



AND ITS SUBSIDIARIES

**CONDENSED INTERIM CONSOLIDATED
FINANCIAL STATEMENTS**

As of June 30, 2005
(Unaudited)

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

CONDENSED INTERIM CONSOLIDATED

FINANCIAL STATEMENTS

AS OF JUNE 30, 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

	June 30, 2005	December 31, 2004
	Unaudited	Audited
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 119,091	\$ 42,611
Short-term investments	142,056	146,009
Trade receivables, net*	6,390	6,112
Other receivables and prepaid expenses*	3,478	1,946
Inventories and contracts-in-progress	2,384	1,984
Total current assets	273,399	198,662
INVESTMENTS AND LONG-TERM RECEIVABLES		
Investments in affiliated companies	112,541	117,124
Investments in other companies and long-term receivables*	58,327	155,929
Deferred taxes	3,957	5,493
Severance pay deposits	2,401	2,637
Total investments and long-term receivables	177,226	281,183
PROPERTY AND EQUIPMENT, NET	7,925	8,064
INTANGIBLE ASSETS		
Goodwill	8,939	10,268
Other intangible assets	2,953	2,979
Total intangible assets	11,892	13,247
Total assets	\$ 470,442	\$ 501,156

* Includes receivables from related parties in the aggregate amount of \$4,307 and \$3,360 as of June 30, 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

	June 30, 2005	December 31, 2004
	Unaudited	Audited
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term loans from banks and others	\$ 2,003	\$ 2,079
Current maturities of long-term loans from banks and others	2,809	2,974
Trade payables	2,431	3,459
Other payables and accrued expenses	43,445	31,333
Total current liabilities	<u>50,688</u>	<u>39,845</u>
LONG-TERM LIABILITIES		
Long-term loans from banks and others	4,200	4,072
Accrued severance pay and retirement obligations	3,567	3,809
Deferred taxes	7,585	41,233
Other	-	22
Total long-term liabilities	<u>15,352</u>	<u>49,136</u>
MINORITY INTEREST	<u>22,833</u>	<u>23,095</u>
SHAREHOLDERS' EQUITY:		
Ordinary shares of NIS 0.003 par value; Authorized - 35,000,000 shares as of June 30, 2005 and December 31, 2004; Issued and outstanding – 29,416,924 shares as of June 30, 2005 and 29,414,424 shares as of December 31, 2004	9,572	9,572
Additional paid-in capital	270,187	270,005
Accumulated other comprehensive income	7,937	57,717
Retained earnings	93,873	51,786
Total shareholders' equity	<u>381,569</u>	<u>389,080</u>
Total liabilities and shareholders' equity	<u>\$ 470,442</u>	<u>\$ 501,156</u>

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

	Six months ended June 30,		Three months ended June 30,		Year ended December 31,
	2005	2004	2005	2004	2004
	Unaudited				Audited
INCOME					
Net revenues*	\$ 8,518	\$ 7,001	\$ 4,260	\$ 3,576	\$ 16,330
Equity in losses of affiliated companies	(7,827)	(2,098)	(4,244)	(1,709)	(10,492)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	22,389	27,901	22,399	21,821	132,396
Other income, net	56,548	4,187	56,262	1,750	4,784
	<u>79,628</u>	<u>36,991</u>	<u>78,677</u>	<u>25,438</u>	<u>143,018</u>
COSTS AND EXPENSES					
Cost of revenues	4,917	4,489	2,427	2,434	9,650
Research and development costs, net	3,229	1,570	1,675	556	3,637
Marketing and selling expenses, net	2,333	1,190	1,233	624	3,202
General and administrative expenses	4,639	7,644	2,492	2,989	13,285
Restructuring costs	-	-	-	-	225
Amortization of intangible assets	163	390	119	196	731
Impairment of goodwill	1,329	-	1,329	-	1,980
Impairment of intangible assets and property and equipment	-	-	-	-	7,097
Financial expenses (income), net	(4,311)	102	(3,389)	57	(643)
	<u>12,299</u>	<u>15,385</u>	<u>5,886</u>	<u>6,856</u>	<u>39,164</u>
Income before taxes on income	67,329	21,606	72,791	18,582	103,854
Taxes on income	25,887	8,154	26,042	7,512	15,132
Income from continuing operations after taxes on income	41,442	13,452	46,749	11,070	88,722
Minority interest in losses (income) of subsidiaries	645	(3,895)	451	(5,535)	(4,135)
Income from continuing operations	42,087	9,557	47,200	5,535	84,587
Loss from discontinued operations	-	(356)	-	(56)	(454)
Net income	<u>\$ 42,087</u>	<u>\$ 9,201</u>	<u>\$ 47,200</u>	<u>\$ 5,479</u>	<u>\$ 84,133</u>
Income (loss) per share:					
Basic :					
Income from continuing operations	\$ 1.43	\$ 0.33	\$ 1.60	\$ 0.19	\$ 2.89
Loss from discontinued operations	-	(0.01)	-	-	(0.02)
Net income	<u>\$ 1.43</u>	<u>\$ 0.32</u>	<u>\$ 1.60</u>	<u>\$ 0.19</u>	<u>\$ 2.87</u>
Diluted:					
Income from continuing operations	\$ 1.42	\$ 0.32	\$ 1.60	\$ 0.19	\$ 2.88
Loss from discontinued operations	-	(0.01)	-	-	(0.02)
Net income	<u>\$ 1.42</u>	<u>\$ 0.31</u>	<u>\$ 1.60</u>	<u>\$ 0.19</u>	<u>\$ 2.86</u>
Weighted average number of ordinary shares used in computing basic net income per share (thousands)	<u>29,415</u>	<u>29,211</u>	<u>29,416</u>	<u>29,212</u>	<u>29,266</u>
Weighted average number of ordinary shares used in computing diluted net income per share (thousands)	<u>29,543</u>	<u>29,323</u>	<u>29,538</u>	<u>29,340</u>	<u>29,385</u>

* Includes revenues from related parties, in the amount of \$4,110 and \$ 4,303 for the six months ended June 30, 2005 and 2004, respectively, an amount of \$2,144 and \$2,065 for the three months ended June 30, 2005 and 2004, respectively, and an amount of \$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							<u>\$ 90,058</u>
Unaudited							
Exercise of options	2,500	-	19	-	-	19	
Stock based compensation	-	-	163	-	-	163	
Other comprehensive income (loss), net of tax:							
Unrealized losses on available for sale securities	-	-	-	(13,252)	-	(13,252)	\$ (13,252)
Reclassification adjustment for gain realized included in net income	-	-	-	(36,365)	-	(36,365)	(36,365)
Foreign currency translation adjustments	-	-	-	(163)	-	(163)	(163)
Net income	-	-	-	-	42,087	42,087	42,087
Balance as of June 30, 2005	29,416,924	\$ 9,572	\$ 270,187	\$ 7,937	\$ 93,873	\$ 381,569	<u>\$ (7,693)</u>
Total comprehensive loss							<u>\$ (7,693)</u>
Unaudited							
Balance as of January 1, 2004	29,206,845	\$ 9,572	\$ 267,113	\$ 51,792	\$ (32,347)	\$ 296,130	
Exercise of options	13,500	-	93	-	-	93	
Stock based compensation	-	-	312	-	-	312	
Other comprehensive income (loss), net of tax:							
Unrealized gains on available-for-sale securities	-	-	-	552	-	552	\$ 552
Reclassification adjustment for gain realized included in net income	-	-	-	(3,309)	-	(3,309)	(3,309)
Foreign currency translation adjustments	-	-	-	292	-	292	292
Unrealized gain on derivative instrument in affiliated company	-	-	-	84	-	84	84
Net income	-	-	-	-	9,201	9,201	9,201
Balance as of June 30, 2004	29,220,345	\$ 9,572	\$ 267,518	\$ 49,411	\$ (23,146)	\$ 303,355	
Total comprehensive income							<u>\$ 6,820</u>

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)
Unaudited							
Balance as of April 1, 2005	29,414,424	9,572	270,114	63,080	46,673	389,439	
Exercise of options	2,500	-	19	-	-	19	
Stock based compensation	-	-	54	-	-	54	
Other comprehensive income (loss), net of tax:							
Unrealized losses on available for sale securities	-	-	-	(18,586)	-	(18,586)	\$ (18,586)
Reclassification adjustment for gain realized included in net income	-	-	-	(36,365)	-	(36,365)	(36,365)
Foreign currency translation adjustments	-	-	-	(192)	-	(192)	(192)
Net income	-	-	-	-	47,200	47,200	47,200
Balance as of June 30, 2005	<u>29,416,924</u>	<u>\$ 9,572</u>	<u>\$ 270,187</u>	<u>\$ 7,937</u>	<u>\$ 93,873</u>	<u>\$ 381,569</u>	
Total comprehensive loss							<u>\$ (7,943)</u>
Unaudited							
Balance as of April 1, 2004	29,211,345	\$ 9,572	\$ 267,327	\$ 54,096	\$ (28,625)	\$ 302,370	
Exercise of options	9,000	-	62	-	-	62	
Stock based compensation	-	-	129	-	-	129	
Other comprehensive income (loss), net of tax:							
Unrealized losses on available-for-sale securities	-	-	-	(3,406)	-	(3,406)	\$ (3,406)
Reclassification adjustment for gain realized included in net income	-	-	-	(1,264)	-	(1,264)	(1,264)
Foreign currency translation adjustment	-	-	-	(117)	-	(117)	(117)
Unrealized gain on derivative instrument in affiliated company	-	-	-	102	-	102	102
Net income	-	-	-	-	5,479	5,479	5,479
Balance as of June 30, 2004	<u>29,220,345</u>	<u>\$ 9,572</u>	<u>\$ 267,518</u>	<u>\$ 49,411</u>	<u>\$ (23,146)</u>	<u>\$ 303,355</u>	
Total comprehensive income							<u>\$ 794</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

	Six months ended June 30,		Year ended December 31,
	2005	2004	2004
	Unaudited		Audited
Cash flows from operating activities			
Net income	\$ 42,087	\$ 9,201	\$ 84,133
Adjustments to reconcile net income to net cash used in operating activities:			
Equity in losses of affiliated companies	7,827	2,098	10,492
Dividend from affiliated companies	-	1,719	1,719
Minority interest in income (losses) of subsidiaries	(645)	3,895	4,135
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	(22,389)	(27,901)	(132,396)
Gain from sale of investments in available for sale securities	(56,423)	(4,995)	(5,360)
Depreciation and amortization	690	957	1,868
Impairment of intangible assets and property and equipment	-	-	7,097
Impairment of goodwill	1,329	-	1,980
Decline in value of other investments	636	150	803
Equity in losses of partnerships	60	31	7
Amortization of deferred stock compensation and changes in liability in respect of call options	(1,128)	2,846	3,033
Deferred taxes, net	(4,645)	4,940	(2,409)
Changes in operating assets and liabilities			
Decrease (increase) in trade receivables	(278)	349	(139)
Decrease (increase) in other receivables and prepaid expenses	(112)	270	88
Decrease in trading securities, net	1	3	5
Decrease (increase) in inventories and contracts-in-progress	(400)	79	333
Decrease in trade payables	(1,028)	(1,201)	(1,184)
Increase in other payables and accrued expenses (mainly provision for income taxes)	12,854	2,807	16,935
Other	(368)	654	(798)
Net cash used in operating activities	<u>(21,932)</u>	<u>(4,098)</u>	<u>(9,658)</u>
Cash flows from investing activities			
Investment in affiliated companies	(3,221)	(9,899)	(57,916)
Proceeds from sale of KIT shares	-	5,706	5,706
Proceeds from sale of Oren shares	10,076	-	-
Proceeds from repayment of loan from an affiliate	2,253	-	-
Proceeds from sale of ESL shares	-	-	196,580
Proceeds from sale of Given Imaging shares	-	9,074	9,074
Proceeds from sale of Partner shares	93,978	-	-
Cash and cash equivalents resulting from newly consolidated subsidiaries (Sch. A)	-	247	247
Investment in other companies	(16,350)	(667)	(15,264)
Proceeds from sale of available for sale securities	957	6,999	8,062
Investments in deposits	(20,535)	(5,332)	(105,378)
Investment in available for sale securities	(18,405)	-	(43,000)
Proceeds from maturities of held to maturity debentures and deposits	50,221	28,682	33,345
Purchase of property and equipment	(429)	(436)	(728)
Proceeds from sale of other companies	93	-	-
Proceeds from sale of property and equipment	120	75	246
Purchase of treasury stock from the minority by a subsidiary	(823)	-	-
Net cash provided by investing activities	<u>97,935</u>	<u>34,449</u>	<u>30,974</u>
Cash flows from financing activities			
Proceeds from options exercised	19	93	2,097
Receipt of long-term loans from banks	-	355	519
Repayment of long-term loans	(44)	(40,621)	(50,677)
Increase (decrease) in short-term bank loan, net	(76)	411	(15,842)
Receipt of short-term loans from minority shareholders of subsidiaries	-	119	137
Proceeds from convertible loans and long-term loans from minority shareholders of a subsidiary	500	1,402	1,402
Issuance of shares to the minority of a subsidiary	145	-	-
Issuance expenses in a subsidiary	(67)	(180)	(180)
Dividend to minority shareholders of a subsidiary	-	(67)	(67)
Net cash used in financing activities	<u>477</u>	<u>(38,488)</u>	<u>(62,611)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>76,480</u>	<u>(8,137)</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>\$ 119,091</u>	<u>\$ 75,769</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

	Six months ended June 30,		Year ended December 31,
	2005	2004	2004
	Unaudited		Audited
Supplemental cash flow information:			
Cash paid for:			
Income taxes	\$ 15,025	\$ 92	\$ 172
Interest	\$ 109	\$ 760	\$ 1,044
Proceeds from sale of an affiliate not yet received	\$ 2,392	\$ -	\$ -

	Six months ended June 30, 2004	Year ended December 31, 2004
	(Unaudited)	(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)	\$ 1,071	\$ 1,071
Deposits	(31)	(31)
Property and equipment	(618)	(618)
Intangible assets	(1,350)	(1,350)
Minority interests	66	66
Investment at equity prior to acquisition	678	678
Long-term liabilities	431	431
Cash and cash equivalents acquired	\$ 247	\$ 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 June 30, 2005, and for the six and 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, included in Form 20-F for the year ended December 31, 2004, filed with the Securities and Exchange Commission ("the Company's annual financial statements").

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 periods presented.

Results for the six and three months ended June 30, 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. The Company did not provide the pro forma information as required by SFAS No. 123 when electing to follow APB Opinion 25 and its interpretations in accounting for its employee stock option plans, due to immateriality.
- d. FASB Statement No. 123 (revised 2004), "Share-Based Payment" (FAS 123(R)) (See Note 2y to the Company's annual financial statements), 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. The Company is currently evaluating the effect of the adoption of FAS 123(R) on its results of operations due to the application of FAS 123(R) by its affiliated companies.
- e. 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- f. In May 2005, the FASB issued SFAS No. 154 "Accounting Changes and Errors Corrections" ("FAS 154"). FAS 154 replaces APB No. 20 "accounting changes" and SFAS No. 3 "Reporting Accounting changes in Interim Financial Statements". FAS 154 applies to all voluntary changes in accounting principle, and changes the accounting for and reporting of a change in accounting principle. FAS 154 requires, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. This statement also provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. FAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The company does not believe that FAS 154 will have a material effect on its financial statements.

NOTE 3:- MAJOR TRANSACTIONS

a. **Partner**

On April 20, 2005 Elbit, Elron's wholly-owned subsidiary, completed the sale of 12,765,190 Partner Communications Company Ltd. ("Partner") shares to Partner 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 recorded in the statement of operations, in the second quarter of 2005, a gain of approximately \$56,400 (approximately \$36,000 net of tax).

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.

b. **NuLens**

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. The investment in NuLens is accounted for under the equity method.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 3:- MAJOR TRANSACTIONS (Cont.)

c. **Teledata**

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 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 the remaining \$3,000. Teledata provides innovative access products and solutions for both traditional and next generation networks to telecom operators and service providers. Following the investment, Elron holds approximately 21% of Teledata, on a fully diluted and on an as converted basis. Since the investment is in preferred shares, which are not considered to be an investment that is in-substance-common stock according to the provisions of EITF 02-14, the investment in Teledata is accounted for under the cost method.

d. **Netvision**

On May 19, 2005, Netvision completed its initial public offering on the Tel Aviv Stock Exchange in Israel of shares and convertible securities in consideration for the immediate net proceeds of approximately NIS135 million (approximately \$31,000). Out of the proceeds received, an amount of approximately NIS38 million (approximately \$8,600) was allocated to the shares and an amount of approximately NIS97 million (approximately \$22,400) was allocated to the convertible securities. In addition, future proceeds from the exercise of options sold in the offering may amount to a maximum of approximately NIS28.8 million (approximately \$6,600). Discount Investment Corporation ("DIC"), which holds approximately 48% of Elron, is the other major shareholder of Netvision. Elron and DIC each converted approximately \$3,100 of loans into equity of Netvision immediately prior to the offering and \$2,200 in loans was repaid to each of Elron and DIC from the proceeds of the offering. As a result of the initial public offering, Elron's interest in Netvision decreased from 45.7% to approximately 39% (27.4% on a fully diluted basis taking into account the possible exercise of the convertible securities) resulting in a gain of approximately \$3,000.

e. **Oren**

On June 10, 2005, Zoran Corporation (NASDAQ: ZRAN) ("Zoran") completed the acquisition of Oren, in which Elron had a 41% interest. Prior to the transaction, Zoran held approximately 17% of Oren. The consideration paid by Zoran to the other shareholders in Oren was determined based on a value of Oren of \$53,500. Zoran paid approximately \$44,600 in the form of cash and Zoran common stock for the remaining 83% of Oren. Upon completion of the transaction, Elron received cash of approximately \$12,500 and Zoran common stock with a value of approximately \$7,700 (based on the market price of Zoran shares on the date of completion). As a result of the sale, Elron recorded a gain in the second quarter of 2005 of approximately \$19,700 (approximately \$17,200 net of taxes). An amount of approximately \$1,900 out of the cash received is deposited in an escrow account, half until June 2006 and half until June 2007, for the assurance of Oren's representations in accordance with the agreement.

The Zoran shares received by Elron are accounted for as available-for-sale securities. Subsequent to balance sheet date, Elron sold all shares of Zoran received by it in the transaction for approximately \$8,800 and will record a gain, in the third quarter of 2005 of approximately \$1,100 (approximately \$700 net of tax).

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.)

f. **Elron Telesoft**

The goodwill associated with the Systems and Projects segment (reporting unit) which consists of the operations of Elron Telesoft Ltd. and Elron Telesoft Export Ltd. ("ET group") is usually tested for impairment in the fourth quarter of each year. In light of ET group's results and level of operations, the goodwill associated with the Systems and Projects reporting unit was tested for impairment during the second quarter of 2005. As a result of the impairment test, the Company recorded impairment losses of approximately \$1,300. This impairment loss is included in a separate line item in the statement of operations. The fair value of the aforementioned reporting unit was estimated using the discounted cash flows approach.

NOTE 4:- 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, 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 in connection with this claim. Certain of the defendants have requested permission to appeal the said decision of the Haifa District Court. It has not yet been determined when the defendants are required to file their statements of defense to the claim.

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.

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:- CONTINGENT LIABILITIES (Cont.)

- 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 claimed 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 counterclaimed damages caused by the lessor. On August 4, 2005, Elron paid the lessor \$950 in full and final settlement and release of all the above claims, pursuant to a settlement agreement signed between the parties in July 2005. The settlement agreement has no effect on the statement of operations.

NOTE 5:- INCOME TAXES

On July 25, 2005, the Israeli parliament approved the Law for the Amendment of the Income Tax Ordinance (No. 147), 2005 which progressively reduces the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%. The amendment is not expected to have a material effect on the Company's financial position and results of operations.

NOTE 6:- BUSINESS SEGMENTS

As of June 30, 2005, the Company operates in two business segments: (1) the System and Projects segment through the ET group and (2) the Other Holdings and Corporate Operations segment which reflects the investments in companies engaged in various fields of advanced technology and also 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). Prior to the above sale, the Company operated indirectly through ESW in a third business segment - Internet Products.

Segment information is as follows:

	<u>Systems and Projects</u>	<u>Other holdings and corporate operations</u>	<u>Internet Products (Discontinued operations)</u>	<u>Adjustments</u>	<u>Total</u>
For the six months ended June 30, 2005 (Unaudited):					
Net revenues	\$ 2,272	\$ 6,246	\$ -	\$ -	\$ 8,518
Net income (loss)	(2,075)	44,162	-	-	42,087
As of June 30, 2005 (Unaudited):					
Total assets	5,165	467,685	-	(2,408) ^(*)	470,442

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 (Cont.)

	<u>Systems and Projects</u>	<u>Other holdings and corporate operations</u>	<u>Internet Products (Discontinued operations)</u>	<u>Adjustments</u>	<u>Total</u>
<u>For the six months ended June 30, 2004 (Unaudited):</u>					
Net revenues	\$ 3,440	\$ 3,561	\$ -	\$ -	\$ 7,001
Net income (loss)	(1,108)	10,665	(356)	-	9,201
<u>For the three months ended June 30, 2005 (Unaudited):</u>					
Net revenues	\$ 999	\$ 3,261	\$ -	\$ -	\$ 4,260
Net income (loss)	(1,599)	48,799	-	-	47,200
<u>For the three months ended June 30, 2004 (Unaudited):</u>					
Net revenues	\$ 1,784	\$ 1,792	\$ -	\$ -	\$ 3,576
Net income (loss)	(551)	6,086	(56)	-	5,479
<u>For the year ended December 31, 2004 (Audited):</u>					
Net revenues	\$ 5,065	\$ 11,265	\$ -	\$ -	\$ 16,330
Net income (loss)	(7,946)	92,533	(454)	-	84,133
<u>As of December 31, 2004 (Audited):</u>					
Total assets	7,630	495,642	-	(2,116) ^(*)	501,156

(*) Inter-company balances.

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:

	<u>Six months ended June 30, 2005</u>		
	<u>As reported</u>	<u>Adjustments</u>	<u>As per Israeli GAAP</u>
	<u>Unaudited</u>		
Net income	\$ 42,087	\$ 18,217	\$ 60,304
	<u>Six months ended June 30, 2004</u>		
	<u>As reported(*)</u>	<u>Adjustments</u>	<u>As per Israeli GAAP</u>
	<u>Unaudited</u>		
Net income	\$ 9,201	\$ (1,004)	\$ 8,197

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 (Cont.)

a. Effect on the statement of operations (Cont.)

	Three months ended June 30, 2005		
	As reported	Adjustments Unaudited	As per Israeli GAAP
Net income	\$ 47,200	\$ 20,789	\$ 67,989

	Three months ended June 30, 2004		
	As reported(*)	Adjustments Unaudited	As per Israeli GAAP
Net income	\$ 5,479	\$ (2,689)	\$ 2,790

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

b. Effect on the balance sheet:

	June 30, 2005		
	As reported	Adjustments Unaudited	As per Israeli GAAP
Total assets	\$ 470,442	\$ (69,432)	\$ 401,010
Total liabilities including minority interest	88,873	(23,772)	65,101
Total equity	381,569	(45,660)	335,909

	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

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 (Cont.)

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, as well as from transactions and events which occurred during the six and three months periods ended June 30, 2005, as follows:

1. As described in Note 3a above, Elbit sold in the second quarter of 2005 12,765,190 shares of Partner. According to Israeli GAAP, the merger between Elron and Elbit which occurred in May 2002, was considered to be a transaction with controlling shareholders and therefore the assets and liabilities of Elbit were recorded by Elron according to their carrying values in Elbit at the date of the merger (see Note 29(c)4 to the Company's annual financial statements). The carrying value of the Partner shares was approximately \$30 and therefore the gain after tax recorded in respect of the above sale of Partner shares under Israeli GAAP amounted to approximately \$61,700, as compared to approximately \$36,000 under US GAAP.
2. As described in Note 3e above, Elron sold all of its holdings in Oren in the second quarter of 2005. As a result of the difference between Israeli GAAP and US GAAP described in Note 29(c)2 to the Company's annual financial statements, Elron's investment in Oren at the date of sale under US GAAP was substantially lower than such investment under Israeli GAAP (the difference amounted to approximately \$5,000). As a result, the gain recorded under Israeli GAAP for the sale of the investment in Oren, amounted to approximately \$12,200, net of tax, compared to a gain, of approximately \$17,200, net of tax under US GAAP.

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 June 30, 2005:

	% of ownership interest ⁽¹⁾	Carrying value of the investment as of June 30, 2005 ⁽²⁾	Market value of the publicly traded investments as of:	
			June 30, 2005	August 8, 2005
<u>Consolidated Companies:</u>				
Elron Telesoft Ltd. and Elron Telesoft Export Ltd.	100%	\$ 2,661	\$ -	\$ -
Galil Medical Ltd. ⁽³⁾	40%	1,218	-	-
3DV Systems Ltd. ⁽³⁾	71%	(58)	-	-
Starling ⁽³⁾	50%	648	-	-
SELA ⁽³⁾	39%	1,348	-	-
<u>Affiliated Companies (equity):</u>				
Given Imaging Ltd. (Nasdaq: GIVN) ⁽³⁾	20%	65,474	124,357	128,446
NetVision Ltd. (TASE: NTSN)	39%	3,975	18,098	20,389
ChipX	26%	3,269	-	-
CellAct Ltd.	45%	479	-	-
Oncura ⁽⁴⁾	10%	11,449	-	-
AMT	41%	3,826	-	-
Wavion, Inc.	38%	573	-	-
Pulsicom Israel Technologies Ltd.	18%	229	-	-
Notal Vision, Inc.	26%	503	-	-
NuLens Ltd.	22%	1,276	-	-
<u>Available for sale:</u>				
Partner (Nasdaq: PTNR)	2%	22,134	22,134	25,133
EVS (Nasdaq: EVSNF.OB)	10%	1,295	1,819	2,163
Zoran (Nasdaq: ZRAN) ⁽⁵⁾	1%	8,152	8,152	-
<u>Partnership:</u>				
Gemini Israel Fund L.P.	5%	37	-	-
InnoMed Ventures L.P.	14%	3,429	-	-
<u>Cost:</u>				
Avantry (formerly: Witcom Ltd.) ⁽³⁾	7%	2	-	-
Jordan Valley	28%	6,707	-	-
Impliant Inc.	28%	7,340	-	-
Teledata Ltd.	21%	16,000	-	-

⁽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⁾ All shares were sold subsequent to the balance sheet date, in consideration for approximately \$ 8,800 (see Note 3e).