



AND ITS SUBSIDIARIES

**CONDENSED INTERIM CONSOLIDATED
FINANCIAL STATEMENTS**

As of March 31, 2005
(Unaudited)

**ELRON ELECTRONIC INDUSTRIES LTD.
AND ITS SUBSIDIARIES**

CONDENSED INTERIM CONSOLIDATED

FINANCIAL STATEMENTS

AS OF MARCH 31, 2005

UNAUDITED

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ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

	March 31, 2005	December 31, 2004
	Unaudited	Audited
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 28,160	\$ 42,611
Short-term investments	141,037	146,009
Trade receivables, net*	5,550	6,112
Other receivables and prepaid expenses*	2,327	1,946
Inventories and contracts-in-progress	2,218	1,984
Total current assets	179,292	198,662
INVESTMENTS AND LONG-TERM RECEIVABLES		
Investments in affiliated companies	114,110	117,124
Investments in other companies and long-term receivables*	164,206	155,929
Deferred taxes	5,687	5,493
Severance pay deposits	2,644	2,637
Total investments and long-term receivables	286,647	281,183
PROPERTY AND EQUIPMENT, NET	8,058	8,064
INTANGIBLE ASSETS		
Goodwill	10,268	10,268
Other intangible assets	2,966	2,979
Total intangible assets	13,234	13,247
Total assets	\$ 487,231	\$ 501,156

* Includes receivables from related parties in the aggregate amount of \$3,670 and \$3,360 as of March 31, 2005 and December 31, 2004, respectively.

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

	March 31, 2005	December 31, 2004
	Unaudited	Audited
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term loans from banks and others	\$ 1,373	\$ 2,079
Current maturities of long-term loans from banks and others	2,930	2,974
Trade payables	3,044	3,459
Other payables and accrued expenses	15,669	31,333
Total current liabilities	23,016	39,845
LONG-TERM LIABILITIES		
Long-term loans from banks and others	4,145	4,072
Accrued severance pay and retirement obligations	3,853	3,809
Deferred taxes	43,891	41,233
Other	22	22
Total long-term liabilities	51,911	49,136
MINORITY INTEREST	22,865	23,095
SHAREHOLDERS' EQUITY:		
Ordinary shares of NIS 0.003 par value; Authorized - 35,000,000 shares as of March 31, 2005 and December 31, 2004; Issued and outstanding - 29,414,424 shares as of March 31, 2005 and December 31, 2004	9,572	9,572
Additional paid-in capital	270,114	270,005
Accumulated other comprehensive income	63,080	57,717
Retained earnings	46,673	51,786
Total shareholders' equity	389,439	389,080
Total liabilities and shareholders' equity	\$ 487,231	\$ 501,156

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands, except share and per share data

	Three months ended March 31,		Year ended December 31,
	2005	2004	2004
	Unaudited		Audited
INCOME			
Net revenues*	\$ 4,258	\$ 3,425	\$ 16,330
Equity in losses of affiliated companies	(3,588)	(389)	(10,492)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	(10)	6,080	132,396
Other income, net	286	2,437	4,784
	<u>946</u>	<u>11,553</u>	<u>143,018</u>
COSTS AND EXPENSES			
Cost of revenues	2,490	2,055	9,650
Research and development costs, net	1,554	1,014	3,637
Marketing and selling expenses, net	1,099	566	3,202
General and administrative expenses	2,147	4,655	13,285
Restructuring costs	-	-	225
Amortization of intangible assets and in process research and development	44	194	731
Impairment of goodwill	-	-	1,980
Impairment of intangible assets and property and equipment	-	-	7,097
Financial expenses (income), net	(926)	45	(643)
	<u>6,408</u>	<u>8,529</u>	<u>39,164</u>
Income (loss) before taxes on income	(5,462)	3,024	103,854
Tax benefit (taxes on income)	155	(642)	(15,132)
Income (loss) after taxes on income	(5,307)	2,382	88,722
Minority interest in losses (income) of subsidiaries	194	1,640	(4,135)
Income (loss) from continuing operations	(5,113)	4,022	84,587
Loss from discontinued operations	-	(300)	(454)
Net income (loss)	<u>\$ (5,113)</u>	<u>\$ 3,722</u>	<u>\$ 84,133</u>
Income (loss) per share:			
Basic:			
Income (loss) from continuing operations	\$ (0.17)	\$ 0.14	\$ 2.89
Loss from discontinued operations	-	(0.01)	(0.02)
Net income (loss)	<u>\$ (0.17)</u>	<u>\$ 0.13</u>	<u>\$ 2.87</u>
Diluted:			
Income (loss) from continuing operations	\$ (0.18)	\$ 0.13	\$ 2.88
Loss from discontinued operations	-	(0.01)	(0.02)
Net income (loss)	<u>\$ (0.18)</u>	<u>\$ 0.12</u>	<u>\$ 2.86</u>
Weighted average number of ordinary shares used in computing basic net income (loss) per share (thousands)	<u>29,414</u>	<u>29,209</u>	<u>29,266</u>
Weighted average number of ordinary shares used in computing diluted net income (loss) per share (thousands)	<u>29,414</u>	<u>29,307</u>	<u>29,385</u>

* Includes revenues from related parties, in the amount of \$1,966 and \$2,238 for the three months ended March 31, 2005 and 2004, respectively, and \$8,480 for the year ended December 31, 2004.

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

STATEMENTS OF SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share and per share data

	Number of shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income	Retained earnings (Accumulated deficit)	Total Shareholders' equity	Total comprehensive income (loss)
Audited							
Balance as of January 1, 2004	29,206,845	\$ 9,572	\$ 267,113	\$ 51,792	\$ (32,347)	\$ 296,130	
Exercise of options	207,579	-	2,097			2,097	
Stock based compensation	-	-	545	-	-	545	
Tax benefit in respect of options exercised	-	-	250	-	-	250	
Other comprehensive income (loss), net of tax:							
Unrealized gains on available for sale securities	-	-	-	8,489	-	8,489	\$ 8,489
Reclassification adjustment for gain realized included in net income	-	-	-	(3,582)	-	(3,582)	(3,582)
Foreign currency translation adjustments	-	-	-	202	-	202	202
Unrealized gain on derivative instruments in affiliated company	-	-	-	84	-	84	84
Reclassification adjustments for loss on derivative instruments, minimum pension liability and foreign currency translation adjustments, included in net income due to sale of affiliated companies	-	-	-	732	-	732	732
Net income	-	-	-	-	84,133	84,133	84,133
Balance as of December 31, 2004	29,414,424	\$ 9,572	\$ 270,005	\$ 57,717	\$ 51,786	389,080	<u>\$ 90,058</u>
Total comprehensive income							
Unaudited							
Stock based compensation	-	-	109	-	-	109	
Other comprehensive income, net of tax:							
Unrealized gains on available for sale securities	-	-	-	5,333	-	5,333	\$ 5,333
Foreign currency translation adjustments	-	-	-	30	-	30	30
Net loss	-	-	-	-	(5,113)	(5,113)	(5,113)
Balance as of March 31, 2005	29,414,424	\$ 9,572	\$ 270,114	\$ 63,080	\$ 46,673	\$ 389,439	<u>\$ 250</u>
Total comprehensive income							
Unaudited							
Balance as of January 1, 2004	29,206,845	\$ 9,572	\$ 267,113	\$ 51,792	\$ (32,347)	\$ 296,130	
Exercise of options	4,500	-	31	-	-	31	
Stock based compensation	-	-	183	-	-	183	
Other comprehensive income, net of tax:							
Unrealized gains on available for sale securities	-	-	-	3,958	-	3,958	\$ 3,958
Reclassification adjustment for gain realized included in net income	-	-	-	(2,045)	-	(2,045)	(2,045)
Foreign currency translation adjustments	-	-	-	409	-	409	409
Unrealized loss on derivative instrument in affiliated company	-	-	-	(18)	-	(18)	(18)
Net income	-	-	-	-	3,722	3,722	3,722
Balance as of March 31, 2004	29,211,345	\$ 9,572	\$ 267,327	\$ 54,096	\$ (28,625)	\$ 302,370	<u>\$ 6,026</u>
Total comprehensive income							

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Three months ended March 31,		Year ended December 31,
	2005	2004	2004
	Unaudited		Audited
Cash flows from operating activities			
Net income (loss)	\$ (5,113)	\$ 3,722	\$ 84,133
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Equity in losses of affiliated companies	3,588	389	10,492
Dividend from affiliated companies	-	-	1,719
Minority interest in income (losses) of subsidiaries	(194)	(1,640)	4,135
Loss (gain) from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	10	(6,080)	(132,396)
Gain from sale of investments in available for sale securities	-	(3,096)	(5,360)
Depreciation and amortization	302	487	1,868
Impairment of intangible assets and property and equipment	-	-	7,097
Impairment of goodwill	-	-	1,980
Decline in value of other investments	-	150	803
Equity in losses (income) of partnerships	31	(32)	7
Amortization (appreciation) of deferred stock compensation and changes in liability in respect of call options	(465)	2,353	3,033
Deferred taxes, net	(184)	553	(2,409)
Changes in operating assets and liabilities			
Decrease (increase) in trade receivables	562	549	(139)
Decrease (increase) in other receivables and prepaid expenses	(374)	(1,840)	88
Decrease (increase) in trading securities, net	1	(4)	5
Decrease (increase) in inventories and contracts-in-progress	(234)	241	333
Decrease in trade payables	(415)	(909)	(1,184)
Increase (decrease) in other payables and accrued expenses (mainly provision for income taxes in 2004 and tax payment in 2005)	(15,125)	(699)	16,935
Other	(508)	578	(552)
Net cash used in operating activities	<u>(18,118)</u>	<u>(5,278)</u>	<u>(9,412)</u>
Cash flows from investing activities			
Investment in affiliated companies	(465)	(3,224)	(57,916)
Proceeds from sale of KIT shares	-	5,706	5,706
Proceeds from sale of ESL shares	-	-	196,580
Proceeds from sale of Given Imaging shares	-	-	9,074
Cash and cash equivalents resulting from newly consolidated subsidiaries (Schedule A)	-	133	247
Investment in other companies	-	(500)	(15,264)
Proceeds from sale of available for sale securities	-	4,241	8,062
Proceeds from sale of other investments	93	-	-
Investments in held to maturity debentures and deposits	-	(4,472)	(105,378)
Investment in available for sale securities	(4,955)	-	(43,000)
Proceeds from maturities of held to maturity debentures and deposits	10,000	26,664	33,345
Purchase of property and equipment	(265)	(239)	(728)
Proceeds from sale of property and equipment	24	26	-
Net cash provided by investing activities	<u>4,432</u>	<u>28,335</u>	<u>30,728</u>
Cash flows from financing activities			
Proceeds from options exercised	-	31	2,097
Receipt of long-term loans from banks	-	355	519
Repayment of long-term loans	(22)	(40,565)	(50,677)
Decrease in short-term bank loan, net	(706)	(65)	(15,842)
Receipt of short-term loans from minority shareholders of subsidiaries	-	316	137
Proceeds from convertible loans and long-term loans from minority shareholders of a subsidiary	-	140	1,402
Investment by minority shareholders of a subsidiary	30	-	-
Issuance expenses in a subsidiary	(67)	(179)	(180)
Dividend to minority shareholders of a subsidiary	-	(67)	(67)
Net cash used in financing activities	<u>(765)</u>	<u>(40,034)</u>	<u>(62,611)</u>
DECREASE IN CASH AND CASH EQUIVALENTS	<u>(14,451)</u>	<u>(16,977)</u>	<u>(41,295)</u>
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD	<u>42,611</u>	<u>83,906</u>	<u>83,906</u>
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	<u>\$ 28,160</u>	<u>\$ 66,929</u>	<u>\$ 42,611</u>

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Three months ended March 31,		Year ended December 31,
	2005	2004	2004
	Unaudited		Audited
Supplemental cash flow information:			
Cash paid for:			
Income taxes	\$ 15,014	\$ 48	\$ 172
Interest	\$ 31	\$ 537	\$ 1,044
		Three months ended March 31, 2004 (Unaudited)	Year ended December 31, 2004 (Audited)
(A) <u>Cash and cash equivalents resulting from newly consolidated subsidiaries</u>			
Assets acquired and liabilities assumed at the purchase date:			
Working capital deficiency, net (except cash and cash equivalents)		\$ 1,254	\$ 1,071
Deposits		(31)	(31)
Property and equipment		(423)	(618)
Intangible assets		(878)	(1,350)
Long-term liabilities		191	431
Investment at equity prior to acquisition		49	678
Minority interests		(29)	66
Cash and cash equivalents acquired		\$ 133	\$ 247

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 1:- GENERAL

The accompanying unaudited condensed interim consolidated financial statements have been prepared as of March 31, 2005, and for the three months then ended in accordance with accounting principles generally accepted in the United States (U.S. GAAP) relating to the preparation of financial statements for interim periods. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States but which are not required for interim reporting purposes, have been condensed or omitted. See Note 7 for the reconciliation from U.S. GAAP to accounting principles generally accepted in Israel ("Israeli GAAP").

These financial statements should be read in conjunction with the Company's annual financial statements and accompanying notes as of December 31, 2004.

The condensed interim consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary to present fairly the financial position, results of operations and cash flows for the period presented.

Results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

- a. The significant accounting policies followed in the preparation of these financial statements are identical to those applied in preparation of the latest annual financial statements.
- b. The financial statements have been prepared in U.S. dollars, since the functional currency of the Company and its principal subsidiaries is the U.S. dollar.
- c. FASB Statement No. 123 (revised 2004), "Share-Based Payment" (FAS 123(R)) (See Note 2y to the Company's annual financial statements for 2004), was to have been effective as of the beginning of the first interim or annual reporting period that commences after June 15, 2005 (July 1, 2005 for the Company); however, on April 14, 2005, the United States Securities and Exchange Commission ("SEC") delayed effectiveness of FAS 123(R) for companies with fiscal years ending December 31 (such as the Company) to January 1, 2006.
- d. In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 provides the SEC staff's position regarding the application of FAS 123(R) and contains interpretive guidance related to the interaction between FAS 123(R) and certain SEC rules and regulations, and also provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 highlights the importance of disclosures made relating to the accounting for share-based payment transactions. The Company is currently reviewing the effect of SAB 107, however it does not believe that SAB 107 will have a material effect on its financial position, results of operations or cash flows.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 3:- MAJOR TRANSACTIONS

a. **Partner Communications Company Ltd. ("Partner")**

Subsequent to the balance sheet date, on April 20, 2005 Elbit completed the sale to Partner of 12,765,190 Partner shares for approximately \$94,000, as part of the sale together with the other Israeli founding shareholders of Partner of an aggregate of approximately 33.3 million Partner shares to Partner for an aggregate consideration of approximately \$245,000.

As a result of the sale, Elron will record in the statement of operations, in the second quarter of 2005, an estimated gain, after tax, of approximately \$35,000. The shares sold are presented in the balance sheet as of March 31, 2005 at an amount of approximately \$116,000 with the unrealized gains of approximately \$51,000 recorded as accumulated other comprehensive income.

Subsequent to the aforementioned sale, Elron's beneficial holding in Partner is approximately 2%. This interest in Partner is no longer pledged to the banks providing financing to Partner but almost all of it is still subject to certain transfer restrictions under Partner's Israeli communications license.

As part of the Company's policy to limit its exposure to foreign currency risks, Elron hedged the dollar value that was received from the sale of its Partner shares by the purchase of a zero cost collar, at a dollar/NIS exchange rate ranging from \$4.36 to \$4.44 for a period of 81 days. The transaction was terminated upon the sale of Partner shares and did not have a material effect on the Company's financial statements.

b. **Nulens**

Subsequent to the balance sheet date, on April 21, 2005, Elron completed an investment of approximately \$2,900 in Nulens Ltd. ("Nulens"), in consideration for 763,584 Series A preferred shares, as part of an aggregate investment of approximately \$3,400. Nulens is an Israeli medical devices company operating in the field of intra-ocular lenses mainly for cataract and presbyopia procedures. Elron's investment will be invested in two installments, the first of approximately \$1,700 was invested immediately for approximately 17% of Nulens on a fully diluted and on an as converted basis and an additional amount of approximately \$1,200 will be invested upon the fulfillment of a certain milestone by Nulens. Following Elron's aggregate investment, Elron will hold approximately 25% of Nulens, on a fully diluted and on an as converted basis.

c. **Teledata**

Subsequent to the balance sheet date, on May 8, 2005, Elron completed an investment of \$16,000 in Teledata Networks Ltd. ("Teledata"), in consideration for 4,923,194 series A preferred shares. The preferred shares entitle their holders to certain preference rights upon liquidation, deemed liquidation and dividend distribution. The investment is part of an aggregate round of financing of \$19,000, in which FBR Infinity II Ventures, an indirectly related venture capital fund, invested \$3,000. Teledata provides innovative access products and solutions for both traditional and next generation networks to telecom operators and service providers. Following completion of the round of investment, Elron holds approximately 21% of Teledata, on a fully diluted and on an as converted basis.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 3:- MAJOR TRANSACTIONS (Cont.)

d. Oren

Subsequent to the balance sheet date, on May 9, 2005, a definitive agreement was signed for the sale of Oren, in which Elron has a 41% interest, to Zoran Corporation (NASDAQ:ZRAN) ("Zoran"), which currently holds approximately 17% of Oren. The consideration to be paid by Zoran to the other shareholders in Oren was determined based on a value of Oren of \$53,500. Zoran will pay approximately \$44,600 in the form of cash and Zoran common stock for the remaining 83% of Oren. Oren is a privately held company which develops demodulator VLSI products for digital televisions, set-top boxes and personal computers, and is also engaged through partnerships in providing customers with a complete front-end solution. The completion of the transaction is subject to certain closing conditions. The transaction is expected to be completed during the second quarter of 2005. However, there is no assurance that the transaction will be consummated or of the exact timing of the closing. Upon completion of the transaction, Elron will receive cash of approximately \$12,400 and Zoran common stock with an estimated value of approximately \$6,700 and will record an estimated gain in the second quarter of 2005, net of taxes, of approximately \$16,000.

e. Netvision

Subsequent to the balance sheet date, on May 13, 2005, NetVision, currently a 45.7% held affiliate of Elron, published a prospectus for a proposed underwritten initial public offering on the Tel Aviv Stock Exchange ("TASE") in Israel. This followed the approval of the Israeli Securities Authority on May 11, 2005. The proposed initial offering is for the sale of shares and convertible securities in consideration for aggregate immediate net proceeds of approximately NIS135 million (approximately \$31,000). In addition, future proceeds from the exercise of options to be sold in the proposed offering amount to approximately NIS28.8 million (approximately \$6,600). Discount Investment Corporation ("DIC"), which also holds approximately 46% of Elron, is the other major shareholder of NetVision, holding 45.7% of NetVision. Elron and DIC will each convert approximately \$3,100 of loans into equity of NetVision immediately prior to the proposed offering. The proposed initial public offering is expected to be completed during May 2005, however there is no assurance that the proposed offering will be consummated.

In the event of the completion of the proposed offering, Elron's holding in NetVision will be decreased to approximately 39% (27.4% on a fully diluted basis if taking into account the convertible securities) resulting in an estimated gain for Elron, in the second quarter of 2005, of approximately \$3,000. This gain is subject to adjustments, depending, among others, upon the allocation of the proceeds raised by NetVision between shares and convertible securities issued, upon completion of the offering.

NOTE 4:- STOCK BASED EMPLOYEE COMPENSATION

The Company elected to follow Accounting Principles Board Opinion No. 25, ("APB 25") "Accounting for Stock Issued to Employees" and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans granted prior to 2003. According to APB 25, compensation expense is measured under the intrinsic value method, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock at the grant date of the award or other measurement date over the exercise price.

Effective January 1, 2003, the Company adopted the fair value recognition provisions of FASB Statement No.123 "Accounting for Stock-Based Compensation ("SFAS No.123").

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 4:- STOCK BASED EMPLOYEE COMPENSATION (Cont.)

Under the prospective method of adoption selected by the Company in accordance with the provisions of FASB Statement No.148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS No.148"), the recognition provisions will be applied to all employee awards granted, modified, or settled after January 1, 2003.

The following pro forma information presents the effect on the Company's and subsidiaries' stock-based employee compensation expense, consolidated net income (loss) and income (loss) per share as if the fair value based method provided under SFAS No. 123 had been applied to all outstanding awards in each reported period.

	Three months ended March 31,		Year ended December 31,
	2005	2004	2004
	Unaudited		Audited
Net income (loss), as reported	\$ (5,113)	\$ 3,722	\$ 84,133
Add: Stock-based employee compensation expense included in reported net income (loss)	122	194	626
Deduct: Total stock-based compensation expense determined under fair value based method for all awards	(169)	(230)	822
Pro forma net income (loss)	<u>\$ (5,160)</u>	<u>\$ 3,686</u>	<u>\$ 83,937</u>
Income (loss) per share:			
Basic - as reported	<u>\$ (0.17)</u>	<u>\$ 0.13</u>	<u>\$ 2.87</u>
Basic - pro forma	<u>\$ (0.18)</u>	<u>\$ 0.13</u>	<u>\$ 2.87</u>
Diluted - as reported	<u>\$ (0.18)</u>	<u>\$ 0.12</u>	<u>\$ 2.86</u>
Diluted - Pro forma	<u>\$ (0.18)</u>	<u>\$ 0.12</u>	<u>\$ 2.86</u>

The fair value for each award granted was estimated at the date of grant using the Black-Scholes option-pricing model assuming no dividend yield and the following assumptions:

	Three months ended March 31,		Year ended December 31,
	2005^(*)	2004^(*)	2004
	Unaudited		Audited
Average risk-free interest rate	-	-	2.5%
Average expected life (in years)	-	-	2.8
Volatility	-	-	42%

^(*) No options were granted during the period.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 5:- CONTINGENT LIABILITIES

There were no material changes in the status of the Company's contingent liabilities as described in the Company's annual financial statements for 2004, the details of which are as follows:

- a. During September 1999, the Company received copies of two claims and a request to approve such claims as a class action on behalf of public shareholders of Elscint (formerly an affiliated company) against the Company and others. The allegation raised by the claimants related to the decision regarding the sale of Elscint's substantial assets. The claim has been stayed pursuant to an arrangement reached by the parties pending the outcome of the appeal in the claim described in paragraph b below. The arrangement provides that if the appeal as described in paragraph b below is accepted, then the proceedings to recognize the lawsuit as a class action will proceed. Otherwise, the application to recognize the claim as a class action suit will be dismissed.
- b. On November 2, 1999, the Company received a copy of a claim, and a request to approve such a claim, as a class action on behalf of some institutional investors and others and those who held shares in Elscint on September 6, 1999. The allegations raised against the Company and certain of its officers including former officers, among others, relate to the period prior to the sale of the Company's holdings in Elbit Medical Imaging ("EMI") (the parent company of Elscint and formerly an affiliated company). The claimants seek a court order pursuant to which EMI would be compelled to execute the alleged buy-out of Elscint's share at \$14 per share or other remedies. On August 16, 2000, the Haifa court dismissed the application to recognize the claim as a class action. Some of the claimants applied for and have been granted permission to appeal to the Supreme Court in Israel, which appeal is currently pending.

In addition, in February 2001, the claimants submitted a revised claim similar to the previous one but not as a class action. In August 2004, the Haifa District Court issued a decision ordering the cancellation of the requirement of the claimants to pay a twenty million shekels filing fee. Certain of the defendants have requested permission to appeal the said decision of the Haifa District Court. The claimants are required to deposit letters of undertaking with the court no later than May 22, 2005, and the defendants are required to file their statements of defense to the claim within 45 days thereof, unless the Supreme Court orders otherwise.

The Company denies all the allegations set forth in the above claims, and based on legal advice received, management is of the opinion that the Company has good defense arguments which, if accepted, will cause dismissal of the above allegations.

- c. In July 2003, ESW terminated the lease of its premises in the U.S. due to defects in the premises and the lessor's failure to repair the defects. The lessor rejected the termination of the lease and is seeking to enforce the lease and to claim all amounts due under the lease from ESW and Elron, as guarantor of the lease. The balance of the rental under the lease amounts to approximately \$2,000. ESW is counterclaiming damages caused by the lessor. The Company's management is of the opinion that ESW has good defense arguments and that the above claim will not have a significant effect on the Company's results of operations.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 6:- BUSINESS SEGMENTS

As of March 31, 2005, the Company operates in two business segments: (1) the System and Projects segment through its subsidiary ETI and (2) the Other Holdings and Corporate Operations segment which reflects the investments in companies engaged in various fields of advanced technology and includes corporate headquarters.

The operations of the System and Projects segment include development and supply of software solutions for revenue assurance and management of large and complex communication and internet networks.

The Other Holdings and Corporate Operations segment includes holdings in various companies that operate in the telecom, medical devices, semiconductors, advanced materials and other fields and the corporate operations.

On September 2, 2003, Elron's majority owned subsidiary, ESW, sold substantially all of its assets and business to Zix (See Note 3d to the Company's annual financial statements for 2004). Prior to the above sale, the Company operated indirectly through ESW in a third business segment - Internet Products.

Segment information is as follows:

	Systems and Projects	Other holdings and corporate operations	Internet Products (Discontinued operations)	Adjustments	Total
For the three months ended					
March 31, 2005 (Unaudited):					
Net revenues	\$ 1,273	\$ 2,985	\$ -	\$ -	\$ 4,258
Net loss	(476)	(4,637)	-	-	(5,113)
As of March 31, 2005 (Unaudited):					
Total assets	6,712	483,021	\$ -	(2,502) ^(*)	487,231
For the three months ended					
March 31, 2004 (Unaudited):					
Net revenues	\$ 1,656	\$ 1,769	\$ -	\$ -	\$ 3,425
Net income (loss)	(557)	4,579	(300)	-	3,722
For the year ended December					
31, 2004 (Audited):					
Net revenues	\$ 5,065	\$ 11,265	\$ -	\$ -	\$ 16,330
Net income (loss)	(7,946)	92,533	(454)	-	84,133
As of December 31, 2004 (Audited):					
Total assets	7,630	495,642	-	(2,116) ^(*)	501,156

(*) Inter-company balances.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 7:- RECONCILIATION TO ISRAELI GAAP

The consolidated financial statements of the Company have been prepared in accordance with U.S. GAAP. Had the consolidated financial statements been prepared in accordance with Israeli GAAP, the effects on the financial statements would have been as follows:

a. Effect on the statement of operations:

	Three months ended March 31, 2005		
	<u>As reported</u>	<u>Adjustments Unaudited</u>	<u>As per Israeli GAAP</u>
Net loss	\$ (5,113)	\$ (2,572)	\$ (7,685)

	Three months ended March 31, 2004		
	<u>As reported</u>	<u>Adjustments Unaudited</u>	<u>As per Israeli GAAP</u>
Net income	\$ 3,722	\$ 1,687	\$ 5,409

	Year ended December 31, 2004		
	<u>As reported</u>	<u>Adjustments Audited</u>	<u>As per Israeli GAAP</u>
Net income	\$ 84,133	\$ 7,896	\$ 92,029

b. Effect on the balance sheet:

	March 31, 2005		
	<u>As reported</u>	<u>Adjustments Unaudited</u>	<u>As per Israeli GAAP</u>
Total assets	\$ 487,231	\$ (187,051)	\$ 300,180
Total liabilities including minority interest	97,792	(65,645)	32,147
			4
			8
			7
			;
			2
Total equity	389,439	(121,406)	3 268,033

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

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NOTE 7:- RECONCILIATION TO ISRAELI GAAP (Cont.)

b. Effect on the balance sheet: (cont.)

	December 31, 2004		
	As reported	Adjustments Audited	As per Israeli GAAP
Total assets	\$ 501,156	\$ (176,476)	\$ 324,680
Total liabilities including minority interest	112,076	(62,976)	49,100
Total equity	389,080	(113,500)	275,580

c. Material adjustments:

The abovementioned adjustments result primarily from the differences between U.S. GAAP and Israeli GAAP as detailed in Note 29 to the Company's annual financial statements for 2004.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

ANNEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

Details relating to major investments as of March 31, 2005:

	% of ownership interest ⁽¹⁾	Carrying value of the investment as of March 31, 2005 ⁽²⁾	Market value of the publicly traded investments as of:	
			March 31, 2005	May 9, 2005
<u>Consolidated Companies:</u>				
Elron Telesoft Ltd. and Elron Telesoft Export Ltd.	100%	\$ 3,742	\$ -	\$ -
Galil Medical Ltd. ⁽³⁾	39%	482	-	-
3DV Systems Ltd. ⁽³⁾	71%	324	-	-
Starling ⁽³⁾	50%	1,266	-	-
SELA ⁽³⁾	39%	1,140	-	-
<u>Affiliated Companies (equity):</u>				
Given Imaging Ltd. (Nasdaq: GIVN) ⁽³⁾	20%	66,473	160,566	140,448
NetVision Ltd.	46%	3,106	-	-
ChipX	26%	3,548	-	-
CellAct Ltd.	45%	419	-	-
Oren Semiconductor Inc.	41%	866	-	-
Oncura ⁽⁴⁾	10%	11,589	-	-
AMT	41%	4,501	-	-
Wavion, Inc.	38%	924	-	-
Pulsicom Israel Technologies Ltd.	18%	237	-	-
Notal Vision, Inc.	26%	443	-	-
<u>Available for sale:</u>				
Partner (Nasdaq: PTNR) ⁽⁵⁾	9%	144,612	144,612	27,111 ⁽⁵⁾
EVS (Nasdaq: EVSNF.OB)	10%	949	1,589	1,589
<u>Partnership:</u>				
Gemini Israel Fund L.P.	5%	37	-	-
InnoMed Ventures L.P.	14%	3,139	-	-
<u>Cost:</u>				
Avantry (formerly: Witcom Ltd.) ⁽³⁾	7%	495	-	-
Jordan Valley	28%	6,707	-	-
Impliant	28%	7,340	-	-

⁽¹⁾ On the basis of the outstanding share capital.

⁽²⁾ Includes loans and convertible notes.

⁽³⁾ Represents the carrying value and the ownership interest of the investment in Elron's books and Elron's share in the carrying value and ownership interest of the investment in RDC's books.

⁽⁴⁾ Represents Elron's share in the carrying value and the ownership interest of the investment in Galil's books.

⁽⁵⁾ On April 20, 2005, Elbit sold 12,765,190 shares of Partner to Partner in consideration for approximately \$94,000. The market value as of May 9, 2005 represents only shares that were not sold to Partner, see also Note 3a.