Shai Saul (4)	1,175,600	7.6%
Michael Elias (4)	1,182,850	7.6%
Tamir Fishman & Co. Ltd. (4)	1,180,700	7.6%
Eldad Tamir (4)	1,180,700	7.6%
Danny Fishman (4)	1,180,700	7.6%
Giora Dishon (5)	963,042	6.1%
Moshe Finarov(6)	871,941	5.6%

* Unless specifically stated otherwise, the information provided hereinabove is based upon information contained in filings made by the named person with the U.S. Securities and Exchange Commission (SEC) pursuant to Regulation 13D-G.

(1) The following information is contained in Schedule 13D (Amendment No. 2) filed on December 18, 2003 by, among others, Clal Electronics Ltd.: each of Clal Electronics Industries Ltd., Clal Industries and Investments Ltd., IDB Development Corporation Ltd., IDB Holding Corporation Ltd., Nochi Dankner (Chairman of Clal Industries), Shelly Dankner-Bergman (Director of Clal Industries), Avraham Livnat and Ruth Manor reported having shared voting and dispositive control over 2,823,584 shares.

(2) The information was provided by Avi Kerbs, President and Chief Executive Officer of Teuza Management & Development Ltd., the management company of Teuza-A Fairchild Technology Venture Ltd.

(3) As reported on the Schedule 13G (Amendment 4) filed by Messrs. Marxe and Greenhouse on February 15, 2006, the amount indicated includes 536,778 shares held by Special Situations Cayman Fund, L.P., 77,631 shares held by Special Situations Technology Fund, L.P., 397,869 shares held by Special Situations Technology Fund II, L.P., 109,246 shares held by Special Situations Fund III, L.P. and 1,246,313 shares held by Special Situations Fund III, QP, L.P.

(4) The following information is contained in a Schedule 13G (Amendment No. 2) filed by, among others, Tamir Fishman Ventures II, LLC (TFV), on March 30, 2005: (a) Five limited partnerships and a corporation directly beneficially own, in the aggregate, 1,175,600 shares; (b) TFV beneficially owns 1,175,600 shares as the sole general partner of the five limited partnerships and by virtue of its management rights with respect to a corporation ; (c) Shai Saul, is a managing member of TFV; (d) Michael Elias is a managing member of TFV and reports having sole voting and dispositive power over an additional 7,250 shares; (d) Tamir Fishman & Co. Ltd is a managing member of TFV and reports directly owning 5,100 additional shares; (e) Eldad Tamir and Danny Fishman are each Co-President and Co-CEO of Tamir Fishman & Co. Ltd. The total number of shares beneficially owned collectively in this group is 1,182,850.

(5) Includes 107,500 shares held in trust under Israeli tax law for the benefit of the named shareholder and options to purchase 255,000 ordinary shares, which are currently exercisable.

(6) Includes 107,600 shares held in trust under Israel tax law for the benefit of the named person and options to purchase 225,000 shares which are currently exercisable.

All the shareholders of the company have the same voting rights.

The Company believes that, as of December 31, 2005, approximately 30% of its ordinary shares were held by United States holders, and there were approximately 30 record holders in U.S.

Control of Registrant

To the Company s knowledge, it is not owned or controlled by a foreign government. Except for the shareholders identified above owning more than ten percent of the Company s ordinary shares, the Company has no knowledge of any corporation or other natural or legal person owning a controlling interest in the Company.

Related Party Transactions

In 2002, the Company obtained directors and officers liability insurance for its officers and directors with coverage in an aggregate amount of $5,000,000. This coverage was renewed in 2003, 2004 and 2005. In addition, the Company undertook to indemnify the Company s officers and directors up to an aggregate amount of $15,000,000 pursuant to the terms set forth in an Indemnification and Exculpation Letter. On September 29, 2005, the General Meeting of Shareholders of the Company approved the continuation of the terms of Indemnification and Exculpation for the directors and officers of the Company, to the extent such terms concern the directors of the Company, until the adoption of new terms to be prepared and approved by the Audit Committee and the Board of Directors in conformity with the 2005 amendment to the Companies Law, which terms shall be presented for the approval of the shareholders at the earliest opportunity.

The Indemnification and Exculpation Letter also exculpates the officers and directors from certain liabilities relating to their positions and directors and officers with in the framework allowed under the Israeli Company s Law. The shareholders further approved our undertaking to indemnify our officers and directors within the framework allowed under Israeli Company s Law up to an aggregate amount of $15,000,000. Under the Companies Law, a company is prohibited from undertaking to indemnify, to insure or to exempt its officers or directors against: (i) breaches of fiduciary duty to the Company (other than with respect to actions taken in good faith and upon reasonable grounds that such actions shall not adversely affect the Company); (ii) breaches of the duty of care which were made either intentionally or recklessly, unless if they were made negligently; (iii) an action intended to produce unlawful personal profit; or (iv) a fine imposed upon the Officer. The directors and officers insurance and Indemnification and Exculpation Letter, to the extent applicable to directors, were approved by the Company s shareholders on October 31, 2002, covering acts and omissions made in their status as officers; worldwide (including the US and Canada). Company s undertakings under the Indemnification and Exculpation Letter are subject to its undertaking made under its F-1 according to which it shall not be bound to indemnify and exculpate its directors and officers if such undertaking shall be held contradictory to public policy under the ruling of a competent court.

For information relating to options granted to officers and directors, see Share Ownership starting on page 43.

Item 8. Financial Information

Consolidated Financial Statements

See Financial Statements on page 68 of this report and pages F-1 through F-24.

Significant Changes

None.

Legal Proceedings

From time to time, we are a party to legal proceedings and claims in the ordinary course of business. We are not currently a party to any material legal proceedings, apart from the below.

In 1998, Intel Corporation (Intel), a major customer and former shareholder, notified us by letter that a lawsuit had been filed against a number of semiconductor manufacturers, including Intel, by the Lemelson Medical, Education & Research Foundation. The suit alleged that these semiconductor manufacturers infringed upon U.S. patents owned by Lemelson. In its 1998 letter, Intel requested that we defend, indemnify and hold it harmless against the Lemelson claims to the extent the claims resulted from the use of the products we sold to Intel. We did not undertake the defense or agree to hold Intel harmless as it requested. Subsequently, in January 2004, in a suit filed against Lemelson by Cognex Corporation,but not involving Intel or Nova, the United States District Court for the District of Nevada found that various Lemelson patents, including those upon which Lemelson based its claims against Intel, were invalid and not enforceable. We, therefore, believe that we will not have any liability to Intel in connection with the Lemelson suit against Intel and other semiconductor manufacturers. We have, however, not received any formal communication from Intel withdrawing its request for defense and indemnification.

In March 2005, we filed a civil action in the United States District Court for the Northern District of California against Nanometrics Inc. seeking to enforce our United States Patent No. 6,752,689 and in April 2006 Nanometrics filed a civil action in the United States District Court for the Northern District of California against us and our wholly-owned subsidiary, Nova Inc. seeking to enforce their United States Patent No. Re:34,783. For additional information regarding this litigation, see Intellectual Property starting on page 21. In addition, as described below under Material Contracts starting on page 54, in connection with our pending acquisition of HyperNex, Inc., we commenced litigation against one of HyperNex s key suppliers as a result of the supplier s refusal to consent to the assignment to Nova of the supplier s contract with HyperNex.

Dividend Policies

We anticipate that, for the foreseeable future, we will retain any earnings to support operations and to finance the growth and development of our business. Therefore, we do not expect to pay cash dividends for at least the next several years.

We obtained the status of approved enterprise under the Law for the Encouragement of Capital Investments, 1959, under which we may take advantage of certain tax exemptions. We may further obtain such status in the future. If we distribute a cash dividend from income which is tax exempt, we would have to pay corporate tax at a rate of up to 25% on the amount equal to the amount distributed and on the amount of corporate tax which would have been due in the absence of the tax exemption, in addition to withholding tax on such dividends paid. For further description of the conditions limiting our ability to declare and pay dividends see Taxation starting on page 56.

The distribution of dividends may also be limited by the Israeli Companies Law, which permits the distribution of dividends only out of retained earnings or earnings derived over the two most recent fiscal years, whichever is higher, provided that there is no reasonable concern that payment of a dividend will prevent a company from satisfying its existing and foreseeable obligations as they become due. Our Articles provide that dividends will be paid at the discretion of, and upon resolution by, our Board of Directors however, the Board of Directors at its discretion, may transfer the decision in this matter to the general meeting.

Export Sales

Substantially all of our products are sold to customers located outside Israel.

Item 9. The Offer and Listing

Offer and listing details

The information presented in the table below presents, for the periods indicated, the reported high and low closing sales prices on the Nasdaq National Market of our ordinary shares. The shares began trading on the Nasdaq National Market on April 11, 2000 at a price of $18 per share. Our ordinary shares were registered for trading on the Tel Aviv Stock Exchange in 2002 and the table below presents, for the periods indicated, the reported high and low sales prices on the Tel Aviv Stock Exchange.

Nasdaq National Market

	Price per share (US$)	
	High	**Low**
Yearly highs and lows		
2001	10.97	2.46
2002	4.54	0.86
2003	7.19	1.42
2004	8.21	3.00
2005	3.84	2.00
Quarterly highs and lows		
2004		
First quarter	8.21	5.15
Second quarter	7.32	3.80
Third quarter	4.25	3.00
Fourth quarter	4.63	3.19
2005		
First quarter	3.84	2.77
Second quarter	3.00	2.22
Third quarter	2.98	2.20
Fourth quarter	2.47	2.00
2006		
First quarter	2.64	1.90
Monthly highs and lows		
2005		
December	2.42	2.14
2006		
January	2.64	2.36
February	2.55	2.08
March	2.24	1.90
April	1.96	1.72
May		

Tel Aviv Stock Exchange *

	Price per share (NIS)	
	High	**Low**
Yearly highs and lows		
2002	11.58	10.80
2005	14.08	9.56

*During the years 2003 and 2004 there has been no market activity at the TASE

Item 10. Additional Information

Set forth below is a summary of certain provisions of the Company s memorandum and articles of association, as amended to date, and Israeli law affecting shareholders of the Company. This summary does not purport to be complete and is qualified in its entirety by reference to our memorandum and articles of association and such law.

Registration. The Company was incepted and registered in the Israeli Registrar of Company s on May 17, 1993, under registration number 51-181-246-3.

Purpose of the Company. The purposes of the Company, as provided by Article B(3) of our memorandum and articles of association, are (a) to invent, design, plan, develop, manufacture, market and trade in the field of measuring instruments in electronics, micro-electronics, medicine, chemistry, metallurgy, ceramics and any other field, (b) to initiate, participate, manage, execute, import and export any kind of project within the borders of the State of Israel and/or outside Israel, (c) to register patents, trademarks, trade names intellectual property rights marketing rights and any other right of any kind whatsoever, both in Israel and abroad and (d) to engage in any legal activity, both in Israel and abroad.

Approval of Related Party Transaction; Corporate Borrowings. The Israeli Companies Law, to which the company is subject, requires that an office holder of a company, including directors and executive officers, promptly disclose to the board of directors of that company any personal interest that the office holder may have and all related material information known about any existing or proposed transaction with the company. The approval of the board of directors is required, as long as the transaction is in the best of the company, for a transaction that it not an extraordinary transaction, between the company and its office holder or between the company and another person in which the office holder has a personal interest, unless the articles of association provide otherwise. If the transaction is an extraordinary transaction, it also requires the approval of the audit committee prior to its being approved by the board of directors. In the event that the transaction is between the company and a director regarding the director s terms of engagement with the company, including with regard to other positions in the company filled by the director and including with respect to indemnification, insurance and exemptions, the transaction requires the approval of the audit committee, the board of directors and the shareholders.

The Companies Law applies the same disclosure requirements to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder that owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights, but excluding a shareholder whose power derives solely from his or her position on the board of directors or any other position with the company. Approving an extraordinary transaction with a controlling shareholder requires the approval of the company s audit committee, the board of directors and the company s shareholders. Approval by the company s shareholder must be by the affirmative vote of a majority of the shares attending in person or by proxy and, in addition, at least one third of the holders of shares who do not have personal interest in approving the transaction attending in person or represented by proxy must vote in favor of the proposal, or the aggregate number of shares voted against the proposal must not exceed one per cent (1%) of the Company s voting rights.

Under our articles of association, a transaction by the Company with an officer or director of the Company, in which transaction such officer or director has a personal interest, other than an extraordinary transaction, does not require any board or shareholder approval. Interested board members may not vote on extraordinary transactions. Arrangements regarding the compensation of directors are considered extraordinary transactions and require approval by the board of directors, audit committee and shareholders. Arrangements as to compensation of officers employment terms require approval only by the board of directors and audit committee.

Under regulations promulgated under the Companies Law regarding payment of compensation to external directors, compensation of external directors shall be comprised of annual compensation and a per meeting payment ranging as stated in the regulations. These amounts are adjusted twice a year in accordance with the Israeli consumer price index. However, with regard to a company, which shares are traded in an exchange outside of Israel, and is subject to laws which impose upon the external directors demands which exceed the demands imposed upon them under Israeli law, the maximum amount payable to the external directors is 100,000 NIS per annum and NIS 3,000 per meeting. The approval of the shareholders of the Company is required for such compensation, unless it is at a fixed amount set forth in these regulations, or if the external director is in its three years tenure and the compensation does not change. Additionally, external directors may entitled to compensation in stock (including by way of granting options to purchase the Company s stock), provided that such compensation is granted within the framework of a stock incentive plan applicable to all other directors and further provided the amount of stock granted or purchasable shall not fall below the lowest amount granted to any other director and shall not exceed the average amount of stock granted to all other directors.

Our articles of association grant broad powers to the board of directors to authorize the Company to borrow funds, repay borrowings, make guarantees, and grant security interests in borrowings. There is no mandatory retirement age for the Company s directors and a director need not be a shareholder of the Company.

Share Capital. The Company currently has one class of ordinary stock, 0.01 NIS par value per share. Our articles of association provide that the board of directors may declare dividends out of funds legally available therefor. Under the Israeli Companies Law, dividends may be paid out of net earnings, as calculated under that law, for the two years preceding the distribution of the dividend and retained earnings, provided that there is no reasonable concern that the dividend will prevent the company from satisfying its existing and foreseeable obligations as they become due. For more information, see the Company s balance sheet and the statement of shareholders equity in the financial statements. Each ordinary share is entitled to one vote of all meetings of shareholders.

Changes of Rights of Holders of the Ordinary Shares. The rights attached to the ordinary shares may be changed, converted, expanded or altered in any other way by the shareholders with the vote of the holders of at least 75% of the ordinary shares.

Shareholders Meetings. An annual meeting shall be convened at least once every calendar year, and no later than 15 months after the preceding annual meeting, to deliberate on the financial reports, appointment of directors, appointment of an auditing accountant, and any other matter which the board of directors places on the agenda of the annual meeting, at a time and place that the board of directors shall determine. An extraordinary meeting may be called by the board of directors and at the demand of any of the following: two directors or one-quarter of the directors then serving; one or more shareholders who hold at least five per cent of the issued and outstanding capital stock and at least one percent of the voting rights in the Company; or one or more shareholders who hold at least five percent of the voting rights in the Company.

According to our articles of association, the quorum required for an ordinary meeting of shareholders is at least two shareholders present in person or by proxy who together hold or represent in the aggregate more than one third (33.33%) of the voting power. A meeting adjourned for lack of a quorum is adjourned to the same day in the following week at the same time and place or to a later date if said date is indicated in the prior written notice or if the Company has sent to the shareholders a prior notice of no less than 72 hours before the date set for the postponed meeting. At the reconvened meeting, the required quorum consists of any number of members present in person or by proxy, regardless of the number of shares represented. Israeli Companies Law and regulations determine that prior notice of no less than 21 days should be given the company s shareholders, prior to convening a meeting. In the event that the issue to be resolved is an issue listed in Article 87 to the Israeli Companies Law and is to be voted upon pursuant to a proxy solicitation, a notice of no less than 35 days should be given to the company s shareholders.

There are no limitations on the rights of non-resident or foreign owners to hold or vote ordinary shares imposed under Israeli law or under the Company s memorandum or articles of association.

Board of Directors. Our articles of association provide that directors may be elected either at our annual general meeting or an extraordinary meeting of shareholders by a vote of the holders of at least 50% of the total number of votes represented at such meeting. In addition, our board of directors is authorized to appoint directors, at its discretion, provided that the total number of directors shall not exceed the maximum number of directors permitted by our articles of association. Each of our directors holds office until the next annual general meeting of shareholders. However, in accordance with the Israeli Companies Law, our external directors serve for three years, which may be renewed for only one additional three year term. The Companies Law requires that the offices of the Chief Executive Officer and the Chairman of the board of directors be held by different persons. However, the Companies Law further provide that those positions may be held by the same person for a period not exceeding three years if approved by a majority of the company s shareholder, including at least two thirds of the voting present shareholders (shares held by abstaining shareholders are not considered) which are not controlling shareholders or the aggregate number of shares voting against the proposal shall not exceed 1% of company voting shareholders.

The Companies Law provides that Israeli public companies must have at least two external directors. External directors may be elected at our annual general meeting or an extraordinary meeting of our shareholders in a number and manner stipulated by law, namely, for a term of three years which may be renewed for only one additional three year term and requires the affirmative vote of a majority of the shares and in addition either that (i) at least one third (33.33%) of the holders of shares who are not controlling shareholders attending in person or represented by proxy have voted in favor of the proposal (shares held by abstaining shareholders shall not be considered) or (ii) the aggregate number of shares voting against the proposal has not exceeded 1% of the company s voting shareholders. External directors may be removed from office only under the following circumstances: (i) an external director ceases to meet the legal requirements for appointment as an external director or breaches his or her fiduciary duty to the company and a resolution to remove such external director is made by the shareholders at a meeting at which such external director is granted a reasonable opportunity to express his position such a resolution requires the same majority of votes that elected the external director) (ii) an external director ceases to meet the legal requirements for appointment as an external director or breaches his or her fiduciary duty to the Company and a court orders that such director be removed; or (iii) an external director is unable to perform his or her duties or is convicted of certain felonies and a court orders that such director be removed.

According to a recent amendment made to the Companies Law, an external director is qualified for nomination as an external director, only if he/she has either professional qualifications or accounting and financial expertise. The amendment also provides that at least one of the external directors must have accounting and financial expertise. Since the Company is not anticipated to nominate an external director before August 2006, this amendment does not apply to the Company until such nomination. At the time of nomination, the Company shall be required to nominate an external director who has professional qualifications or accounting and financial expertise provided that at least one of the external directors to serve the Company has accounting and financial expertise.

Regulations adopted pursuant to that recent legislation provide that a director with accounting and financial expertise is a director that due to his education, experience and skills has high expertise and understanding in business-accounting matters and financial statements in a way that enables him to deeply understand the financial statements of the company and to facilitate discussion with respect to the way the financial data should be presented. The assessment of the accounting and financial expertise of a director shall be made by the board of directors, who shall take into consideration, *inter alia*, the education, experience and knowledge of the director in the following subjects:

(1) Accounting matters and audit accounting matters, which are typical to the sector in which the company works and of companies with the same size and complexity as of the company;

(2) The duties and obligations of the auditing accountant; and

(3) Preparing of financial statements and their approval according to applicable law, including securities law.

The regulations also provide that a director with professional qualifications is a director who meets one of the following conditions:

(1) A holder of an academic degree in one of the following: economics, business administration, accounting, law, or public administration;

(2) A holder of another academic degree or is otherwise a graduate of higher education in a major field of business of the company or in other filed which is relevant to the role;

(3) He has experience of at least five years in one of the following, or that he has cumulative experience of at least five years in two or more of the following:

  (a) In a senior position in the business management of a corporation which has a significant scope of business;

  (b) In a senior public position or in a senior role in the public service; or

  (c) In a senior position in the major fields of business of the company.

According to the Companies Law, the Board of directors of a public company must establish the minimum number of board members that are to have accounting and financial expertise while considering, *inter alia*, the nature of the company, its size, the scope and complexity of its operations and the number of directors stated in the Articles of Association of the company. When adopting such a resolution (that sets the minimum number of board members that are to have accounting and financial expertise) the company must also appoint such directors.

On April 2006, the Board of Directors resolved that the minimum number of board members that need to have accounting and financial expertise, including the external director with accounting and financial expertise is one (1).

The board stated that the member that has accounting and financial expertise is Ms. Lauri Hanover.

Our board of directors has the authority to issue preferred stock in one or more classes or series and to fix the voting powers, preferences and relative participating, optional or other special rights of such preferred stock, without any further vote or action by the shareholders, subject to specific events as detailed in our Articles of Association and relevant rules.

Changes in Capital. Our share capital may be increased or decreased by a vote of the holders of at least 75% of the shares present at the shareholders meeting.

Acquisition of a Controlling Stake. According to the Company s Law, an acquisition pursuant to which a purchaser shall hold a controlling stake , that is defined as 25% or more of the voting rights if no other shareholder holds a controlling stake, or an acquisition pursuant to which such purchaser shall hold 45% or more of the voting rights of the company if no other shareholder owns more than 45% of the voting rights, may not be performed by way of market accumulation, but only by way of a tender offer made to all of the company s shareholders on a pro rata basis. Such offer needs to be approved by the company s shareholders. A shareholder may be free to object to such offer without such objection being deemed as waiver of his right to sell its respective shares if the transaction is approved by a majority of the company s shareholders despite his objection. Shares purchased not in accordance with those provisions shall become dormant shares and shall not grant the purchaser any rights so long as held by the purchaser.

Merger. The Companies Law requires an acquirer of a public company s shares who wishes to acquire all of the company s shares without the approval of its minority shareholders to acquire at least 95% of all outstanding shares. Even if the acquirer acquires 95% of the outstanding shares, the remaining minority shareholders may seek to block the acquisition in court.

The Companies Law provides that corporate mergers require the approval of both companies boards of directors and shareholders. In the event, however that shares of the target company are held by the acquiring company or by a person holding 25% or more of any type of controlling means of the acquiring company, the merger will not be approved if a majority of the shareholders of the target company attending and voting at the meeting at which the merger is considered (without taking into account, for that purpose, the shares held by the acquiring company or by a person holding 25% or more of any type of controlling means of the acquiring company) object to and do not vote in favor of the merger. If a person holds 25% or more of any type of controlling means of more than one merging company, the same provisions shall apply with regard to the shareholders vote with respect to each such company. Upon the request of a creditor of either party to the proposed merger, the Israeli courts may delay or prevent the merger if the courts conclude that there exists a reasonable concern that as a result of the merger the surviving company will be unable to satisfy the target company s obligations. Furthermore, a merger may not close unless at least 30 days have passed from the time that the general meeting of each of the merging companies was held and at least 50 days have passed from the date on which the merger proposal was sent to the Israeli Registrar of Companies.

In addition, the Companies Law preserves provisions of its predecessor, the Companies Ordinance, dealing with arrangements between a company and its shareholders. These arrangements may be used to effect squeeze out transactions in which the target company becomes a wholly owned subsidiary of the acquirer. These provisions generally require that the merger be approved by at least 75% of the shares of participating shareholders and a majority of the shareholders voting at a shareholders meeting. In addition to shareholder approval, court approval of the transaction is required, which entails further delay.

A merger, the acquisition of a controlling stake or any transaction in which all or substantially all the assets of a company are de facto transferred to another company, may require the approval of the Israeli Commissioner of Restrictive Trade Practices, in the event that the aggregate annual sales volume in Israel of all the companies which are parties to such transaction, exceeds 150,000,000 NIS (approximately $33,000,000, an amount which is adjusted on an annual basis), and also if after the consummation of such transactions, the joint market, in Israel, or at any identified geographic part of Israel will be in excess of 50% with respect to such products and services.

Material Contracts

On April 24, 2006, we entered into an Asset Purchase Agreement with HyperNex, Inc. (HyperNex), Delaware corporation located at State College, Pennsylvania and its shareholders providing for the acquisition by us of substantially all the assets of HyperNex and our assumption of certain specified liabilities, including liabilities accruing after the closing relating to contracts assumed by Nova. A copy of the agreement is filed with this report as Exhibit 4.19.

Under the terms of the Asset Purchase Agreement, we will issue up to 1.8 million ordinary shares as follows: at the closing of the acquisition transaction, we will issue 883,350 ordinary shares to HyperNex and 286,650 ordinary shares to HyperNex employees; and 15 months after closing, subject to certain contingencies, including potential indemnity claims that may be made by us, we will issue up to an additional 475,650 ordinary shares to HyperNex and an additional 154,350 ordinary shares to the employees. The total number of shares issuable 15 months after the closing is also subject to downward adjustment in the event that HyperNex s net worth is less than the target net worth set forth in the Asset Purchase Agreement. The Asset Purchase Agreement also provides the recipients of our ordinary shares with certain limited piggy-back registration rights with respect to our ordinary shares they receive. These piggy-back registration rights are subject to certain customary carve-outs and limitations as well as other limitations set forth in the Asset Purchase Agreement.

The Asset Purchase Agreement also provides that in connection with the closing, each HyperNex employee receiving shares will enter into a restricted stock agreement with respect to our ordinary shares received and to be received by the employee, an employment agreement and a non-compete agreement. In addition, so long as either HyperNex or its shareholders own at least 8% of our outstanding capital stock, they will be entitled to appoint an observer to our Board of Directors.

The Asset Purchase Agreement contains customary representations, warranties and covenants and generally provides that the parties respective liabilities for breaches of the representations and warranties will not exceed 35% of the stock issued under the Asset Purchase Agreement or its monetary value at closing, or 100% of the stock or its monetary value at closing in the case of breaches of certain representations and warranties and certain knowing breaches. Under certain circumstances, a party s liability for a knowing breach of a representation or a warranty may also be unlimited. The transaction is also subject to certain closing conditions, including the completion of legal due diligence by us to its satisfaction and the negotiation and execution of amendments to certain agreements with third parties. Under certain specified circumstances, the Asset Purchase Agreement may be terminated by us or HyperNex prior to the consummation of the transactions described in the agreement.

The forgoing summary does not purport to be complete and is qualified in its entirety by reference to the full text of the Asset Purchase Agreement, a copy of which is filed with this report as Exhibit 4.19.

The closing of the HyperNex acquisition is being delayed because of the refusal of a key supplier of HyperNex to consent to the assignment of its contract with HyperNex to us. The terms of the agreement between HyperNex and the supplier provide, among other things, that the supplier s consent to the assignment of its agreement with us may not be unreasonably withheld or delayed. We believe that HyperNex s supplier is being unreasonable in withholding its consent. Accordingly, on June 6, 2006, we filed a civil action in the United States District Court for the Middle District of Pennsylvania, seeking to enjoin the supplier from interfering with the closing of the Asset Purchase Agreement. As this litigation is in its initial stages, we cannot predict its outcome. If the outcome of the litigation is adverse to us, we may not be able to consummate our proposed acquisition of HyperNex Inc. which may have a material adverse effect on us. In addition, we have incurred, and it is likely that we will continue to incur, substantial costs as a result of this litigation which, in the future, may be material.

Costs related to this agreement have accumulated to approximately $1 million as of June 2006. These costs include legal, accounting and consulting fees, travels and bridge funding to support Hypernex on-going activity until closing. There is no assurance that we will be able to recover the bridge funding in case we are not able to consummate the acquisition. The above described costs will be presented in our 2006 second quarter financial results and forward.

Exchange Controls

Non-residents of Israel who purchase our ordinary shares outside of Israel with U.S. dollars or other foreign currency will be able to convert dividends (if any) thereon, and any amounts payable upon the dissolution, liquidation or winding up of the affairs of the Company, as well as the proceeds of any sale in Israel of the ordinary shares to an Israeli resident, into freely repatriable dollars, at a rate of exchange prevailing at the time of conversion, pursuant to regulations issued under the Currency Control Law, 1978, provided that Israeli income tax has been withheld by the Company with respect to such amounts. Israeli residents are eligible to purchase securities of certain companies, including our ordinary shares, if they are listed on a foreign exchange in a designated country, which is defined to include the Nasdaq.

Taxation

The following summary describes the current tax structure applicable to companies in Israel, with special reference to its effect on us. It also discusses Israeli tax consequences material to persons holding our ordinary shares. Because some parts of the summary are based on new tax legislation yet to be judicially or administratively interpreted, we cannot be sure that the views expressed will accord with any future interpretation. The summary is not intended, and should not be construed, as legal or professional tax advice and does not exhaust all possible tax considerations. Accordingly, you should consult your own tax advisor as to the particular tax consequences of an investment in our ordinary shares.

Tax Reform

During the year 2002, tax reform legislation was enacted with effect from January 1, 2003, which significantly changed the taxation basis of corporate and individual taxpayers from a territorial basis to a worldwide basis. From such date, an Israel resident taxpayer will be taxed on income produced and derived both in and out of Israel. The main provisions of the tax reform that may affect the Company are as follows:

Transfer pricing of international transactions with related parties. The Income Tax Ordinance was amended to include provisions concerning transfer pricing between related parties, where one of the parties is situated abroad. Detailed provisions are to be included in Income Tax Regulations that have yet to be issued. Although the Company considers that the transfer pricing policy adopted with foreign affiliates is economically fair, an adjustment may be required following the issue of the said Regulations.

Employee stock incentive plans. The tax reform codified past practice and determined three alternative tracks for taxing employee stock option plans. Where a trustee arrangement is in place, the employer can either claim an expense for tax purposes while the employee will be fully taxed up to the maximum marginal tax rate of 50% or the Company can waive the tax expense and the employee will pay a reduced tax rate of 25%. Where there is no trustee arrangement, the employee is fully taxable and no expense is allowed to the Company. There are detailed provisions for implementing these tracks. For Option Plans 6 and 7, which were allocated after the implementation of the tax reform, the Company has used the trustee arrangement, with waiver of the tax expense for the company and employee payment of reduced tax rate of 25%. As a result of the reform, the income tax authorities allowed the Company a change of tracks with regard to unvested options issued under option plans prior to the tax reform taking effect, subject to the optionees agreeing to certain restrictions.

Controlled foreign company (CFC). The amendment to the law introduced Controlled Foreign Company (CFC) provisions, which, in certain circumstances, will lead to the Israeli company being charged tax on passive income of foreign affiliates as if it had received a dividend from such companies. This change is not expected to have material affect on the company s financial results and tax payments.

Capital gains tax. Capital gains tax is reduced to 25% from 36%, except with respect to capital gains from marketable securities, with transitional provisions for assets acquired prior to January 1, 2003. For further discussion see below Capital Gains Tax .

C*arrying forward of capital losses.* The seven year limit for carrying forward of capital losses has been removed with respect to capital losses arising from 1996 and thereafter. This change is not expected to have material affect on the company s financial results and tax payments.

General Corporate Tax Structure

In 2005, the Israeli Knesset approved a law for the amendment of the Income Tax Ordinance, according to which the regular corporate tax rate is to be reduced gradually and annually from 35% in 2004 tax year to 34% in 2005 tax year, ending at 25% for the 2010 tax year.

Following this amendment of law, Israeli companies are taxed at a rate of 34% of taxable income in 2005. This rate is currently scheduled to decrease as follows: in 2006-31%, 2007-29%, 2008-27%, 2009-26% and 2010 and onward-25%. However, the effective tax rate payable by a company that derives income from an approved enterprise may be considerably less, as further discussed below.

Tax Benefits under the Law for the Encouragement of Capital Investments, 1959

The Law for the Encouragement of Capital Investments, 1959, provides that upon application to the Investment Center of the Ministry of Industry Trade and Labor, a proposed capital investment in eligible facilities may be designated as an approved enterprise. Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, such as the equipment to be purchased and utilized under the program. The tax benefits derived from this certificate of approval relate only to taxable income derived from growth in operations as determined generally by the growth in manufacturing revenues attributable to the specific approved enterprise. If a company has more than one approval or only a portion of its capital investments are approved, its effective tax rate is the result of a weighted combination of the applicable rates. The tax benefits under the law are not available for income derived from products manufactured outside of Israel.

Taxable income of a company derived from an approved enterprise is taxed at the maximum rate of 25%, rather than the usual rate of 35% (or less as described above), for the benefit period. This period is ordinarily seven years commencing with the year in which the approved enterprise first generates taxable income, and is limited to 12 years from the year of commencement of operations, as determined by the Investment Center, or 14 years from the year of approval, whichever is earlier.

A company owning an approved enterprise may elect to receive an alternative package of benefits. Under the alternative package, the company s undistributed income derived from an approved enterprise will be exempt from tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the approved enterprise within Israel, subject to the 12- and 14-year limitations, and the company will be eligible for the tax benefits under the law for the remainder of the benefits period.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors company. A foreign investors company is a company more than 25% of whose share capital and combined share and loan capital is owned by non-Israeli residents. A company, which qualifies as a foreign investors company and has an approved enterprise program is eligible for tax benefits for a ten-year benefit period instead of the ordinary seven-year period. Income derived from the approved enterprise program will be exempt from tax for a specified period and will be taxed at a reduced rate for the rest of the period. The tax rate for the additional eight years is 25%, unless the level of foreign investment exceeds 49%, in which case the tax rate is 20% if the foreign investment is more than 49% and less than 74%, 15% if more than 74% and less than 90%, and 10% if 90% or more.

The Investment Center bases its decision of whether to approve or reject a company s application for designation as an approved enterprise on criteria set forth in the law and related regulations, the then prevailing policy of the Investment Center and the specific objectives and financial criteria of the applicant. Accordingly, a company cannot be certain in advance whether its application will be approved. In addition, the benefits available to an approved enterprise are conditional upon compliance with the conditions stipulated in the law and related regulations and the criteria set forth in the specific certificate of approval. In the event that a company violates these conditions, in whole or in part, it would be required to refund the amount of tax benefits plus an amount linked to the Israeli consumer price index and interest.

A major portion of our production facilities has been granted the status of approved enterprises. Income arising from our approved enterprise facilities is tax-free under the alternative package of benefits described above and entitled to reduced tax rates of up to 25%, based on the level of foreign ownership for specified periods. We have derived, and expect to continue to derive, a substantial portion of our income from our approved enterprise facilities. In general, the benefits for most of our current production facilities in Israel will continue until termination in 2006. Our current investments in facilities are made under new approvals, the benefits of which will continue no longer than 2012.

An approved enterprise may elect to distribute dividends from taxable or tax-exempt income. Dividends distributed from taxable income are considered to be attributable to the entire taxable income of the enterprise and their effective tax rate is the result of a weighted combination of the applicable tax rates. We currently intend to reinvest the amount of our income and not to distribute such income as a dividend. In the event that we do pay a cash dividend from income that is derived from our approved enterprises under the alternative package of benefits, which income would normally be tax-exempt, we would be required to pay tax on the amount intended to be distributed as dividends at the rate which would have been applicable had we not elected the alternative package of benefits, generally 10% to 25%, depending on the percentage of our shares held by foreign shareholders. The dividend recipient is taxed at the reduced rate of 15% applicable to dividends from approved enterprises if the dividend is distributed during the tax-exemption period or within 12 years thereafter. We would be required to withhold this tax at source, as final tax in Israel. See U.S. Taxation - Distributions on the Ordinary Shares and Note 11 to our Consolidated Financial Statements.

The law also provides that an approved enterprise is entitled to accelerated depreciation on property and equipment included in an approved investment program, generally ranging from 200% for equipment, to 400% for buildings, of ordinary depreciation rates during the first five tax years of the operation of these assets with a ceiling of 20% per year for depreciation on buildings.

In March 2005, the government of Israel approved an amendment to the Investment Law, in which it revised the criteria for investments qualified to receive tax benefits as an Approved Enterprise. Among other things, company that met the criteria of alternate package of tax benefits will receive those benefits without a prior approval.

Tax Benefits for Research and Development

Israeli tax law allows a tax deduction in the year incurred for expenditures, including capital expenditures, in scientific research and development projects, if the projects are approved by the relevant Israeli government ministry and the research and development is for the promotion of the enterprise. Expenditures from projects not so approved are deductible over a three-year period. However, expenses made out of proceeds made available to us through government grants are not deductible according to Israeli law.

Tax Benefits under the Law for the Encouragement of Industry (Taxes), 1969

According to the Law for the Encouragement of Industry (Taxes), 1969, an industrial company is a company located in Israel, of which at least 90% of the income, exclusive of income from defense loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity. We believe that we currently qualify as an industrial company within the definition of the Law for the Encouragement of Industry (Taxes), 1969.

Under the law, industrial companies are entitled to the following preferred corporate tax benefits:

deduction of purchases of know-how and patents over an eight-year period for tax purposes;

deduction of specified expenses incurred in connection with a public issuance of securities over a three-year period for tax purposes, although Israeli tax authorities have indicated that they do not allow these deductions in connection with offerings outside of Israel;

an election to file a consolidated tax return with related Israeli industrial companies that satisfy conditions set forth in the law; and

Additionally, certain tax laws and regulation allow accelerated depreciation rates on equipment and buildings for industrial companies while referring to the definition of industrial company set out by the Law for the Encouragement of Industry (Taxes), 1969.

Eligibility for the benefits under the law does not require receipt of prior approval from any governmental authority. However, the Israeli tax authorities may determine that we do not qualify as an industrial company. In addition, we might not continue to qualify as an industrial Company in the future. As a result of either of the foregoing, the benefits described above might not be available in the future.

Special Provisions Relating to Taxation Under Inflationary Conditions

The Income Tax Law (Inflationary Adjustments) (the Inflationary Adjustments Law), 1985 represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing inflation. The law is highly complex. Its features that are material to us can be described as follows:

A special tax adjustment for the preservation of equity whereby corporate assets are classified broadly into fixed, or inflation immune assets and non-fixed, or soft assets. Where a company s equity exceeds the depreciated cost of its fixed assets, the company may take a deduction from taxable income, including tax-exempt income, that reflects the effect of multiplication of the annual rate of inflation on this excess, up to a ceiling of 70% of taxable income, including tax exempt income, in any single tax year, with the unused portion carried forward on a linked basis. If the depreciated cost of fixed assets exceeds a company s equity, then the excess multiplied by the annual rate of inflation is added to taxable income.

Depreciation deductions on fixed assets and losses carried forward are generally adjusted for inflation based on the increase of the Israeli consumer price index.

Gains on traded securities, which are normally exempt from tax, are taxable in specified circumstances. However, the regular tax rules governing business income in Israel apply to dealers in securities.

In accordance with an amendment to the Inflationary Adjustments Law, the Minister of Finance may, with the approval of the Knesset Finance Committee, determine by order, during a certain fiscal year (or until February 28th of the following year), in which the rate of increase of the price index would not exceed or shall not have exceeded, as applicable, 3%, that all or some of the provisions of this law shall not apply to such fiscal year, or, that the rate of increase of the price index relating to such fiscal year shall be deemed to be 0%, and to make the adjustments required to be made as a result of such determination.

Capital Gains Tax

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between the inflationary surplus and the real gain. The inflationary surplus is a portion of the total capital gain, which is equivalent to the increase of the relevant asset s purchase price that is attributable to the increase in the Israeli consumer price index between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus. Inflationary surplus accumulated after December 31, 1993 is exempt from any capital gains tax in Israel. The real gain is added to ordinary income, which is taxed at ordinary rates of 30% to 50% for individuals and 36%, up to December 31, 2002 and 25% thereafter for corporations. Prior to the reform, individuals were exempt from capital gains tax on the sale of shares listed for trade in certain stock exchanges, including Nasdaq under certain conditions.

As a result of the recent tax reform legislation in Israel, gains from the sale of our ordinary shares and warrants to purchase our ordinary shares derived from January 1, 2003 and on will in general be liable to capital gains tax of up to 15% so long as our shares are eligible for sale on a designated foreign stock market such as Nasdaq. However, according to the tax reform subordinate legislation, non-residents of Israel will be exempt from any capital gains tax from the sale of our securities so long as the gains are not derived through a permanent establishment that the non-resident maintains in Israel, and so long as our securities remain listed for trading as described above. These provisions dealing with capital gains exemptions are not applicable to a person whose gains from selling or otherwise disposing of our securities are: (i) deemed to be business income (such as a broker or dealer); (ii) whose taxable income is determined pursuant to the Israeli Income Tax Law (Inflation Adjustments), 1985; or (iii) who purchased our shares prior to our initial public offering. The Israeli Income Tax Law (Inflation Adjustments) would not normally be applicable to non-resident shareholders who have no business activity in Israel.

In any event, under the US-Israel Tax Treaty, a US treaty resident may only be liable for Israeli capital gains tax on the sale of our ordinary shares (subject to the provisions of Israeli domestic law as described above) if that US treaty resident holds 10% or more of the voting power in our company.

Under a treaty between the governments of the United States and Israel, Israeli capital gains tax does not apply to the sale, exchange or disposition of ordinary shares by a person who qualifies as a resident of the United States within the meaning of the treaty and who is entitled to claim the benefits afforded to such resident by the treaty. This exemption does not apply if the person holds, directly or indirectly, ordinary shares representing 10% or more of our voting power during any part of the 12-month period preceding the applicable sale, exchange or disposition. However, the person would be permitted to claim a credit for the capital gains tax paid in Israel against the U.S. income tax imposed for the applicable sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to the U.S. state or local taxes.

Taxation of the Ordinary Income of Non-Resident Holders of Our Shares

Non-residents of Israel pay income tax on income accrued or derived from sources in Israel. These sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares, or stock dividends, income tax at the rate of 25% is withheld at source. If the income out of which the dividend is being paid is attributable to an approved enterprise, the rate is 15%. A different rate may be provided in a treaty between Israel and the shareholder s country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a U.S. resident is 25% however, the tax rate is reduced to 12.5% for dividends not generated by an approved enterprise to a corporation which holds 10% or more of the company s voting power during a certain period preceding the distribution of the dividend. Also, under the treaty with the U.S., if the income out of which the dividend is being paid is attributable to an approved enterprise and the non-resident is a U.S. corporation that holds 10% of the company s voting power, the rate is 15%.

A non-resident of Israel who receives interest, dividend or royalty income derived from or accrued in Israel, from which tax was withheld at the source, is generally exempt from the duty to file tax returns in Israel on such income, provided that income was not derived from a business conducted in Israel by the taxpayer.

Under Israeli law, non-Israeli corporations might be required to pay Israeli taxes on the sale of traded securities in an Israeli Company, taking into consideration the provisions of any applicable double taxation treaty.

Foreign Exchange Regulations

Non-residents of Israel who hold our ordinary shares are able to receive any dividends, and any amounts payable upon the dissolution, liquidation and winding up of our affairs, freely repatriable in non-Israeli currency at the rate of exchange prevailing at the time of conversion. However, Israeli income tax is required to have been paid or withheld on these amounts. In addition, there are currently no Israeli currency control restrictions on the proceeds from the sale of ordinary shares. However, legislation remains in effect by which currency controls can be imposed by administrative action at any time.

U.S. TAXATION

The following describes the material United States federal income tax consequences of the purchase, ownership and disposition of our ordinary shares to a U.S. holder.

For purposes of this discussion, a U.S. holder is:

- a natural person who is a citizen or resident of the United States;
- a corporation or another entity taxable as a corporation created or organized under the laws of the United States or any political subdivision of the United States;
- an estate, the income of which is includable in gross income for United States federal income tax purposes regardless of its source; or
- a trust, if (a) a U.S. court is able to exercise primary supervision over its administration and (b) one or more U.S. persons have the authority to control all of its substantial decisions.

This summary is for general information purposes only and does not purport to be a comprehensive description of all of the U.S. federal income tax considerations that may be relevant to a decision to purchase, hold or dispose of the ordinary shares. This summary generally considers only U.S. holders that will own the ordinary shares as capital assets and does not consider the U.S. tax consequences to a person that is not a U.S. holder or the tax treatment of persons who hold the ordinary shares through a partnership or other pass-through entity. In addition, the possible application of U.S. federal estate or gift taxes or any aspect of state, local or non-U.S. tax laws is not considered. This discussion is based on current provisions of the Internal Revenue Code of 1986, as amended (the Code), current and proposed Treasury Regulations promulgated under the Code, and administrative and judicial interpretations of the Code, all as in effect today and all of which may change, possibly with a retroactive effect.

This discussion does not address all aspects of U.S. federal income taxation that may be relevant to any particular U.S. holder based on the holder s particular circumstances, such as,

- persons who own, directly, indirectly or constructively, 10% or more of our outstanding voting shares;
- persons who hold the ordinary shares as part of a hedging, straddle or conversion transaction;
- persons whose functional currency is not the dollar;
- persons who acquire their ordinary shares in a compensatory transaction;
- broker-dealers;
- insurance companies;
- tax-exempt organizations;
- financial institutions; and
- persons subject to the alternative minimum tax.

Availability of Reduced Tax Rates

U.S. legislation enacted in 2003 reduced to 15% the maximum U.S. Federal income tax rate on certain long-term capital gains and on qualifying dividends. Long-term capital gains from the sale of our ordinary shares would be eligible for this reduced rate. Dividends, if any, would also be eligible for this reduced rate, provided that we do not constitute a passive foreign investment company.

Distributions on the Ordinary Shares

We currently do not intend to pay dividends for at least the next several years. However, if we make any distributions of cash or other property to a U.S. holder of our ordinary shares, the amount of the distribution for U.S. federal income tax purposes will equal the amount of cash and the fair market value of any property distributed and will also include the amount of Israeli taxes withheld, if any, as described above under Taxation of the Ordinary Income of Non-Resident Holders of Our Shares starting on page 60. In general, a distribution paid by us on the ordinary shares to a U.S. holder will be treated as dividend income if the distribution does not exceed our current or accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of any distribution which exceeds these earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. holder s tax basis in its ordinary shares to the extent thereof, and then as capital gain from the deemed disposition of the ordinary shares. Corporate holders generally will not be allowed a deduction for dividends received on the ordinary shares.

A dividend paid by us in NIS will be included in the income of U.S. holders at the U.S. dollar value of the dividend, based upon the spot rate of exchange in effect on the date of the distribution. U.S. holders will have a tax basis in the NIS for U.S. federal income tax purposes equal to that U.S. dollar value. Any subsequent gain or loss resulting from exchange rate fluctuations between the day the dividend was included in income of U.S. holders and the day the NIS are converted into U.S. dollars or otherwise are disposed of, will be taxable as ordinary income, gain or loss from U.S. sources.

Dividends paid by us generally will be foreign source passive income for U.S. foreign tax credit purposes or, in the case of a U.S. holder that is a financial services entity, financial services income. U.S. holders may elect to claim as a foreign tax credit against their U.S. federal income tax liability the Israeli income tax withheld from dividends received on the ordinary shares. The Code provides limitations on the amount of foreign tax credits that a U.S. holder may claim. U.S. holders that do not elect to claim a foreign tax credit may instead claim a deduction for Israeli income tax withheld, but only for a year in which these U.S. holders elect to do so for all foreign income taxes. The rules relating to foreign tax credits are complex, and you should consult your tax advisor to determine whether and if you would be entitled to this credit.

Sale or Exchange of the Ordinary Shares

Upon the sale or exchange of the ordinary shares, a U.S. holder generally will recognize capital gain or loss in an amount equal to the difference between the amount realized on the sale or exchange and the U.S. holder s tax basis in the ordinary shares. The gain or loss recognized on the sale or exchange of the ordinary shares generally will be long-term capital gain or loss if the U.S. holder s holding period of the ordinary shares is more than one year at the time of the disposition.

Gain or loss recognized by a U.S. holder on a sale or exchange of ordinary shares generally will be treated as U.S. source income or loss for U.S. foreign tax credit purposes. Under the tax treaty between the United States and Israel, gain derived from the sale, exchange or other disposition of ordinary shares by a holder who is a resident of the U.S. for purposes of the treaty and who sells the ordinary shares within Israel may be treated as foreign source income for U.S. foreign tax credit purposes.

Passive Foreign Investment Companies

In general, a foreign (that is, non-U.S.) corporation will be a passive foreign investment company (a PFIC) for any taxable year if either (1) 75% or more of its gross income in the taxable year is passive income, or (2) 50% or more of the average value of its gross assets in the taxable year is held for the production of, or produces, passive income. For purpose of the income test, passive income includes dividends, interest, royalties, rents, annuities and net gains from the disposition of assets, which produce passive income. For purposes of the assets test, assets held for the production of passive income include assets held for the production of, or that produce dividends, interest, royalties, rents, annuities, and other income included in the income test. The income test is conducted at the taxable year-end. The asset test is conducted on a quarterly basis and the quarterly results are then averaged together.

If a corporation is treated as a PFIC for any year during a U.S. holder s holding period and the U.S. holder does not timely elect to treat the corporation as a qualified electing fund under Section 1295 of the Code or elect to mark its ordinary shares to market (both as described below), any gain on the disposition of the shares will be treated as ordinary income, rather than capital gain, and the holder will be required to compute its tax liability on that gain, as well as on dividends and other distributions, as if the income had been earned ratably over each day in the U.S. holder s holding period for the shares. The portion of the gain and distributions allocated to prior taxable years in which a corporation was a PFIC will be taxed at the highest ordinary income tax rate in effect for each taxable year to which this portion is allocated. An interest charge will be imposed on the amount of the tax allocated to these taxable years. A U.S. holder may elect to treat a corporation as a qualified electing fund only if the corporation complies with requirements imposed by the IRS to enable the shareholder and the IRS to determine the corporation s ordinary income and net capital gain. Additionally, if a corporation is a PFIC, a U.S. holder who acquires shares in the corporation from a decedent will be denied the normally available step-up in tax basis to fair market value for the shares at the date of death and instead will have a tax basis equal to the decedent s tax basis if lower than fair market value.

Status of Nova as a PFIC. Under the income test, less than 75% of our gross income was passive income in 2005. The determination of our status under the asset test is more difficult because that test requires a quarterly determination of the fair market value of our passive and non-passive assets and there is no definitive method set forth in the Code, U.S. Treasury Regulations or administrative or judicial interpretations thereof for determining the value of a foreign corporation s assets under the asset test. While there are no definitive rules, the legislative history of the U.S. Taxpayer Relief Act of 1997 indicates that for purposes of the PFIC assets test, the total value of a publicly-traded foreign corporation s assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities.

For 2005, while we continued to have substantial amounts of cash and short-term deposits and the market value of our ordinary shares continued to decrease, a determination of the value of our assets by reference to the market value of our ordinary shares and our liabilities results in a conclusion that the average value of our passive assets did not exceed 50% of the average value of our gross assets in 2005. Nonetheless, there is a risk that we were a PFIC in 2005 or we will be a PFIC in 2006 or subsequent years because, as indicated above, there are no definitive rules regarding the manner in which a company should value its assets for purposes of the PFIC asset test.

Available Elections. If we will be treated as a PFIC for any taxable year, U.S. holders should consider whether or not to elect to treat us as a qualified electing fund or to elect to mark-to-market their ordinary shares. If a U.S. holder makes a qualified electing fund election (a QEF election) for all taxable years that the U.S. holder holds our ordinary shares and during which we are treated as a PFIC, the U.S. holder will be required for each taxable year to include in income a pro rata share of our undistributed ordinary earnings and net capital gain, if any, as ordinary income and long-term capital gain, respectively. In order to make (or maintain) a QEF election, the U.S. holder must annually complete and file IRS From 8621. In addition, we must make certain information regarding our net capital gains and ordinary earnings available to the U.S. holder and permit our books and recorded to be examined to verify such information. Therefore, if you determine that we are a PFIC for any year and make a request to us in writing at the address on the cover our latest Annual Report on Form 20-F, Attention Chief Financial Officer, for the information required to make a QEF election, we will promptly make the information available to you and comply with any other applicable requirements of the Code.

A QEF election, once made with respect to us, applies to the tax year for which it was made and to all subsequent tax years, unless the election is invalidated or terminated, or the IRS consents to revocation of the election. If you make a QEF election and we cease to qualify as a PFIC in a subsequent tax year, the QEF election will remain in effect, although it will not be applicable during those tax years in which we do not qualify as a PFIC. Therefore, if we - after ceasing to qualify as a PFIC - again qualify as a PFIC in a subsequent tax year, the QEF election will be effective and you will again be subject to the rules described above for US holders making QEF elections in such tax year and any subsequent tax years in which we qualify as a PFIC. A QEF election also remains in effect even after you dispose of all of your direct and indirect interest in our ordinary shares. As a result, if you subsequently acquire any of our ordinary shares or an interest in any of our ordinary shares, you will again be subject to the rules described above for US holders making a QEF election for each tax year in which we qualify as a PFIC.

Alternatively, if a U.S. holder elects to mark-to-market its ordinary shares, the U.S. holder will generally include in its income any excess of the fair market value of our ordinary shares at the close of each taxable year over the holder s adjusted basis in such ordinary shares. A U.S. holder generally will be allowed an ordinary deduction for the excess, if any, of the adjusted tax basis of the ordinary shares over the fair market value of the ordinary shares as of the close of the taxable year, or the amount of any net mark-to-market gains recognized for prior taxable years, whichever is less. A U.S. holder s adjusted tax basis in the ordinary shares will generally be adjusted to reflect the amounts included or deducted under the mark-to-market election. Additionally, any gain on the actual sale or other disposition of the ordinary shares generally will be treated as ordinary income. Ordinary loss treatment also will apply to any loss recognized on the actual sale or other disposition of ordinary shares to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such ordinary shares. An election to mark-to-market generally will apply to the taxable year in which the election is made and all subsequent taxable years. A mark-to-market election applies to the tax year for which the election is made and to each subsequent year, unless our ordinary shares cease to be marketable, as specifically defined, or the IRS consents to revocation of the election. No view is expressed regarding whether our ordinary shares are marketable for these purposes or whether the election will be available.

If a U.S. holder makes either the QEF election or the mark-to-market election, distributions and gain will not be recognized ratably over the U.S. holder s holding period or be subject to an interest charge as described above. Further, the denial of basis step-up at death described above will not apply. If a U.S. holder elects to treat us as a qualified electing fund, gain on the sale of the ordinary shares will be characterized as capital gain. However, U.S. holders making one of these two elections may experience current income recognition, even if we do not distribute any cash. The elections must be made with the U.S. holder s federal income tax return for the year of election, filed by the due date of the return (as it may be extended) or, under certain circumstances provided in applicable Treasury Regulations, subsequent to that date.

The foregoing discussion relating to the QEF election and mark-to-market elections assumes that a U.S. holder makes the applicable election with respect to the first year in which Nova qualifies as a PFIC. If the election is not made for the first year in which Nova qualifies as a PFIC, the procedures for making the election and the consequences of election will be different.

A number of specific rules and requirements apply to both the QEF election and the mark-to-market election, and you are urged to consult your tax advisor concerning our PFIC status and the various elections you can make.

United States Information Reporting and Backup Withholding

Dividend payments and proceeds from the sale or disposal of ordinary shares may be subject to information reporting to the Internal Revenue Service and possible U.S. federal backup withholding at the rate of 28%. Backup withholding will not apply, however, to a holder who furnishes a correct taxpayer identification number or certificate of foreign status and makes any other required certification or who is otherwise exempt from backup withholding (for example, if you are a corporation). Any U.S. holder who is required to establish exempt status generally must file Internal Revenue Service Form W-9 (Request for Taxpayer Identification Number and Certification). Finalized Treasury Regulation, which are applicable to payments made after December 31, 2000, have generally expanded the circumstances under which information reporting and backup withholding may apply.

Amounts withheld as backup withholding may be credited against a U.S. holder s federal income tax liability. A U.S. holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the Internal Revenue Service and furnishing any required information.

Documents on Display

The documents referred to herein, including our memorandum and articles of association, can be obtained from the Company at its registered office at Weizmann Science Park, Building 22, 2nd Floor, Ness-Ziona 76100, Israel. In addition, the Company is subject to certain informational requirements of the Securities Exchange Act of 1934 and the rules and regulations promulgated thereunder. In accordance therewith, the Company files reports with the United States Securities and Exchange Commission (SEC). Reports and other information provided to the SEC by the Company may be inspected and copied at the public reference facilities maintained by the SEC at Room 1024, 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation of the public reference facilities may be obtained by calling the SEC at 1-800-SEC-0330. In addition, certain of the Company s reports filed with the SEC are available on-line at www.sec.gov.

Item 11. Quantitative and Qualitative Disclosures About Market Risk

Market risk

Market risk represents the risk of loss that may impact the consolidated financial position, results of operations or cash flows of the Company. The Company is exposed to market risk in the area of foreign exchange rates, as described below.

The Company does not utilize financial instruments for trading purposes and holds no derivative financial instruments that could expose it to significant market risk.

Impact of Inflation and Currency Fluctuation

Substantially all of our sales are made in U.S. dollars. Over 50% of our expenses in 2005 were in dollars or in NIS linked to the dollar. Most of the remaining expenses were in NIS. The dollar cost of our operations in Israel is influenced by any increase and the timing of such increase, in the rate of inflation in Israel that is not offset by the devaluation of the NIS in relation to the dollar During 2005, the value of the NIS decreased against the dollar by 5.6%, while the consumer price index in Israel increased 2.39%. During 2004, the value of the NIS increased against the dollar by 1.62%, while the consumer price index in Israel increased 2.38%. During 2003, the value of the NIS increased against the dollar by 7.6%, while the consumer price index in Israel decreased 1.9%. We believe that the rate of inflation in Israel has had a minor effect on our business to date. However, our dollar costs in Israel will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of this devaluation lags behind inflation in Israel. As of December 31, 2005, the majority of our net monetary assets were denominated in dollars and the remainder was denominated mainly in NIS. Net monetary assets that are not denominated in dollars or dollar-linked NIS are affected by the risk of currency fluctuations. In addition, approximately 5% of our expenses are in Euros. During 2005, the value of the Euro decreased against the dollar by approximately 15%. The strength of the dollar against the Euro and the NIS has decreased the average dollar value of expenses valued in those currencies.

Based upon historical US dollar currency movement, the Company does not believe that reasonably possible near-term changes in the US dollar currency of 5% will result in a material effect on future earnings, financial position or cash flows of the Company.

In 2003, the Company entered into currency-forward and currency-put options transactions (NIS/dollar) to insure (NIS/dollar) the rate in 2003. The total accumulated sum insured in the year was approximately $4 million, and the results of these transactions did not have, as expected, any material effect on the operational results of the Company.

In 2004, the Company entered into currency-forward and currency-put options transactions (NIS/dollar) to insure (NIS/dollar) the rate in 2004. The total accumulated sum insured in the year was approximately $7.7 million with settlement dates through 2005, and the results of these transactions did not have, as expected, any material effect on the operational results of the Company.

In 2005, the Company entered into currency-forward and currency-put and currency call options transactions (NIS/dollar, Euro/dollar, Yen/dollar) to insure (NIS/dollar, Euro/dollar, Yen/dollar) the rate in 2005. The total accumulated sum insured in the year was approximately $4.25 million with settlement dates through 2005, and the results of these transactions did not have, as expected, any material effect on the operational results of the Company.

Item 12. Description of Securities Other than Equity Securities

Not applicable.

PART II

Item 13. Defaults, Dividend Arrearages and Delinquencies

None.

Item 14. Material Modification to the Rights of Security Holders and Use of Proceeds

The effective date of the Securities Act registration statement for which use of proceeds is being disclosed is April 11, 2000. The commission file number assigned to that registration statement is 333-11640.

We sold 3,000,000 ordinary shares for consideration of $54 million. The net proceeds amounted to $49.2 million. As of March 31, 2006, approximately $29 million of the net proceeds had been used for working capital requirements and $5.5 million for capital expenditures.

Item 15. Evaluation of disclosure controls and procedures

Based on their evaluation as of the end of the period covered by this Annual Report on Form 20-F, the Company s President and Chief Executive Officer and Chief Financial Officer initially concluded that the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) were effective so as to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission s rules and forms.

In early 2006, and before publishing the financial results for year 2005, we initiated a review of our recognition of revenues in 2004 and for the first three quarters of 2005. As a result of this review, we concluded that we did not properly recognize revenues from multiple deliverables sales arrangements in 2004 which included upgrade commitments or trade-in rights. We also concluded that we did not properly recognize revenues in the first three quarters of 2005 from multiple deliverables sales arrangements that included upgrade commitments or trade-in rights, and in the first quarter of 2005 from extended warranty contracts. This review led us to restate our 2004 financial statements, as described in Note 14 to our Consolidated Financial Statements for the year ended December 31, 2005 contained elsewhere in the report, and to correct our financial results for the first three quarters of 2005.

In connection with the restatement of our 2004 financial results, our management, under the supervision and with the participation of our President and Chief Executive Officer and our Chief Financial Officer re-evaluated our disclosure controls and procedures as of December 31, 2005. Based upon the re-evaluations, our President and Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of December 31, 2005 because at that time we did not have effective controls designed and in place to ensure that revenues relating to multiple deliverables sales arrangements were properly recognized in accordance with generally accepted accounting principles.

In order to address the failure to have effective controls designed and in place as described above, we implemented several additional disclosure controls in 2006, including a quarterly review of all purchase orders and agreements governing the purchase orders, stricter controls to ensure that all multiple deliverables sales arrangements are properly approved by management in writing, and monitoring of the accuracy and proper use of new computer systems which are used to allocate revenue from warranty contracts.

There is no assurance that the disclosure controls and procedures will operate effectively under all circumstances. Nevertheless, our President and Chief Executive Office and our Chief Financial Officer believe that with the implementation of the above remedial and corrective actions, the controls and procedures are now effective so as to provide reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission s rules and forms.

Changes in internal controls

During the fiscal year ended December 31, 2005 there were no changes in our internal controls over financial reporting that materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting. However, as discussed above, in early 2006, we implemented several new internal controls and over financial reporting.

Item 16. Reserved

Reserved.

Item 16A. Audit Committee Financial Expert

Our Board of Directors has determined that our Audit Committee includes one audit committee financial expert, as defined by Item 16A of Form 20-F, Ms. Lauri Hanover. Ms. Hanover is an independent director as such term is defined by Rule 4200(15) of the NASDAQ Stock Market.

Item 16B. Code of Ethics

The Company has adopted a written code of conduct that applies to all Company employees, including the Company s directors, principal executive officer, principal financial officer and principal accounting officer.

You may review our code of conduct on our website, http://nova.co.il under About Nova .

Item 16C. Principal Accountant Fees and Services

During each of the last two fiscal years, Brightman Almagor & Co., an independent registered accounting firm and a member firm of Deloitte Touche Tohmatsu (Deloitte & Touche) has acted as the Company s registered public accounting firm and independent auditors.

AUDIT FEES

Deloitte & Touche billed the Company approximately $38,000 for audit services for fiscal 2004, including fees associated with the annual audit and reviews of the Company s quarterly financial results submitted on Form 6-K, consultations on various accounting issues and performance of local statutory audits. Deloitte & Touche billed the Company approximately $43,000 for audit services in fiscal 2005.

AUDIT-RELATED FEES

Deloitte & Touche did not bill for any audit-related services in 2005 or 2004, except as included under the caption AUDIT FEES .

TAX FEES

Deloitte & Touche billed the Company approximately $2,000 for tax advice, including fees associated with tax compliance services, tax planning services and other tax consulting services for fiscal 2004. Deloitte & Touche billed the Company approximately $2,000 for tax advice in fiscal 2005.

ALL OTHER FEES

Deloitte & Touche billed the Company approximately $5,000 for services other than Audit Fees and Tax Fees described above for fiscal 2004. In fiscal 2004, such other services included consulting for Office of the Chief Scientist grants refund and consulting regarding investment center application. Deloitte & Touche billed the Company approximately $5,000 for SEC compliance related services other than Audit Fees and Tax Fees described above for fiscal 2005.

PRE-APPROVAL POLICIES FOR NON-AUDIT SERVICES

Prior to the engagement of Deloitte & Touche each year, the engagement is approved by the Audit Committee of the Board of Directors. The Company s Audit Committee rules of procedure provide for a process with respect to the prior approval of all services, including non-audit services, to be performed by the independent auditors for the Company. In fiscal 2005 and 2004, the Company s Audit Committee approved all of the services provided by Deloitte & Touche.

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

The Company has not obtained any exemption from applicable audit committee listing standards.

Item 16E. Purchases of Equity Securities by the Issuer and Affiliates Purchasers

In 2005, neither the Company nor any affiliated purchaser (as defined in the Exchange Act) purchased any of the Company s ordinary shares.

PART III

Item 17. Financial Statements

Not applicable.

Item 18. Financial Statements

See pages F-1 through F-24.

Item 19. Exhibits

Number	Description
1.1	Articles of Association (incorporated by reference to exhibit 3.1 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
1.2	First Amendment to the Company s Articles of Association (incorporated by reference to the Company s Current Report on Form 6-K filed on June 4, 2002)
1.3	Second Amendment to the Company s Articles of Association (incorporated by reference to the Company s Current Report on Form 6-K filed on December 16, 2004).
4.1	1997 Stock Option Plan (Plan 2) (incorporated by reference to exhibit 10.1 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.2	Option Plan 3 (incorporated by reference to exhibit 10.2 to the Company s Registration Statement on Form F-1 (registration number 333-11640))

Number	Description
4.3	Option Plan 4A and 4B (incorporated by reference to exhibit 10.3 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.4	Option Plan 5 (incorporated by reference to Exhibit 4.4 to the Company s Annual Report for 20-F for 2002 filed May 9, 2002
4.5	Option Plan 6 (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed December 24, 2002 (registration number 333-102193))
4.6	Employment Agreement between Nova and Giora Dishon (incorporated by reference to exhibit 10.4 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.7	Employment Agreement between Nova and Moshe Finarov (incorporated by reference to exhibit 10.6 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.8	Employment Agreement between Nova and Chai Toren (incorporated by reference to exhibit 10.7 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.9	Employment Agreement between Nova and Ronen Frish (incorporated by reference to exhibit 10.8 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.10	Agreements between Nova and the Office of the Chief Scientist in Israel (incorporated by reference to exhibit 10.10 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.11	Certificate of Approval from the Investment Center in Israel (incorporated by reference to exhibit 10.11 to the Company s Registration Statement on Form F-1 (registration number 333-11640))
4.12	Lease Agreement between Nova and Ef-Shar Ltd. (incorporated by reference to Exhibit 4.14 to the Company s Annual Report on Form 20-F filed on May 9, 2002)
4.13	Summary of Lease Agreement between Nova and Ef-Shar Ltd. (incorporated by reference to Exhibit 4.15 to the Company s Annual Report on Form 20-F filed on May 9, 2002)
4.14	Letter Agreement between Barry Cox and the Company dated May 15, 2003 (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on May 17, 2004 (registration number 333-115556))
4.15	Employee Stock Purchase Plan 1 (incorporated herein by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on March 24, 2003 (File No. 33-103981))
4.16	Letter of Indemnification and Exculpation for certain directors, officers and/or employees (incorporated herein by reference Annex A to the Company s Current Report on Form 6-K filed on October 8, 2002)
4.17	Option Plan 7A (incorporated by reference to Exhibit 4.1. to the Company s Registration Statement on Form S-8 filed on May 17, 2004 (registration number 333-115554))
4.18	Option Plan 7B (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on March 7, 2005 (registration number 333-123158)
4.19	Asset Purchase Agreement dated April 24, 2006 by and among Nova, HyperNex, Inc. and the Stockholders listed on Schedule 4(a) therein, including a list of omitted schedules and exhibits (filed herewith). The Company agrees to furnish supplementary a copy of any omitted schedule or exhibit to the Securities and Exchange Commission upon request.
4.20	Option Plan 7C (filed herewith).
4.21	Option Plan 8 (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on December 29, 2005 (registration number 333-130745).
8	List of Subsidiaries (filed herewith)
12.1	Certification required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith)

12.2 Certification required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith)

13.1 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

Number	Description
13.2	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
14.1	Consent of Brightman Almagor & Co. (filed herewith)

Signatures

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned, thereunto duly authorized.

NOVA MEASURING INSTRUMENTS, LTD.

By: /s/ Giora Dishon

Giora Dishon, President and Chief Executive Officer

Date: June 29, 2006

NOVA MEASURING INSTRUMENTS LTD.

CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2005

NOVA MEASURING INSTRUMENTS LTD.

CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2005

Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE SHAREHOLDERS OF

NOVA MEASURING INSTRUMENTS LTD.

We have audited the accompanying consolidated balance sheets of Nova Measuring Instruments Ltd. (the Company) and its subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders equity and comprehensive loss and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2005 and 2004, and their consolidated results of operations and cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

Brightman Almagor & Co.
Certified Public Accountants
A member firm of Deloitte Touche Tohmatsu

Tel Aviv, Israel
April 11, 2006

NOVA MEASURING INSTRUMENTS LTD.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	As of December 31,	
	2005	**2004**
CURRENT ASSETS		
Cash and cash equivalents	$ 5,776	$ 12,171
Short-term interest-bearing bank deposits	1,206	1,916
Short-term investments	3,500	-
Held to maturity securities	4,388	8,583
Trade accounts receivable (net of $14 and $0 allowance for doubtful accounts, respectively)	6,841	6,850
Inventories (Note 3)	6,606	6,354
Other current assets	1,141	1,169
	29,458	37,043
LONG-TERM ASSETS		
Long-term interest-bearing bank deposits	2,974	2,145
Held to maturity securities	4,952	5,989
Other long-term assets	262	382
Severance pay funds (Note 6)	2,186	2,288
	10,374	10,804
FIXED ASSETS, NET (Note 4)	2,507	2,119
Total assets	$ 42,339	$ 49,966
CURRENT LIABILITIES		
Trade accounts payable	$ 5,744	$ 4,795
Other current liabilities (Note 5)	8,880	6,539
	14,624	11,334
LONG-TERM LIABILITIES		
Liability for employee termination benefits (Note 6)	2,907	3,075
Deferred income	1,264	3,831
Other long-term liability	100	145
	4,271	7,051
COMMITMENTS AND CONTINGENCIES (Note 7)		
SHAREHOLDERS EQUITY (Note 8)		
Ordinary shares, NIS 0.01 par value - authorized 40,000,000 shares, issued and outstanding 15,457,471 and 15,308,544 shares, respectively	46	46
Additional paid-in capital	73,636	73,333
Accumulated other comprehensive income (loss)	(18)	8
Accumulated deficit	(50,220)	(41,806)

Total shareholders equity	23,444	31,581
Total liabilities and shareholders equity	$ 42,339	$ 49,966

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

NOVA MEASURING INSTRUMENTS LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except shares and per share data)

	Year ended December 31,		
	2005	**2004**	**2003**
REVENUES:			
Product sales	$ 21,985	$ 29,274	$ 21,152
Services	8,157	7,532	5,536
	30,142	36,806	26,688
COST OF REVENUES:			
Product sales	11,413	14,396	10,270
Services	7,893	6,715	6,265
	19,306	21,111	16,535
GROSS PROFIT	10,836	15,695	10,153
OPERATING EXPENSES:			
Research and development expenses, net of participation by the Office of Chief Scientist of $1,896, $1,926 and $2,321, respectively (Note 7)	9,301	8,665	8,561
Sales and marketing expenses	6,950	6,647	6,534
General and administrative expenses	3,626	2,331	1,898
Other operating income (Note 9)	-	-	(2,203)
	19,877	17,643	14,790
OPERATING LOSS	(9,041)	(1,948)	(4,637)
INTEREST INCOME, NET (net of expenses of $35, $56 and $28, respectively)	627	528	425
NET LOSS FOR THE YEAR	$ (8,414)	$ (1,420)	$ (4,212)
LOSS PER SHARE:			
Basic and diluted loss per share	$ (0.55)	$ (0.09)	$ (0.28)
Shares used in calculation of basic and diluted loss per share	15,437	15,259	14,994

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

NOVA MEASURING INSTRUMENTS LTD.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)

(In thousands)

	Ordinary shares	Additional Paid-in Capital	Deferred stock-based compensation	Accumulated other Comprehensive Income (loss)	Accumulated Deficit	Total
Balance as of January 1, 2003	$ 46	$ 72,614	$ (809)	$ -	$ (36,174)	$ 35,677
Employee share-based plans	(*) -	318				318
Amortization of deferred stock- based compensation			540			540
Forfeiture of employee share options		(147)	147			-
Increase in fair market value of derivatives				13		13
Loss for the year					(4,212)	(4,212)
Total comprehensive loss						**(4,199)**
Balance as of December 31, 2003	$ 46	$ 72,785	$ (122)	$ 13	$ (40,386)	$ 32,336
Employee share-based plans	(*) -	548				548
Amortization of deferred stock- based compensation			122			122
Decrease in fair market value of derivatives				(5)		(5)
Net loss for the year					(1,420)	(1,420)
Total comprehensive loss						**(1,425)**
Balance as of December 31, 2004	$ 46	$ 73,333	$ -	$ 8	$ (41,806)	$ 31,581
Employee share-based plans	(*) -	275				275
Deferred stock-based compensation		28	(28)			-
Amortization of stock-based compensation			28			28
Decrease in fair market value of derivatives				(26)		(26)
Loss for the year					(8,414)	(8,414)
Total comprehensive loss						**(8,440)**
Balance as of December 31, 2005	$ 46	$ 73,636	$ -	$ (18)	$ (50,220)	$ 23,444

(*) Less than $1

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

NOVA MEASURING INSTRUMENTS LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

		Year ended December 31,		
		2005	2004	2003
CASH FLOWS OPERATING ACTIVITIES				
Net loss for the year		$ (8,414)	$ (1,420)	$ (4,212)
Adjustments to reconcile net loss for the year to net cash used in operating activities	Schedule A	1,033	(418)	(1,320)
Net cash operating activities		(7,381)	(1,838)	(5,532)
CASH FLOWS INVESTING ACTIVITIES				
Decrease (increase) in short-term interest-bearing bank deposits		931	(1,205)	(89)
Increase in short term investments		(3,500)	-	-
Proceeds from held to maturity securities		5,612	4,530	1,019
Investment in short-term held to maturity securities		-	(1,948)	(4,296)
Investment in long-term held to maturity securities		-	(12,549)	-
Investment in long-term interest-bearing bank deposits		(1,050)	(759)	(1,386)
Additions to fixed assets		(1,282)	(1,242)	(364)
Net cash investing activities		711	(13,173)	(5,116)
CASH FLOWS FINANCING ACTIVITIES				
Shares issued under employee share-based plans		275	548	318
Net cash financing activities		275	548	318
Decrease in cash and cash equivalents		(6,395)	(14,463)	(10,330)
Cash and cash equivalents beginning of year		12,171	26,634	36,964
Cash and cash equivalents end of year		$ 5,776	$ 12,171	$ 26,634
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION:				
Taxes paid		$ 62	$ 65	$ 67

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

NOVA MEASURING INSTRUMENTS LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

SCHEDULE A ADJUSTMENTS TO RECONCILE LOSS TO NET LOSS TO NET CASH USED IN OPERATING ACTIVITIES

	Year ended December 31,		
	2005	2004	2003
Income and expense items not involving cash flows:			
Depreciation and amortization	$ 894	$ 548	$ 716
Net recognized gains on investments	(380)	(309)	(25)
Amortization of deferred stock-based compensation	-	122	540
Increase (decrease) in liability for employee termination benefits, net	(66)	310	168
Stock options acceleration	28	-	-
	476	671	1,399
Changes in assets and liabilities:			
Decrease (increase) in trade accounts receivable	9	(1,046)	(2,902)
Decrease (increase) in other current assets and other long-term assets	148	(70)	(336)
Increase in inventories	(252)	(2,202)	(1,002)
Increase (decrease) in trade accounts payables and other long-term liabilities	904	(624)	2,011
Increase (decrease) in long-term deferred income	(2,567)	3,568	24
Increase (decrease) in other current liabilities	2,315	(715)	(514)
	557	(1,089)	(2,719)
	$ 1,033	$ (418)	$ (1,320)

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

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 1 GENERAL

A. Business Description

Nova Measuring Instruments (the Company) was incorporated in May 1993 and commenced operations in October 1993 in the design, development and production of integrated process control systems, used in the manufacturing of semiconductors. In October 1995, the Company began manufacturing and marketing its systems. In addition, the Company is continuing research and development for the next generation of its products and additional applications for such products. The Company operates in one operating segment.

The Company has wholly owned subsidiaries in the United States of America (the U.S.), Japan, The Netherlands and Taiwan. All companies (the subsidiaries) are engaged in pre-sale activities and providing technical support to customers.

The industry in which the Company operates is characterized by rapid technological development in a competitive environment. Substantially most of the Company s current sales are derived from a single product line for usage exclusively by the semiconductor industry, whose business is highly cyclical. The Company depends on a limited number of suppliers, and at times a sole supplier. Any disruption or termination of the suppliers operations may adversely affect the Company s production capabilities. In addition, certain of the Company s development projects are in the early stages and there can be no assurance that these projects will be successful.

The ordinary shares of the Company are traded on the NASDAQ National Market System since April, 2000. The ordinary shares are also traded on the Tel-Aviv Stock Exchange, since June, 2002.

B. Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of 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.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES

The company s consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) in the United States of America.

The following is a summary of the significant accounting policies, which were applied in the preparation of these financial statements, on a consistent basis:

A. Financial Statements in U.S. Dollars

The currency of the primary economic environment in which the operations of the Company and its subsidiaries are conducted is the U.S. dollar (the dollar). Accordingly, the Company use the dollar as its functional and reporting currency. Certain of the dollar amounts in the financial statements may represent the dollar equivalent of other currencies, including the New Israeli Shekel (NIS), and may not be exchangeable for dollars.

Transactions and balances denominated in dollars are presented at their dollar amounts. Non-dollar transactions and balances are remeasured into dollars in accordance with the principles set forth in Statement of Financial Accounting Standards (SFAS) No. 52, Foreign Currency Translation of the Financial Accounting Standards Board (FASB). Net financing income includes translation gains (losses), which were immaterial for all years presented.

B. Principles of Consolidation

The Company s consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries (the Group), after elimination of material intercompany transactions and balances.

C. Cash and Cash Equivalents

Cash and cash equivalents are comprised of cash and demand deposits in banks and other short-term, highly liquid investments (primarily interest-bearing time deposits and commercial papers) with maturity dates not exceeding three months from the date of deposit.

D. Allowance for Doubtful Accounts

The allowance for doubtful accounts is computed on the specific identification basis.

E. Held to Maturity Securities

Securities held to maturity include investments in debt securities that the Company has positive intent and ability to hold to maturity. Securities held to maturity are measured at amortized cost.

F. Inventories

Inventories are presented at the lower of cost or market. Cost is determined as follows:

Raw materials-on the average cost basis.

Finished goods and work in process - on actual production cost basis (materials, labor and indirect manufacturing costs).

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)

G. Fixed assets

Fixed assets are presented at cost, net of accumulated depreciation. Annual depreciation is calculated based on the straight-line method over the shorter of the estimated useful lives of the related assets or terms of the related leases. Annual depreciation rates are as follows:

	Years
Electronic equipment	2-5
Office furniture and equipment	7-15
Leasehold improvements	5

In accordance with SFAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets of the FASB, which supersedes SFAS No. 121, management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable based on estimated future undiscounted cash flows. If so indicated an impairment loss would be recognized for the difference between the carrying amount of the asset and its fair value.

H. Accrued Warranty Costs

Accrued warranty costs are calculated in respect of the warranty period on the Company s products (generally one year) and are based on the Company s prior experience and in accordance with management s estimate. See Note 5B for disclosure with regard to accrued warranty costs.

I. Revenue Recognition

Revenues are recognized upon shipment of products to the customer or provision of support service provided that persuasive evidence of an arrangement exists, title has transferred, the price is fixed, collection of resulting receivables is probable and there are no remaining significant obligations. In addition to the above mentioned criteria, in cases of arrangements with multiple deliverables a Vendor-Specific Objective Evidence must exist to allocate a portion of the total fee to any undelivered elements of the arrangement. Such undelivered elements in these arrangements typically consist of services and/or upgrades. If vendor-specific objective evidence does not exist for the undelivered elements of the arrangement, all revenue is deferred until such evidence does exist, or until all elements are delivered, whichever is earlier. See also note 14.

Service contracts generally specify fixed payment amounts for periods longer than one month, and are recognized on a straight-line basis over the term of the contract. Revenue from sale of spare parts is usually recognized upon shipment of the parts.

J. Research and Development

Research and development costs are charged to operations as incurred. Amounts received or receivable from the Government of Israel through the Office of the Chief Scientist (OCS) as participation in certain research and development programs are offset against research and development costs. The accrual for grants receivable is determined based on the terms of the programs, provided that the criteria for entitlement have been met.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)

K. Income Taxes

The Group accounts for income taxes utilizing the asset and liability method in accordance with SFAS No. 109, Accounting for Income Taxes of the FASB. Current tax liabilities are recognized for the estimated taxes payable on tax returns for the current year. Deferred tax liabilities or assets are recognized for the estimated future tax effects attributable to temporary differences between the income tax bases of assets and liabilities and their reported amounts in the financial statements, and for tax loss carryforwards. Measurement of current and deferred tax liabilities and assets is based on provisions of enacted tax laws, and deferred tax assets are reduced, if necessary, by the amount of tax benefits, the realization of which is not considered likely based on available evidence.

L. Stock-Based Compensation

The Group accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and in accordance with FASB Interpretation No. 44. Pursuant to these accounting pronouncements, the Group records compensation for stock options granted to employees over the vesting period of the options based on the difference, if any, between the exercise price of the options and the market price of the underlying shares at the grant date. With respect to variable awards, changes in the market price of the underlying shares at each balance sheet date affect the aggregate amount of compensation recorded. Deferred compensation is amortized to compensation expense over the vesting period of the options. See below for pro forma disclosures required in accordance with SFAS No. 123, Accounting for Stock-Based Compensation , as amended by SFAS 148.

Pro forma Loss Per Share According to SFAS 123 and SFAS 148:

For purposes of estimating fair value in accordance with SFAS 123, the Company utilized the Black-Scholes option-pricing model. The following assumptions were utilized in such calculations for 2004 and 2003. No stock options were granted during 2005 (all in weighted averages):

	2004	2003
Risk-free interest rate	4%	1.4%
Expected life of options	7 years	7 years
Expected weekly volatility	56%	82%
Expected dividend yield	none	none

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)

L. Stock-Based Compensation (Cont.)

Had compensation cost for the Company s stock option plans been determined based on fair value at the grant dates for all awards made in 2004 and 2003 in accordance with SFAS 123, as amended by SFAS 148, the Company s pro forma loss per share would have been as follows:

	2005	2004	2003
Pro forma net loss			
Net loss for the year, as reported	$ (8,414)	$ (1,420)	$ (4,212)
Deduct stock-based compensation determined under APB-25	28	122	540
Add - stock-based compensation determined under SFAS 123	(2,710)	(1,258)	(1,348)
Pro forma net loss	$ (11,096)	$ (2,556)	$ (5,020)
Pro forma loss per share			
Basic - as reported	$ (0.55)	$ (0.09)	$ (0.28)
Basic - pro forma	$ (0.72)	$ (0.17)	$ (0.33)

In July 2005, the Company s Board of Directors approved a plan to accelerate the vesting of certain outstanding stock options. Based on this action, most of the stock options outstanding as of December 29, 2005 were vested and became fully exercisable as of that date. Aside from the acceleration of the vesting date, the terms and the conditions of the stock option award agreements governing the underlying stock options grants remained unchanged. As a result of this plan, options to purchase approximately 1,126,145 shares became exercisable. This action results in stock option expense in the Consolidated Statements of Operations over the next three years in accordance with SFAS 123 (revised 2004) Share-Based Payment (SFAS 123(R)) to be approximately $1,491 thousand less (in the aggregate) than the expense would have been if the vesting had not been accelerated. As a result of the accelerated vesting, the pro forma stock-based employee compensation expense for 2005 increased by $28 thousand.

M. Loss per Share

Loss per share is presented in accordance with SFAS 128 of the FASB, Earnings per Share. Pursuant to this standard, basic earnings (loss) per share exclude the dilutive effects of convertible securities and are computed by dividing income (loss) available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings (loss) per share reflect the potential dilutive effect of all convertible securities. Due to the anti-dilutive effect, basic loss per share was equal to diluted loss per share for years 2005, 2004 and 2003. The number of potentially dilutive securities excluded from diluted earnings per share due to the anti-dilutive effect amounted to 2,444,175, 754,109 and 2,608,475 in 2005, 2004 and 2003, respectively.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)

N. Derivative Financial Instruments

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities as amended by SFAS No. 138 and SFAS 149, requires, principally, the presentation of all derivatives as either assets or liabilities on the balance sheet and the measurement of those instruments at fair value. Gains and losses resulting from changes in the fair values of derivative instruments would be accounted for depending on the use of the derivative and whether it qualifies for hedge accounting.

See Note 13 for disclosure of the derivative financial instruments in accordance with such pronouncements.

O. Reclassification

Certain amounts in prior years financial statements have been reclassified in order to conform to the 2005 financial statements presentation.

P. New Accounting Pronouncements

(1) In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R). SFAS No. 123(R) requires employee share-based equity awards to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25 and allowed under the original provisions of SFAS No. 123. SFAS No. 123(R) requires the use of an option pricing model for estimating fair value, which is then amortized to expense over the service periods. Had the Company adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net income and income per share above. SFAS No. 123(R) allows for either prospective recognition of compensation expense or retrospective recognition.

In January 2005, the SEC issued SAB No. 107, which provides supplemental implementation guidance for SFAS No. 123(R). SFAS No. 123(R) will be effective for the Company beginning in the first quarter of fiscal 2006. In the first quarter of 2006, the company began to apply the prospective recognition method and implemented the provisions of SFAS No. 123(R).

Management has recently commenced identifying the potential future impact of applying the provisions of SFAS 123(R), including each of its proposed transition methods, yet is currently unable to fully quantify the effect of this Standard on the Company s future financial position and results of operations. Nonetheless, it is expected that the adoption of SFAS 123(R) will increase the stock-based-award expenses the Company is to record in the future in comparison to the expenses recorded under the guidance currently applied by the Company.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES (Cont.)

a. In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 replaces APB Opinion No. 20. Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The Company does not expect the adoption of SFAS No. 154 will have any material impact on its consolidated financial statements.

b. In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP 115-1 and 124-1), which clarifies when an investment is considered impaired, whether the impairment is other than temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 and 124-1 are effective for all reporting periods beginning after December 15, 2005. The Company does not anticipate that the implementation of these statements will have a significant impact on its financial position or results of operations.

NOTE 3 INVENTORIES

A.

	As of December 31,	
	2005	**2004**
Raw materials	$ 931	$ 1,640
Work in process	3,530	3,444
Finished goods	2,145	1,270
	$ 6,606	$ 6,354

B. In the years ended December 31, 2005 and 2004 the Company wrote-off inventories in the amounts of $116 and $250, respectively.

NOTE 4 FIXED ASSETS, NET

	As of December 31,	
	2005	**2004**
Cost:		
Electronic equipment	$ 5,552	$ 4,341
Office furniture and equipment	616	597

Leasehold improvements	1,802	1,750
	7,970	6,688
Accumulated depreciation and amortization:		
Electronic equipment	3,778	3,140
Office furniture and equipment	429	354
Leasehold improvements	1,256	1,075
	5,463	4,569
Net book value	$ 2,507	$ 2,119

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 5 OTHER CURRENT LIABILITIES

A. Consists of:

	As of December 31,	
	2005	2004
Accrued salaries and fringe benefits	$ 2,229	$ 2,667
Accrued warranty costs (See B below)	1,864	2,915
Deferred income	3,852	-
Governmental institutions	917	933
Other	18	24
	$ 8,880	$ 6,539

B. Accrued warranty costs:

	December 31,	
	2005	2004
Balance as of beginning of year	$ 2,915	$ 2,558
Services provided under warranty	(3,090)	(2,830)
Changes in provision	2,039	3,187
Balance as of end of year	$ 1,864	$ 2,915

NOTE 6 LIABILITY FOR EMPLOYEE TERMINATION BENEFITS, NET

Israeli law and labor agreements determine the obligations of the Company to make severance payments to dismissed employees and to employees leaving employment under certain other circumstances. The obligation for severance pay benefits, as determined by Israeli law, is based upon length of service and the employee s most recent salary. The liability is partially covered through insurance policies purchased by the Company and deposits in a severance fund.

Severance-pay expense amounted to $597, $691 and $614 for 2005, 2004 and 2003, respectively.

NOTE 7 COMMITMENTS AND CONTINGENT LIABILITIES

A. The Company has received grants in the aggregate amount of $8,945 from the OCS, as its participation of up to 50% of certain development costs. In consideration for such grants, the Company has undertaken to pay royalties amounting to 3%-3.5% of the net sales of products developed, directly or indirectly, from the projects financed, not to exceed 100% of the grants received. Refund of the grants thereon is contingent on future sales and the Company has no obligation to refund grants if sufficient sales are not generated. During the fourth quarter of 2003, the OCS has approved the

Company s request to allocate $2,203 from the grants provided by OCS to a specific lithography project, to be repaid as royalties only from sales of lithography products. As a result, the Company has canceled a provision in the total amount of $2,203, made by it mainly in prior years. Such cancellation is included as Other Operating Income in the Statement of Operations for the year ended December 31, 2003. Royalty expense amounted to $ 0 for the years 2005, 2004 and $ 656 for the year 2003. The balance of the contingent liability to the OCS as of December 31, 2005 was approximately $ 5,741 (including $2,203 with respect to the lithography project, as mentioned above).

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 7 COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

B. The Group rents its facilities under various operating lease agreements, which expire on various dates, the latest of which is in 2010. The minimum rental payments are as follows:

Year	Amount (US dollars)
2006	1,087
2007	1,072
2008	27

Rental expense for the facilities amounted to $1,062, $1,248 and $851 for the years 2005, 2004 and 2003, respectively.

C. The Company leases vehicles under various operating lease agreements, which expire on various dates, the latest of which is in 2008. The minimum rental payments are as follows:

Year	Amount (US dollars)
2006	520
2007	94
2008	8

Vehicle lease expense amounted to $717, $669 and $516 for the years 2005, 2004 and 2003, respectively.

D. A major customer who was a related party until August 2001 (the Former Related Party), has notified the Company that a lawsuit has been filed against him by a third party. The suit alleges that the Former Related Party, while using the Company s products, has infringed upon numerous U.S. patents owned by the third party.

According to the agreement between the Company and the Former Related Party, the Company is to assume responsibility and to indemnify the Former Related Party for any losses with regard to such suit. The Company is unable to determine at this time with any certainty the ultimate outcome of the aforementioned issue and its effect, if any, on the Company s financial condition, operating results and business.

E. In 2004 the Israeli Tax Authorities approached Israeli public companies and other entities with a request to provide certain information relating the stamping of commercial documents in Israel. To the best of the Company s knowledge such companies and entities are arguing that the request contradicts the common practice in Israel. Management estimates that the Company s exposure, if any, in connection with this request is not expected to have a material effect on the Company s financial position and results of operations. In January 2006 the Stamp Tax was canceled.

F. On March 9, 2005 the Company filed a complaint in the United States District Court for the Northern District of California against one of its competitors (hereinafter-the Competitor) for infringing its US Patent. The patent relates to the Company s Integrated Metrology (IM) tools and the fundamental aspects of these systems. The Competitor has filed counter claim seeking an injunction that will determine that the patent is invalid. The Company is unable to determine at this time with any certainty the ultimate outcome of the aforementioned issue and its effect, if any, on the Company s financial condition, operating results and business.

NOVA MEASURING INSTRUMENTS LTD.
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NOTE 8 SHAREHOLDERS EQUITY

A. Share Capital Transactions

The Company sponsored an employee stock purchase plan (ESPP) for the benefit of its employees. Under the ESPP, substantially all employees were entitled to purchase the Company s ordinary shares through payroll deductions at a price equal to 85 percent of the lower of fair market value at the beginning or end of each six-month offering period. The ESPP ended on March 19, 2005. Total shares issued under the ESPP were 138,505, out of which 42,062 shares were issued under the ESPP in 2005. The Company issued 42,062, 52,858 and 43,585 shares, in 2005, 2004 and 2003 respectively under the ESPP.

B. Rights of Shares

Holders of ordinary shares are entitled to participate equally in the payment of cash dividends and bonus shares (stock dividends) and, in the event of the liquidation of the Company, in the distribution of assets after satisfaction of liabilities to creditors. Each ordinary share is entitled to one vote on all matters to be voted on by shareholders.

C. Share Option Plans

The Company s Board of directors approves, from time to time, employee share option plans, the last of which was approved in December 2004. The options usually vest over four years and their term may not exceed 7 years. The exercise price of each option is usually the market price of the underling share at the date of each grant.

Through December 31, 2005, 5,730,822 share options have been issued under the plans, of which 1,728,567 options have been exercised, 485,030 options have been forfeited, 338,221 have been terminated and 3,170,885 options were exercisable as of December 31, 2005.

The weighted average fair value (in dollars) of the options granted during 2004 and 2003, according to Black-Scholes option-pricing model, amounted to $2.11 and $1.43 per option, respectively. Fair value was determined on the basis of the price of the Company s share.

A summary of the status of the Company s share option plans as of December 31, 2005, 2004 and 2003, as well as changes during each of the years then ended, is presented below:

	2005		2004		2003	
	Share options	Weighted average exercise price	Share options	Weighted average exercise price	Share options	Weighted average exercise price
Outstanding - beginning of year	3,630,378	$ 3.57	2,621,213	$ 3.38	1,922,402	$ 3.99
Granted	-		1,250,000	3.86	1,010,000	2.09
Exercised	(107,079)	1.51	(138,640)	2.58	(144,180)	1.66
Terminated	(173,965)	4.39	(37,974)	5.81	(72,240)	5.38
Forfeited	(170,330)	2.52	(64,221)	2.30	(94,769)	3.27
Outstanding - year end	3,179,004	3.57	3,630,378	3.57	2,621,213	3.38
Options exercisable at year-end	3,170,885		1,575,108		1,290,609	

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 8 SHAREHOLDERS EQUITY (Cont.)

C. Share Option Plans (Cont.)

The following table summarizes information about share options outstanding as of December 31, 2005:

Outstanding as of December 31, 2005				Exercisable as of December 31, 2005	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
(US dollars)		(in years)	(US dollars)		(US dollars)
0.0025	4,000	0.5	0.0025	4,000	0.0025
2.06	720,829	4.2	2.06	720,829	2.06
2.17-3.69	807,234	2.4	2.69	799,115	2.69
3.4	590,500	5.9	3.4	590,500	3.4
4.01	476,054	5.4	4.01	476,054	4.01
5.15	60,000	5.2	5.15	60,000	5.15
5.16	102,272	1.0	5.16	102,272	5.16
6.27-7.37	418,115	1.5	6.97	418,115	6.97
	3,179,004			3,170,885	

NOTE 9 OTHER OPERATING EXPENSES (INCOME)

The amount for the year ended December 31, 2003 represents cancellation of a provision with respect to royalties to the OCS (see Note 7A.).

NOTE 10 INCOME TAXES

A. Law for the Encouragement of Capital Investments 1959

In October 1995, the Company was granted approved enterprise status under the tax-exempt benefit track, as provided by the Israeli Law for the Encouragement of Capital Investments - 1959, for an investment program in the aggregate amount of $732 (the first program). The Company had completed the investments under the program, which received the approval of the Investments Center. The tax-exempt benefit track provides for a tax exemption on undistributed earnings derived from assets included in the approved enterprise investment program for the first four years of the seven-year benefit period and a 25% tax rate for the remaining three years of the benefit period. Pursuant to the tax-exempt benefit track, the Company is liable for tax at a 25% rate on distributions to shareholders of earnings subject to the exemption.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 10 INCOME TAXES (Cont.)

A. Law for the Encouragement of Capital Investments 1959 (Cont.)

In December 1999, the Company was granted another approved enterprise status for an investment expansion program in the aggregate amount of $3,229 (the second program) under the tax-exempt benefit track. The Company had completed the investments under the expansion program and filed the final report with respect to this plan. The tax-exempt benefit track provides for a tax exemption on undistributed earnings derived from assets included in the approved enterprise investment program for the first two years of the seven-year benefit period and a 25% tax rate for the remaining five years of the benefit period. Pursuant to the tax-exempt benefit track, the Company is liable for tax at a 25% rate on distributions to shareholders of earnings subject to the exemption.

In January 2005, the Company granted another approved enterprise status for an investment expansion program in the aggregate amount of $1,000 (the third program) under the tax-exempt benefit track. The tax-exempt benefit track, once approved, provides for a tax exemption on undistributed earnings derived from assets included in the approved enterprise investment program for the first two years of the seven-year benefit period and a 25% tax rate for the remaining five years of the benefit period. Pursuant to the tax-exempt benefit track, the Company is liable for tax at a 25% rate on distributions to shareholders of earnings subject to the exemption.

The period in which the Company is entitled to the abovementioned tax benefits is limited to seven years from the first year that taxable revenues are generated, and such benefits must be utilized within 12 years from the year that operation (as defined) of the approved enterprise commences, or 14 years from the year the approval is granted, whichever is earlier. Accordingly, under the existing conditions, the tax benefits period under the above-mentioned first, second and third programs ends in 2006, 2012 and 2018, respectively.

Dividends paid from earnings that benefited from the approved enterprise tax status are subject to a 15% tax to the recipient (for a period of 12 years from the end of the seven-year benefit period), whereas dividends paid out of other earnings are subject to tax to the recipient at the rate of 25% (or lower if paid to a treaty country), except when paid to another Israeli company, in which case such dividends are exempt from tax.

The income of the Company that is not derived from assets, which are eligible for reduced taxation benefits, as described above, is taxed at the statutory rate for Israeli companies (see H below).

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 10 INCOME TAXES (Cont.)

A. Law for the Encouragement of Capital Investments 1959 (Cont.)

The above tax benefits are conditioned upon fulfillment of the requirements stipulated by the aforementioned law and the regulations promulgated there under, as well as the criteria set forth in the certificates of approval. In the event of failure by the Company to comply with these conditions, the tax benefits could be canceled, in whole or in part, and the Company would be required to refund the amount of the canceled benefits, plus interest and certain inflation adjustments.

If the investments of non-Israeli investors (as such investments are defined by the Law) will exceed 25% then the seven-year benefit period mentioned above may be extended to ten years. If the investments of non-Israeli investors is 49% or more, then the rate of tax on earnings derived from assets included in the approved enterprise investment program will decrease to 10% - 20%, depending on the level of ownership by non-Israeli investors, examined on a yearly basis.

In March 2005, the government of Israel past an amendment to the Investment Law, in which it revised the criteria for investments qualified to receive tax benefits as an Approved Enterprise. Among other things, company that met the criteria of alternate package of tax benefits, will receive those benefits without a prior approval.

B. Law for the Encouragement of Industry (Taxation), 1969

The Company is an industrial company under the Law for the Encouragement of Industry (Taxation), 1969 and, therefore, is entitled to certain tax benefits, mainly accelerated rates of depreciation.

C. Taxation Under Inflationary Conditions

The Company reports for tax purposes in accordance with the provisions of the Income Tax Law (Adjustments Due to Inflation) - 1985, under which taxable income is measured in terms of NIS adjusted for changes in the Israeli Consumer Price Index.

D. Deferred Taxes

The Company has accumulated losses for Israeli tax purposes as of December 31, 2005 in the amount of approximately $50,000. At such date, other temporary differences were approximately $8,000.

The Israeli tax loss carryforwards have no expiration date. The Company expects that during the period these losses are utilized, its undistributed earnings will be tax exempt. Since the Company has no intention to distribute such earnings, there will be no tax benefit available from such tax losses and no deferred taxes have been included in these financial statements for these losses.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 10 INCOME TAXES (Cont.)

D. Deferred Taxes (Cont.)

As of December 31, 2005, the subsidiaries had a net operating loss carryforwards of approximately $883.

E. Effective Tax Rates

The Company s effective tax rates differ from the statutory rates applicable to the Company for all years presented due primarily to its approved enterprise status (see A above) and the tax loss carryforwards.

F. Tax Assessments

The Company received final tax assessments until and including tax year 2001.

G. In light of losses for both financial reporting and tax purposes in 2002 and 2003, a reconciliation of the effective income tax rate has not been presented. In 2004, theoretical income taxes on the Company s pre-tax income were primarily reduced by the utilization of tax loss carryforwards from prior years for which a deferred tax asset had not been recorded and reduced tax rates related to approved enterprise.

H. Tax Rates

In 2005 the Israeli Knesset approved a law for the amendment of the Income Tax Ordinance, according to which the regular corporate tax rate is to be reduced gradually and annually from 35% in 2004 tax year to 34% in 2005 tax year, ending at 25% for 2010 tax year.

NOTE 11 GEOGRAPHIC AREAS AND MAJOR CUSTOMERS

A. Sales by geographic area (as percentage of total sales):

	Year ended December 31,		
	2005	2004	2003
	%	%	%
USA	66	67	62
Europe -primarily Italy, France and Germany	11	11	10
Japan	18	18	21
Other	5	4	7
Total	100	100	100

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 11 GEOGRAPHIC AREAS AND MAJOR CUSTOMERS (Cont.)

B. Sales by major customers (as percentage of total sales):

	Year ended December 31,		
	2005	2004	2003
	%	%	%
Customer A	48	45	36
Customer B	16	18	29
Customer C	15	12	14
Other	21	25	21
Total	100	100	100

C. Assets by location

Substantially all fixed assets are located in Israel.

NOTE 12 TRANSACTIONS AND BALANCES WITH RELATED PARTIES

The total directors fees (including the Chairman of the Board) for the year 2005 amounted to $114 (2004 - $103, 2003 -$122). Number of options granted to directors amounted 380,000 in 2004.

NOTE 13 FINANCIAL INSTRUMENTS

A. Fair value of financial instruments

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that impose on one entity a contractual obligation either to deliver cash or receive cash or another financial instrument to or from a second entity. Examples of financial instruments include cash and cash equivalents, short-term interest-bearing bank deposits, held to maturity securities, trade accounts receivable, investments, trade accounts payable, accrued expenses, options and forward contracts.

At December 31, 2005 and 2004 the fair market value of the Company s financial instruments did not materially differ from their respective book value.

B. Hedging activities

In 2003, the Company entered into currency-forward transaction (NIS/dollar) of $400 with settlement date of January 2004, designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of $400. In accordance with SFAS 133 the Company recorded in 2003 an increase of $13 in fair market value in Other Comprehensive Income . In 2004 this increase was charged to operations on the relevant settlement dates.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 13 FINANCIAL INSTRUMENTS (Cont.)

B. Hedging activities (Cont.)

In 2004, the Company entered into currency-forward transaction, to currency-put option and to currency-call option (NIS/dollar, Euro/dollar, Yen/dollar) of 7,700 with settlement date through 2005, designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of 7,700. In accordance with SFAS 133 the Company recorded in 2004 an increase of $8 in fair market value in Other Comprehensive Income .

In 2005, the company entered into currency-forward transaction, to currency-put option and to currency-call option (NIS/dollar, Euro/dollar, Yen/dollar) of 4,250 with settlement date through 2005, designed to reduce cash-flow exposure to the impact of exchange-rate fluctuations on firm commitments of 4,250. In accordance with SFAS 133 the Company recorded in 2005 a decrease of $26 in fair market value in Other Comprehensive Income .

NOTE 14 RESTATEMENT OF FINANCIAL STATEMENTS

Subsequent to the issuance of the 2004 financial statements, the Company decided to restate its financial statements for the fiscal year ended December 31, 2004, to correctly apply revenue recognition principles relating to certain sales transactions, as described below.

During 2004, the Company sold certain systems to several customers. These transactions included an option to upgrade the sold system free of charge once for an unlimited period or during a two year period. The Company recognized all revenues from the sales of these systems in 2004. EITF 00-21 Revenue Arrangements with Multiple Deliverables (EITF), requires evaluation of each deliverable to determine whether it should be a separate unit of accounting. Under the EITF these transactions are considered multiple deliverables arrangement, for which the upgrade right was not delivered. The Company was unable to establish a vendor specific objective evidence (VSOE) for the fair value of the upgrade right, therefore all revenues from the sale of these systems have been deferred until such an upgrade will be either exercised or expires. The restated financial statements include the effect of such deferral of revenues and costs related to these transactions.

In another instance in 2004 the Company granted to one of its customers trade in rights with decreasing rates of discounts over a period of 5 years. The trade-in right provided the customer with a discount toward the purchase price of a new system that is calculated based on the price of the originally sold systems as follows: if the trade-in is performed during the 1st and 2nd year after the sale 72% of the price of the originally bought systems; 3rd year 47%; 4th year 31%; 5th year 14%.

The Company had recognized all revenues from the sales of these systems in 2004. The Company reached a conclusion that only the portion that is not subject to the discounts schedule above, is fixed and determinable. The Company recognized only that portion and will recognize the remaining balance in future periods based on the amounts released from the above discount schedule. The restated financial statements include the effect of such deferral and the directly related costs.

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 14 RESTATEMENT OF FINANCIAL STATEMENTS (Cont.)

The tables below summarize the impact of the aforementioned restatement with respect to the financial statements as of December 31, 2004 and for the year then ended:

Consolidated Statement of Operations:

	Year ended December 31, 2004		
	Previously Reported	Adjusted	As Restated
Revenues-Product sales	$ 33,347	$ (4,073)	$ 29,274
Cost of revenues-Product Sales	15,361	(965)	14,396
Sales and marketing expenses	6,868	(221)	6,647
Operating Profit (Loss)	939	(2,887)	(1,948)
Net income (loss)	1,467	(2,887)	(1,420)
Basic earning (loss) per share	$ 0.10	$ (0.19)	$ (0.09)

Consolidated Balance Sheet:

	As of December 31, 2004		
	Previously Reported	Adjusted and Reclassified	As Restated
Trade Accounts Receivables	$ 7,461	$ (611)	$ 6,850
Inventories	5,239	1,115	6,354
Total Current Assets	36,539	504	37,043
Total Assets	49,462	504	49,966

Trade Accounts Payables	5,016	(221)	4,795
Other Current Liabilities	6,389	150	6,539
Total Current Liabilities	$ 11,405	$ (71)	$ 11,334

NOVA MEASURING INSTRUMENTS LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except share and per share data)

NOTE 14 RESTATEMENT OF FINANCIAL STATEMENTS (Cont.)

Consolidated Balance Sheet (Cont.):

	As of December 31, 2004		
	Previously Reported	Adjusted	As Restated
Long Term Liabilities-Deferred Income	$ 369	$ 3,462	$ 3,831
Total Long Term Liabilities	3,589	3,462	7,051
Accumulated Deficit	(38,919)	(2,887)	(41,806)
Total Shareholders Equity	$ 34,468	$ (2,887)	$ 31,581

NOTE 15 SUBSEQUENT EVENT

In April 2006, the Company s Competitor, against whom The Company has filed civil action for patent infringement, has filed a civil action in the United States District Court against the Company and the Company s wholly-owned US subsidiary, seeking to enforce its United States Patent. The Company has filed a response declaring the patent invalid and asserting that neither it nor the Company s wholly-owned subsidiary, infringe the patent. The Company is unable to determine at this time with any certainty the ultimate outcome of the aforementioned issue and its effect, if any, on the Company s financial condition, operating results and business.

EXHIBIT INDEX

Number	Description	Page Number
1.1	Articles of Association (incorporated by reference to exhibit 3.1 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
1.2	First Amendment to the Company s Articles of Association (incorporated by reference to the Company s Current Report on Form 6-K filed on June 4, 2002)	
1.3	Second Amendment to the Company s Articles of Association (incorporated by reference to the Company s Current Report on Form 6-K filed on December 16, 2004).	
4.1	1997 Stock Option Plan (Plan 2) (incorporated by reference to exhibit 10.1 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.2	Option Plan 3 (incorporated by reference to exhibit 10.2 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.3	Option Plan 4A and 4B (incorporated by reference to exhibit 10.3 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.4	Option Plan 5 (incorporated by reference to Exhibit 4.4 to the Company s Annual Report for 20-F for 2002 filed May 9, 2002	
4.5	Option Plan 6 (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed December 24, 2002 (registration number 333-102193))	
4.6	Employment Agreement between Nova and Giora Dishon (incorporated by reference to exhibit 10.4 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.7	Employment Agreement between Nova and Moshe Finarov (incorporated by reference to exhibit 10.6 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.8	Employment Agreement between Nova and Chai Toren (incorporated by reference to exhibit 10.7 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.9	Employment Agreement between Nova and Ronen Frish (incorporated by reference to exhibit 10.8 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.10	Agreements between Nova and the Office of the Chief Scientist in Israel (incorporated by reference to exhibit 10.10 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.11	Certificate of Approval from the Investment Center in Israel (incorporated by reference to exhibit 10.11 to the Company s Registration Statement on Form F-1 (registration number 333-11640))	
4.12	Lease Agreement between Nova and Ef-Shar Ltd. (incorporated by reference to Exhibit 4.14 to the Company s Annual Report on Form 20-F filed on May 9, 2002)	
4.13	Summary of Lease Agreement between Nova and Ef-Shar Ltd. (incorporated by reference to Exhibit 4.15 to the Company s Annual Report on Form 20-F filed on May 9, 2002)	
4.14	Letter Agreement between Barry Cox and the Company dated May 15, 2003 (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on May 17, 2004 (registration number 333-115556))	
4.15	Employee Stock Purchase Plan 1 (incorporated herein by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on March 24, 2003 (File No. 33-103981))	
4.16	Letter of Indemnification and Exculpation for certain directors, officers and/or employees (incorporated herein by reference Annex A to the Company s Current Report on Form 6-K filed on October 8, 2002)	

4.17	Option Plan 7A (incorporated by reference to Exhibit 4.1. to the Company s Registration Statement on Form S-8 filed on May 17, 2004 (registration number 333-115554))	
4.18	Option Plan 7B (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on March 7, 2005 (registration number 333-123158)	
4.19	Asset Purchase Agreement dated April 24, 2006 by and among Nova, HyperNex, Inc. and the Stockholders listed on Schedule 4(a) therein, including a list of omitted schedules and exhibits (filed herewith). The Company agrees to furnish supplementary a copy of any omitted schedule or exhibit to the Securities and Exchange Commission upon request.	E-3
4.20	Option Plan 7C (filed herewith).	E-4
4.21	Option Plan 8 (incorporated by reference to Exhibit 4.1 to the Company s Registration Statement on Form S-8 filed on December 29, 2005 (registration number 333-130745).	
8	List of Subsidiaries (filed herewith)	E-5

Number	Description	Page Number
12.1	Certification required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith)	E-6
12.2	Certification required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (filed herewith)	E-7
13.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)	E-8
13.2	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)	E-9
14.1	Consent of Brightman Almagor & Co. (filed herewith)	E-10