

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

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2005**

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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders of  
**ELRON ELECTRONIC INDUSTRIES LTD**

We have audited the accompanying consolidated balance sheets of Elron Electronic Industries Ltd. (the "Company") and its subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, changes in shareholders' equity 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 did not audit the financial statements of certain affiliates, the investment in which, at equity, amounted to \$ 46.2 million and \$ 56.7 million as of December 31, 2005 and 2004, respectively, and the Company's equity in their income (losses) amounted to \$ (9.1) million, \$ 1.2 million and \$ (9.7) million for the years ended December 31, 2005, 2004 and 2003, respectively. Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those companies, is based solely on the reports of other auditors.

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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit 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, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, 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 the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2(s) to the consolidated financial statements, effective January 1, 2003, the Company adopted the full provision of SFAS 123, "Accounting for Stock – Based Compensation" with respect to all employee awards granted, modified or settled after January 1, 2003. As discussed in Note 2(i) to the consolidated financial statements, effective October 1, 2004, the Company adopted the provisions of EITF 02-14 "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other than Common Stock".

Tel-Aviv, Israel  
March 14, 2006

**KOST FORER GABBAY & KASIERER**  
A Member of Ernst & Young Global

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

**CONSOLIDATED BALANCE SHEETS**

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

	Note	December 31,	
		2005	2004 ***
<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash and cash equivalents	4	\$ 26,520	\$ 42,097
Short-term investments	5	54,661	101,024
Available for sale marketable securities	6	62,617	44,985
Trade receivables(net of allowance of doubtful accounts of \$426 and \$463 at December 31, 2005 and 2004 respectively)*		6,440	3,698
Other receivables and prepaid expenses *		2,846	1,505
Inventories		2,117	1,961
Total assets attributed to discontinued operations**	22	-	7,652
<b>Total current assets</b>		<u>155,201</u>	<u>202,922</u>
<b>INVESTMENTS AND LONG-TERM RECEIVABLES</b>			
Investments in affiliated companies	7	102,780	117,124
Investments in other companies and long-term receivables *	8	73,931	155,929
Deferred taxes	14	6,521	5,493
Severance pay deposits		1,971	2,136
<b>Total investments and long-term receivables</b>		<u>185,203</u>	<u>280,682</u>
<b>PROPERTY AND EQUIPMENT, NET</b>	9	<u>7,809</u>	<u>8,057</u>
<b>INTANGIBLE ASSETS</b>	10		
Goodwill		2,742	6,657
Other intangible assets		2,818	2,838
<b>Total intangible assets</b>		<u>5,560</u>	<u>9,495</u>
<b>Total assets</b>		<u>\$ 353,773</u>	<u>\$ 501,156</u>

\* Includes short-term receivables from related parties in the aggregate amount of \$5,043 and \$2,292 as of December 31, 2005 and 2004, respectively, and long-term receivables from related parties in the aggregate amount of \$434 and \$405 as of December 31, 2005 and 2004, respectively.

\*\* Includes short-term receivables from related parties in the aggregate amount of \$663 as of December 31, 2004.

\*\*\* Reclassified – see Note 3(d) and Note 22.

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**

		<b>December 31,</b>	
	<b>Note</b>	<b>2005</b>	<b>2004***</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>CURRENT LIABILITIES</b>			
Short-term loans from banks and others	11	\$ 3,808	\$ 389
Current maturities of long-term loans from banks and others	13	2,065	2,974
Trade payables		2,146	2,024
Other payables and accrued expenses	12	11,025	29,681
Total liabilities attributed to discontinued operations	22	<u>-</u>	<u>5,602</u>
Total current liabilities		<u>19,044</u>	<u>40,670</u>
<b>LONG-TERM LIABILITIES</b>			
Long-term loans from banks and others	13	1,477	4,072
Accrued severance pay and retirement obligations		2,635	3,006
Deferred taxes	14	<u>9,494</u>	<u>41,233</u>
Total long-term liabilities		<u>13,606</u>	<u>48,311</u>
<b>CONTINGENT LIABILITIES, PLEDGES AND COMMITMENTS</b>			
	15		
<b>MINORITY INTEREST</b>			
		<u>19,007</u>	<u>23,095</u>
<b>SHAREHOLDERS' EQUITY:</b>			
Ordinary shares of NIS 0.003 par value; Authorized: 35,000,000 shares as of December 31, 2005 and 2004; Issued and outstanding: 29,483,455 and 29,414,424 shares as of December 31, 2005 and 2004, respectively;	16	9,572	9,572
Additional paid-in capital		271,132	270,005
Accumulated other comprehensive income	24	10,741	57,717
Retained earnings		<u>10,671</u>	<u>51,786</u>
Total shareholders' equity		<u>302,116</u>	<u>389,080</u>
Total liabilities and shareholders' equity		<u>\$ 353,773</u>	<u>\$ 501,156</u>

\*\*\* Reclassified – see Note 3(d) and Note 22.

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

<u>March 14, 2006</u>			
Date of approval of the financial statements	Ami Erel Chairman of the Board of Directors	Avraham Asheri Director	Doron Birger President & Chief Executive Officer

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

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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

	Note	Years ended December 31		
		2005	2004***	2003***
<b>INCOME</b>				
Net revenues*		\$ 12,646	\$ 11,265	\$ 9,157
Equity in losses of affiliated companies	18	(17,522)	(10,492)	(8,698)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	19	23,328	132,396	25,754
Other income , net	20	58,648	4,749	14,637
Financial income , net	21	5,483	1,433	751
		<u>82,583</u>	<u>139,351</u>	<u>41,601</u>
<b>COSTS AND EXPENSES</b>				
Cost of revenues		7,201	6,304	5,583
Research and development costs, net		6,163	2,889	3,263
Marketing and selling expenses, net		3,092	1,798	6,777
General and administrative expenses		9,249	12,292	12,872
Amortization of intangible assets		392	142	299
Impairment of intangible assets	10	-	4,192	-
		<u>26,097</u>	<u>27,617</u>	<u>28,794</u>
Income before taxes on income		56,486	111,734	12,807
Taxes on income	14	(10,461)	(15,101)	(6,796)
Income after taxes on income		46,025	96,633	6,011
Minority interest in losses (income) of subsidiaries		5,160	(4,135)	(10,907)
Income (loss) from continuing operations		51,185	92,498	(4,896)
Loss from discontinued operations**	22	(3,850)	(8,365)	(2,309)
Net income (loss)		<u>\$ 47,335</u>	<u>\$ 84,133</u>	<u>\$ (7,205)</u>
Income (loss) per share	17			
Basic:				
Income (loss) from continuing operations		\$ 1.74	\$ 3.26	\$ (0.17)
Loss from discontinued operations		\$ (0.13)	\$ (0.39)	\$ (0.08)
Net income (loss)		<u>\$ 1.61</u>	<u>\$ 2.87</u>	<u>\$ (0.25)</u>
Diluted :				
Income (loss) from continuing operations		\$ 1.73	\$ 3.25	\$ (0.17)
Loss from discontinued operations		\$ (0.13)	\$ (0.39)	\$ (0.08)
Net income (loss)		<u>\$ 1.60</u>	<u>\$ 2.86</u>	<u>\$ (0.25)</u>
Weighted average number of Ordinary shares used in computing basic net income (loss) per share (thousands)		<u>29,437</u>	<u>29,266</u>	<u>29,194</u>
Weighted average number of Ordinary shares used in computing diluted net income (loss) per share (thousands)		<u>29,550</u>	<u>29,385</u>	<u>29,194</u>

\* Includes revenues from related parties in the amount of \$8,046, \$7,182 and \$3,535, for the years ended December 31, 2005, 2004 and 2003, respectively.

\*\* Includes revenues from related parties in the amount of \$174, \$1,298 and \$620, for years ended December 31, 2005, 2004 and 2003, respectively.

\*\*\* Reclassified – see Note 3(d) and Note 22.

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

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

**STATEMENT OF SHAREHOLDERS' EQUITY**

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

	<u>Number of shares</u>	<u>Share capital</u>	<u>Additional paid-in capital</u>	<u>Accumulated other comprehensive income</u>	<u>Retained earnings (Accumulated deficit)</u>	<u>Total shareholders' equity</u>	<u>Total comprehensive income</u>
Balance as of January 1,2003	29,180,970	\$ 9,572	\$ 267,482	\$ 7,529	\$ (25,142)	\$ 259,441	
Exercise of options	25,875	-	177	-	-	177	-
Changes in additional paid-in capital in affiliated companies	-	-	(932)	-	-	(932)	-
Stock based compensation	-	-	386	-	-	386	-
Other comprehensive income (loss), net of tax:							
Unrealized gains on available for sale securities	-	-	-	55,960	-	55,960	\$ 55,960
Reclassification adjustment for gain realized included in net loss	-	-	-	(11,113)	-	(11,113)	(11,113)
Foreign currency translation adjustment	-	-	-	(304)	-	(304)	(304)
Minimum pension liability in an affiliated company	-	-	-	(172)	-	(172)	(172)
Unrealized loss on derivative instrument in affiliated company	-	-	-	(108)	-	(108)	(108)
Net loss	-	-	-	-	(7,205)	(7,205)	(7,205)
Balance as of December 31, 2003	29,206,845	9,572	267,113	51,792	(32,347)	296,130	
Total comprehensive income							<u>\$ 37,058</u>
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	
Total comprehensive income							<u>\$ 90,058</u>
Exercise of options	69,031	-	697	-	-	697	
Stock based compensation	-	-	405	-	-	405	
Tax benefit in respect of options exercised	-	-	25	-	-	25	
Dividend paid	-	-	-	-	(88,450)	(88,450)	
Other comprehensive income (loss), net of tax:							
Unrealized loss on available for sale securities	-	-	-	(10,450)	-	(10,450)	(10,450)
Reclassification adjustment for gain realized and other than temporary impairment included in net income	-	-	-	(36,335)	-	(36,335)	(36,335)
Foreign currency translation adjustments	-	-	-	(191)	-	(191)	(191)
Net income	-	-	-	-	47,335	47,335	47,335
Balance as of December 31, 2005	29,483,455	\$ 9,572	\$ 271,132	\$ 10,741	\$ 10,671	\$ 302,116	
Total comprehensive income							<u>\$ 359</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, except share and per share data**

	Year ended December 31,		
	2005	2004	2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income (loss)	\$ 47,335	\$ 84,133	\$ (7,205)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Equity in losses of affiliated companies	17,522	10,492	8,698
Dividend from affiliated companies	-	1,719	2,971
Minority interest in income (losses) of subsidiaries	(5,160)	4,135	10,907
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	(23,328)	(132,396)	(25,754)
Gain from sale of investments in available for sale securities	(56,515)	(5,360)	(17,924)
Gain from disposal of businesses included in discontinued operations	(213)	-	(4,137)
Depreciation and amortization	1,513	1,868	3,573
Impairment of intangible assets and property and equipment	1,329	7,097	-
Impairment of goodwill	-	1,980	-
Decline in value of other investments	636	803	3,716
Equity in losses (gains) of partnerships	(174)	7	547
Stock based compensation and changes in liability in respect of call options	(811)	3,033	2,564
Deferred taxes, net	(7,288)	(2,409)	6,229
Changes in operating assets and liabilities			
Decrease (increase) in trade receivables	(947)	(139)	3,491
Decrease (increase) in other receivables and prepaid expenses	(38)	88	1,888
Decrease (increase) in trading securities, net	4	5	(4)
Decrease (increase) in inventories and contracts-in-progress	(519)	333	589
Decrease in trade payables	(834)	(1,184)	(2,009)
Increase (decrease) in other payables and accrued expenses (mainly provision for income taxes)	(12,139)	16,935	(5,275)
Other	(753)	(552)	652
Net cash used in operating activities	<u>(40,380)</u>	<u>(9,412)</u>	<u>(16,483)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Investment in affiliated companies	(3,823)	(57,916)	(14,884)
Proceeds from sale of affiliated companies shares	10,522	211,360	13,878
Cash and cash equivalents resulting from newly consolidated subsidiaries(Schedule A)	-	247	-
Change in cash and cash equivalents resulting from disposal of businesses (Schedule B)	1,800	-	(4,648)
Investment in other companies	(27,651)	(15,264)	(299)
Proceeds from sale of investments in other companies	237	-	-
Proceeds from repayment of loan from an affiliate	2,253	-	-
Collection of long term receivables	-	-	772
Proceeds from sale of available for sale securities	119,888	8,062	46,143
Investments in debentures and deposits	(59,185)	(105,378)	(8,925)
Investment in available for sale securities	(35,405)	(43,000)	(1,952)
Proceeds from maturities of held to maturity debentures and deposits	105,802	33,345	8,975
Purchase of property and equipment	(995)	(728)	(547)
Proceeds from sale of property and equipment	197	-	329
Purchase of treasury stock from the minority by a subsidiary	(823)	-	-
Net cash provided by investing activities	<u>112,817</u>	<u>30,728</u>	<u>38,842</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from options exercised	697	2,097	177
Proceeds from exercise of options in a subsidiary	8	-	-
Receipt of long-term loans from banks	-	519	4,032
Repayment of long-term loans	(777)	(50,677)	(6,200)
Decrease in short-term bank loan, net	(1,079)	(15,842)	(4,076)
Repayment of loans from minority shareholders of a subsidiary	-	-	(4,246)
Receipt of short-term loans, convertible loans and long-term loans from minority shareholders of a subsidiary	1,003	1,539	3,959
Issuance expenses in a subsidiary	(75)	(180)	-
Issuance of shares to the minority of a subsidiary	145	-	-
Dividend paid	(88,450)	-	-
Dividend to minority shareholders of a subsidiary	-	(67)	-
Net cash used in financing activities	<u>(88,528)</u>	<u>(62,611)</u>	<u>(6,354)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>(16,091)</u>	<u>(41,295)</u>	<u>16,005</u>
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	42,611	83,906	67,901
	26,520	42,611	83,906
LESS CASH AND CASH EQUIVALEMENTS ATTRIBUTED TO DISCONTINUED OPERATIONS	-	(514)	(2,567)
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	<u><u>26,520</u></u>	<u><u>\$ 42,097</u></u>	<u><u>\$ 81,339</u></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 (Cont.)**

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

	Year ended December 31,		
	2005	2004	2003
Supplemental cash flow information:			
Cash paid during the year for:			
Income taxes	\$ 30,591	\$ 172	\$ 96
Interest	\$ 203	\$ 1,044	\$ 1,466
Proceeds from sale of an affiliate not yet received	\$ 1,958	\$ -	\$ -
Proceeds from sale of an affiliate received in Zoran shares	\$ 7,700	\$ -	\$ -

SCHEDULE A:	Year ended December 31,		
	2005	2004	2003
<b>Change in cash and cash equivalents resulting from newly consolidated subsidiaries</b>			
Assets and liabilities at date of sale:			
Working capital deficiency, net (except cash and cash equivalents)	\$75	\$ 1,071	\$ -
Deposits	-	(31)	-
Property and equipment	(14)	(618)	-
Intangible assets	(237)	(1,350)	-
Accrued severance pay, net	27	-	-
Long-term liabilities	-	431	-
Investment at equity prior to acquisition	-	678	-
Minority interests	-	66	-
Liability incurred	149	-	-
Cash and cash equivalents acquired	\$ -	\$ 247	\$ -

SCHEDULE B:	Year ended December 31,		
	2005	2004	2003
<b>Change in cash and cash equivalents resulting from disposal of businesses</b>			
Assets and liabilities at date of sale:			
Working capital deficiency, net (except cash and cash equivalents)	\$ (671)	\$ -	\$ (708)
Property and equipment	40	-	1,274
Intangible assets	2,389	-	6,532
Deferred tax liability	-	-	(907)
Accrued severance pay, net	(171)	-	-
Gain resulting from sale of businesses	213	-	22,833
Securities received:			
Marketable securities	-	-	(5,400)
Other investments	-	-	(1,000)
Investment in affiliated Company	-	-	(30,272)
Liability incurred	-	-	3,000
Net increase (decrease) in cash and cash equivalents	\$ 1,800	\$ -	\$ (4,648)

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



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1:- GENERAL**

- a. Elron Electronic Industries Ltd. ("Elron" or "the Company"), an Israeli corporation, is high technology operational holding company. Elron's global business is conducted through subsidiaries and affiliates, primarily in the fields of medical devices, information and communication technology, semiconductors and advanced materials.
- b. On August 22, 2004 Discount Investment Corporation Ltd. ("DIC") completed a tender offer to purchase 7.5% of the Company's shares. In addition, in May 2005, DIC purchased additional 1.8% of the Company's shares. Following the consummation of the tender offer and the additional purchase of shares, DIC's interest in the Company increased from approximately 38.5% to approximately 46% in 2004 and to 47.5% in 2005 of the Company's outstanding shares.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("US GAAP").

The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are:

- a. Use of estimates

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 income and expenses during the reported period. Actual results could differ from those estimates.

- b. Financial statements in U.S. dollars

The financial statements have been prepared in U.S. dollars, since the currency of the primary economic environment in which the operations of the Company, its principal subsidiaries and affiliates are conducted is the U.S. dollar. Most of the Company's assets and liabilities are in U.S. dollars and sales of its subsidiaries are mainly in U.S. dollars. Therefore, the functional and reporting currency of the Company and its subsidiaries is the U.S. dollar.

Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies have been remeasured into U.S. dollars in accordance with the principles set forth in Statement of Financial Accounting Standards ("SFAS") No. 52, "Foreign Currency Translation" ("SFAS 52").

Accordingly, amounts in currencies other than U.S dollars have been translated as follows:

Monetary balances - at the exchange rate in effect on the balance sheet date.

Revenues and costs – at the exchange rates in effect as of the date of recognition of the transactions.

All exchange gains and losses from the remeasurement mentioned above are reflected in the statement of operations in financial income, net.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

b. Financial statements in U.S. dollars (Cont.)

The financial statements of an affiliate accounted for under the equity method, whose functional currency is not the U.S. dollar, have been translated into dollars in accordance with SFAS 52. All balance sheet accounts have been translated using the exchange rate in effect at the balance sheet date. Statement of income amounts have been translated using average exchange rates prevailing during the year. The resulting aggregate translation adjustments are reported as a component of accumulated other comprehensive income in shareholders' equity.

c. Principles of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries, in which the Company has a controlling voting interest and of VIEs for which the Company is the primary beneficiary according to the provisions of FIN 46, as described below. Inter-company balances and transactions have been eliminated upon consolidation.

In December 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46(R), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" ("FIN 46"). FIN 46 provides a new framework for identifying variable interest entities ("VIE") and determining when a company should include the assets, liabilities, noncontrolling interests and results of activities of a VIE in its consolidated financial statements.

In general, a VIE is a corporation, partnership, limited-liability corporation, trust, or any other legal structure used to conduct activities or hold assets that either (1) has an insufficient amount of equity to carry out its principal activities without additional subordinated financial support, (2) has a group of equity owners that is unable to make significant decisions about its activities, or (3) has a group of equity owners that does not have the obligation to absorb losses or the right to receive returns generated by its operations.

FIN 46 requires a VIE to be consolidated by the party with an ownership, contractual or other financial interest in the VIE (a variable interest holder) that will absorb a majority of the risk of loss from the VIE's activities, is entitled to receive a majority of the VIE's residual returns (if no other variable interests absorb a majority of the VIE's losses), or both.

A variable interest holder that consolidates the VIE is called the primary beneficiary. Upon consolidation, the primary beneficiary generally must initially record all of the VIE's assets, liabilities and noncontrolling interests at fair value and subsequently account for the VIE as if it were consolidated based on a majority voting interest. FIN 46 also requires disclosures about VIEs that the variable interest holder is not required to consolidate but in which it has a significant variable interest.

FIN 46 was effective immediately for VIEs created after January 31, 2003. For VIEs created before January 31, 2003, the provisions of FIN 46, as revised, were adopted as of March 31, 2004. The adoption of FIN 46 did not have a material effect on the company's financial statements.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

c. Principles of consolidation (Cont.)

As of the balance sheet date the significant subsidiaries whose balances and results are consolidated are:

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>Consolidated % of outstanding share capital</b>	
Elbit Ltd. ("Elbit")	100.0	100.0
DEP Technology Holdings Ltd. ("DEP")	100.0	100.0
RDC Rafael Development Corporation Ltd. ("RDC")	50.1	49.6
Elron Telesoft Ltd. and Elron Telesoft Export Ltd. (together the "ET group")	-	100.0
Galil Medical Ltd. ("Galil")	59.1	59.1
Mediagate Ltd. ("Mediagate")	100.0	100.0
SELA Semiconductors Engineering Laboratories Ltd. ("SELA")	66.2	54.4
Starling Advanced Communications Ltd. ("Starling")	66.5	66.5
3DV Systems Ltd. ("3DV")	88.7	94.8
Enure Networks Ltd. ("Enure") (formerly Gaia broadband services management Ltd.)	57.2	-

d. Business combinations

Business combinations have been accounted for using the purchase method of accounting. Under the purchase method of accounting the results of operations of the acquired business are included from the effective date of acquisition. The costs to acquire companies, including transactions costs, have been allocated to the underlying net assets of each acquired company in proportion to their respective fair values. Any excess of the purchase price over estimated fair values of the identifiable net assets acquired has been recorded as goodwill.

e. Cash and cash equivalents

Cash and cash equivalents are short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less at the date acquired.

f. Bank deposits

Bank deposits with original maturities of more than three months but less than one year are presented as part of short-term investments. Deposits are presented at their cost including accrued interest. Interest on deposits is recorded as financial income.

g. Marketable securities

Management determines the classification of marketable investments in debt securities with fixed maturities and marketable equity securities at the time of purchase and reevaluates such designations at each balance sheet date.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

g. Marketable securities (Cont.)

Certain marketable securities covered by SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities", ("SFAS 115") are classified as available-for-sale. Accordingly, these securities are measured at fair value, with unrealized gains and losses reported net-of-tax in accumulated other comprehensive income, a separate component of shareholders' equity. Realized gains and losses on sales of investments, and a decline in value which is considered as other than temporary, are included in the consolidated statement of operations. The Company considers a decline in value to be other than temporary with regard to available-for-sale marketable debentures when the fair value is lower than cost for a continuing period which exceeding six months and when the Company do not intend to hold the debentures until maturity. When computing realized gain or loss, cost is determined on an average basis. Interest and amortization of premium and discount on debt securities are recorded as financial income.

Debt securities, which the Company has the positive intent and ability to hold to maturity, are classified as held-to-maturity investments. Held-to-maturity investments are measured at amortized cost plus accrued interest. Interest and amortization of premium and discount on such debt securities are recorded as financial income.

h. Inventories and contracts in progress

Inventories are stated at the lower of cost or market value. Inventory write-offs are provided for slow-moving items and technological obsolescence.

Cost is determined as follows:

Raw materials - using the "first in, first out" method.

Contracts-in-progress (included in assets attributed to discontinued operations) - represent amounts related to contracts as determined by the percentage of completion method of accounting.

Finished Products – on the basis of direct manufacturing costs with the additional of allocable indirect manufacturing costs, with cost measured on an average basis.

i. Investments in companies

Investments in common stock or in-substance-common stock of entities in which the Company has significant influence but less than a controlling voting interest are accounted for using the equity method ("affiliated companies") (see below for provisions of EITF 02-14). Significant influence is presumed to exist when the Company holds between 20%-50% of the investee's voting stock. However, whether or not the Company has significant influence depends on evaluation of certain factors including among others, the Company's representation on the investee's board of directors, agreements with other shareholders, additional voting rights, participation in policy making processes, existence of material intercompany transactions and technological dependency and the extent of ownership by the Company in relation to the concentration of other shareholders.

The Company discontinues applying the equity method when its investment (including advances and loans) is reduced to zero and it has not guaranteed obligations of the affiliate or is not otherwise committed to provide further financial support to the affiliate.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

i. Investments in companies (Cont.)

In July 2004, the EITF reached a consensus on Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock" ("EITF 02-14"). EITF 02-14 states that the Company must apply the equity method of accounting to investments in common stock and in in-substance-common stock if it has the ability to exercise significant influence over the operating and financial policies of the investee.

EITF 02-14 defines in-substance-common stock as an investment with similar risk and reward characteristics to common stock. The provisions of EITF 02-14 are effective since the beginning of the fourth quarter of 2004. For investments that are not common stock or in-substance-common stock, but were accounted for under the equity method prior to the effective date of EITF 02-14, the equity method of accounting should be discontinued at the effective date. Previously recognized equity method earnings and losses were not reversed. Upon adoption of EITF 02-14, the Company evaluated all of its investments at the adoption date and concluded that no change should be made to its then implemented accounting treatment as a result of the adoption of EITF 02-14.

The Company applies EITF 02-18 "Accounting for Subsequent Investments in an Investee after suspension of Equity Method Loss Recognition" ("EITF 02-18") in cases where the Company suspended equity method loss recognition in a certain investee, and it subsequently invests in the aforementioned investee (not resulting in the ownership interest increasing from one of significant influence to one of control), if the additional investment, in whole or in part, represents, in substance, the funding of prior losses, the Company recognizes previously suspended losses up to the amount of the additional investment determined to represent the funding of prior losses. Whether the investment represents the funding of prior losses, however, depends on the facts and circumstances.

In circumstances where the Company's ownership in an affiliate is in the form of a preferred security or other senior security, the Company recognizes losses based on the ownership level of the particular affiliate's security or loan held by the Company to which the equity method losses are being applied.

The excess of the purchase price over the proportional fair value of net tangible assets acquired is attributed to goodwill, technology and other identifiable intangible assets. Technology and other identifiable intangible assets are amortized over a weighted averaged period of approximately 14 years, commencing from the acquisition date.

Gains arising from issuance of shares by affiliated companies to third parties are recorded as income in the consolidated statements of operations, unless the issuing company is a development stage company for which the gain (loss) from issuance is accounted for as an equity transaction pursuant to Staff Accounting Bulletin ("SAB") No. 51 "Accounting for Sales of Stock by a Subsidiary".

When an investment in common stock or in-substance common stock, that was previously accounted for on other than the equity method, becomes qualified for use of the equity method by an increase in level of ownership, the equity method of accounting is adopted retroactively and financial statements of prior periods are adjusted accordingly.

Investments in partnerships in which the Company has a greater than five percent interest, are accounted for under the equity method.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

i. Investments in companies (Cont.)

Investments in non-marketable securities of companies, in which the Company does not have the ability to exercise significant influence over their operating and financial policies, and investments in non-marketable companies that are not common stock or in-substance-common stock, are presented at cost.

Management evaluates investments in affiliates and other companies for evidence of other than temporary declines in value. When relevant factors indicate a decline in value that is other than temporary, the Company records a provision for the decline in value. A judgmental aspect of accounting for investments involves determining whether an other-than-temporary decline in value of the investment has been sustained. Such evaluation is dependent on the specific facts and circumstances. Accordingly, management evaluates financial information (e.g. budgets, business plans, financial statements, etc.) in determining whether an other-than-temporary decline in value exists. Factors indicative of an other-than-temporary decline include recurring operating losses, failure of research and development efforts, extremely negative deviation from the business plan, credit defaults, specific conditions affecting the investment such as in the industry or in geographic area and subsequent rounds of financings at an amount below the cost basis of the investment. This list is not all inclusive and management weighs all quantitative and qualitative factors in determining if an other-than-temporary decline in value of an investment has occurred.

j. Property and equipment

Property and equipment are stated at cost, net of accumulated depreciation and investment grants. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets at the following annual rates:

	%
Land and Buildings	0-4
Computers, Machinery and Furniture	6 - 33
Motor vehicles	15
Leasehold improvements	over the term of the lease

k. Impairment and disposal of long-lived assets

The Company and its subsidiaries long-lived assets (including identifiable intangible assets subject to amortization) are reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If an asset is considered to be impaired, the impairment is measured by the difference between the carrying amount of the asset and its fair value. Assets to be disposed of are reported at the lower of their carrying amount or fair value less costs to sell. See Note 3c regarding impairment of intangible assets.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

l. Intangible assets

Intangible assets include mainly technology, goodwill and other identifiable intangible assets acquired in connection with the purchase of subsidiaries and businesses. Technology and other identifiable intangible definite lived assets are amortized over their estimated useful lives.

The Company evaluate the amortization periods of all identifiable intangible assets to determine whether events or circumstances warrant revised estimates of useful lives.

Under SFAS No. 142 "Goodwill and other Intangible Assets" ("SFAS 142") goodwill and intangible assets with indefinite lives are no longer amortized but instead are tested for impairment at least annually (or more frequently if impairment indicators arise).

SFAS 142 prescribes a two phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase (if necessary) measures impairment.

In the first phase of impairment testing, goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. If the carrying value of the reporting unit exceeds its fair value the second phase is then performed. The second phase of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. That is, the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit .

Fair value of the company's reporting unit is determined using discounted cash flows and market capitalization.

In 2004 and in the second quarter of 2005 when performing the first phase of the goodwill impairment test, the fair value of the systems and projects segment (reporting unit) of the ET group, which is included in discontinued operations, was found to be lower than its carrying value. Therefore the second phase of the goodwill impairment test was then performed and as a result goodwill was written down by \$1,980 in 2004 and \$1,300 in 2005. The fair value of the reporting units was determined using the discounted cash flow method. Significant estimates used in the discounted cash flow methodology include estimates of future cash flows, future short-term and long-term growth rates and discount rates. The Company performs its annual impairment tests during the fourth fiscal quarter of each year.

The impairment test for other intangible assets not subject to amortization consists of a comparison of the fair value of the intangible asset with its carrying value. If the carrying value of the intangible asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess.

m. Revenue recognition

The Company's subsidiaries sell software, license and support systems products and disposable medical products.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

m. Revenue recognition (Cont.)

The ET group generated revenues from software, sale of license and support systems, which are included in discontinued operations. Software sales are accounted for in accordance with Statement of Position (SOP) 97-2, "Software Revenue Recognition," as amended. Other product sales and revenues are accounted for in accordance with SAB No. 104, "Revenue Recognition in Financial Statements" ("SAB 104").

Revenues from license fees or product sales are recognized when delivery of the product has occurred, the fee is fixed or determinable, collectibility is probable and persuasive evidence of an arrangement exists.

When the products are warranted, a provision is recorded for probable costs, in connection with the warranties, based on the Company's subsidiaries' experience and estimates.

Revenues from software licenses that require significant customization, integration and installation (included in discontinued operations) are recognized based on SOP 81-1, "Accounting for Performance of Construction Type and Certain Production - Type Contracts", according to which revenues are recognized on a percentage of completion basis. Percentage of completion is measured by the efforts expended method based on the ratio of hours performed to date to estimated total hours at completion. Anticipated losses on contracts are charged to earnings when identified. Estimated gross profit or loss from contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis. Revenues derived from software licensing arrangements based on new technology, in which the Company's subsidiary does not have sufficient prior experience and estimates are not reasonably determinable, are recognized using the completed-contract method.

Deferred revenues include unearned amounts received under maintenance and support contracts and amounts received from customers but not recognized as revenues.

Revenues from service agreement on a cost plus basis are recognized as the services are performed, based on the costs incurred.

n. Research and development costs

Research and development costs, net of grants received, are charged to the statement of operations as incurred. SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the subsidiaries' product development process, technological feasibility is established upon completion of a working model. Costs, incurred by the Company's subsidiaries between completion of the working models and the point at which the products are ready for general release, have been insignificant. Therefore, research and development costs are charged to the statement of operations, as incurred.

o. Advertising costs

Advertising costs are charged to the consolidated statement of operations as incurred.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

p. Royalty-bearing grants

Royalty-bearing grants from the Government of Israel and other governmental institutions for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred. Such grants are included as a deduction of research and development costs, since at the time received it is not probable that they will be repaid.

Research and development grants received by certain of the Company's subsidiaries in 2005 amounted to \$1,528 (2004 - \$1,535, 2003 - \$382).

Research and development grants received by the ET group, which are presented in the discontinued operations in 2005 amounted to \$0 (2004 - \$181, 2003 - \$105).

q. Income taxes

The Company and its subsidiaries account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities, using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to the amount that is more likely than not to be realized.

r. Income (loss) per share

Basic net income (loss) per share is computed based on the weighted average number of ordinary shares outstanding during each year. Diluted net income (loss) per share is computed based on the weighted average number of ordinary shares and ordinary share equivalents outstanding during the year; ordinary share equivalents are excluded from the computation if their effect is anti-dilutive.

In 2003, all shares relating to the outstanding stock options were excluded from the calculation of the diluted net loss per ordinary share because all such stock options were anti-dilutive. The total ordinary share equivalents relating to the outstanding options, excluded from the calculations of diluted net loss per share, were 1,799 for the year ended December 31, 2003.

s. Stock based compensation

For stock options granted prior to 2003, the Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and the FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" in accounting for its employee stock option plans. 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 over the exercise price at the grant date of the award or if applicable at a subsequent measurement date. Compensation cost is recorded over the vesting period on a straight line basis.

Effective January 1, 2003 the Company adopted the fair value recognition provisions of FASB Statement No.123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the prospective method of adoption selected by the company under the provisions of FASB Statement No.148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148"), the fair value recognition provisions were applied to all employee awards granted, modified, or settled after January 1, 2003. Compensation cost is recorded over the vesting period on a straight line basis.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

s. Stock based compensation (Cont.)

The expense related to stock-based employee compensation included in the determination of net income (loss) for 2005, 2004 and 2003 is less than that which would have been recognized if the fair value method had been applied to all awards granted after the original effective date of SFAS 123. If the Company, its subsidiaries and its affiliated companies had elected to adopt the fair value recognition provisions of SFAS 123 as of its original effective date, pro forma net income (loss) and pro forma basic and diluted net income (loss) per share would be as follows:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Net income (loss), as reported	\$ 47,335	\$ 84,133	\$ (7,205)
Add: Stock-based employee compensation expense included in reported net income (loss)	347	202	1,030
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards	2,739	2,981	3,094
Pro forma net income (loss)	\$ 44,943	\$ 81,354	\$ (9,269)
Income (loss) per share:			
Basic - as reported	\$ 1.61	\$ 2.87	\$ (0.25)
Basic - pro forma	1.53	2.78	(0.32)
Diluted - as reported	1.60	2.86	(0.25)
Diluted - pro forma	1.52	2.77	(0.32)

The fair value of stock options for the company was estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions for 2005, 2004 and 2003:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Risk-free Interest Rate	4.75%	2.5%	1%
Expected Dividend Yield *)	0%	0%	0%
Expected Volatility	38%	42%	53%
Expected Lives	2.8	2.8	2.7

\*) According to the Company's option plan, the exercise price is to be reduced in the event of a distribution of a dividend in the amount of the dividend distributed per share. Accordingly, the Company, when calculating fair value of the options based on the Black-Scholes option-pricing model, assumes a 0% dividend yield. When such a reduction in exercise occurs, there is no accounting consequence.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

s. Stock based compensation (Cont.)

The Company's additional disclosures required by SFAS 123 and SFAS 148 are provided in Note 16.

Call options granted to employees to purchase shares in subsidiaries, affiliates and other companies are recorded at fair value using the Black-Scholes option-pricing model. The fair value of the option is recorded as a liability and changes in the liability are recorded as compensation expenses in general and administrative expenses.

t. Comprehensive income

Comprehensive income consists of net income (loss) and other gains and losses affecting shareholders equity that under generally accepted accounting principles are excluded from the net income (loss). For the Company, such items consist of unrealized gains and losses on available for sale securities and foreign currency translation adjustments (See Note 24).

u. Severance pay

The Company's and its subsidiaries' liability for severance pay, with respect to their Israeli employees, is calculated pursuant to Israeli severance pay law and employee agreements based on the most recent salary of the employees. The Company's liability for all of its Israeli employees is fully provided for by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligations pursuant to Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrender value of these policies, and includes immaterial profits.

Severance pay expenses for the years ended December 31, 2005, 2004 and 2003 amounted to \$354, \$816 and \$611, respectively.

Severance pay expenses for the years ended December 31, 2005, 2004 and 2003 presented in the discontinued operations amounted to \$28, \$62 and \$120, respectively.

v. Discontinued operations

Under SFAS 144, when a component of an entity, as defined in SFAS 144, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on its disposal should be classified as discontinued operations and the assets and liabilities of such component should be classified as assets and liabilities attributed to discontinued operations, that is provided that the operations, assets and liabilities and cash flows of the component have been eliminated from the Company's consolidated operations and the Company will no longer have any significant continuing involvement in the operations of the component.

w. Fair value of financial instruments

SFAS No. 107, "Disclosure about Fair Value of Financial Instruments", requires disclosure of an estimate of the fair value of certain financial instruments. The Company's financial instruments consist of cash and cash equivalents, marketable securities, short-term deposits and debentures, trade receivables, other receivables, trade payables, other payables and short-term and long-term bank loans. The estimated fair value of these financial instruments approximates their carrying value as of December 31, 2005 and 2004, unless otherwise

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

w. Fair value of financial instruments (Comt.)

stated. The estimated fair values have been determined through information obtained from market sources and management estimates.

It was not practical to estimate the fair value of the Company's investments in shares and loans of non-public affiliates and other companies because of the lack of a quoted market price or without incurring excessive costs. The carrying amounts of these companies were \$75,143 and \$64,146 at December 31, 2005 and 2004, respectively, and they represent the original cost, net of any impairment charges, and in the case of affiliates also the Company's equity in the losses of the affiliates and its share in the changes of the affiliates equity, since the dates of acquisition.

x. Concentrations of credit risk

Financial instruments that potentially subject the Company and its subsidiaries to concentrations of credit risk consist principally of cash and cash equivalents, short-term bank deposits, marketable debentures and trade receivables.

Cash and cash equivalents and bank deposits are invested mainly in U.S. dollars with major banks in the United States and Israel. Marketable debentures are mainly debentures of U.S. government agencies with high credit quality and with limited amount of credit exposure to any corporation. Accordingly, the Company's management believes that minimal credit risk exists with respect to these investments.

Trade receivables are derived from sales to major customers located primarily in the U.S and in Asia. The Company's subsidiaries perform ongoing credit evaluations of their customers and obtain letters of credit and bank guarantees for certain receivables. An allowance for doubtful accounts is determined with respect to those amounts that were determined to be doubtful of collection and a general allowance is provided to cover additional potential exposures.

As of the balance sheet date there is no significant off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

y. Recently issued accounting pronouncements

i. In May 2005, the FASB issued SFAS No. 154 "Accounting Changes and Errors Corrections" ("FAS 154"). FAS 154 replaces APB No. 20 "accounting changes" ("APB 20") 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. APB 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. There is no effect on the Company's financial position and results of operations.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

- y. Recently issued accounting pronouncements (Cont.)
- ii. In November 2005, the FASB issued FSP ("FASB staff positions") FAS 115-1. The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The FSP also includes accounting considerations subsequent to the recognition of other than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends FASB Statements No. 115, "Accounting for Certain Investments in Debt and Equity". The FSP replaces the impairment evaluation guidance of EITF Issue No. 03-1, "The Meaning of other-than-Temporary Impairment and its Application to Certain Investments", with references to the existing other-than-temporary impairment guidance. The FSP clarifies that an investor should recognize an impairment loss no later than when the impairment is deemed other-than-temporary, even if a decision to sell an impaired security has not been made. The guidance in this FSP is to be applied to reporting periods beginning after December 15, 2005. The Company does not expect that the adoption of FSP FAS 115-1 will have a material effect on its financial position or results of operations.

iii. On December 16, 2004 the FASB issued FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), which is a revision of SFAS 123. SFAS 123(R), supersedes APB 25, and amends FASB Statement No. 95, "Statements of Cash Flows". Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS 123(R) 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, 2005 (such as the Company) to January 1, 2006.

SFAS 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.
2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purpose of pro forma disclosures all prior periods presented.

The company plans to adopt SFAS 123(R) using the modified-prospective method.

The Company adopted the fair-value-based method of accounting for share-based payments effective January 1, 2003 using the prospective method" described in SFAS 148.

Because SFAS 123(R) must be applied not only to new awards but also to previously granted awards that are not fully vested on the effective date, and because the Company adopted SFAS 123 using the prospective transition method (which applied only to award granted, modified or settled after the adoption date), compensation cost for some previously granted awards that were not recognized under SFAS 123 will be recognized under SFAS 123(R). However, had the Company adopted SFAS 123(R) in prior periods, the impact of that

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

y. Recently issued accounting pronouncements (Cont.)

standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net income and earnings per share in Note 2(s) to the consolidated financial statements.

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 SFAS 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.

z. Reclassifications

Certain prior year amounts were reclassified to conform with current year financial statement presentation.

**NOTE 3:- BUSINESS COMBINATIONS AND SALE OF BUSINESSES**

a. Galil

Galil Medical Ltd. ("Galil") develops, manufactures and markets systems and disposable kits for the performance of minimal invasive cryo-therapy by means of freezing tissues.

1. On July 1, 2003, Galil announced the completion of the merger of Galil's urology business and the Brachytherapy business of Amersham plc ("Amersham") (Amersham was subsequently acquired by General Electric Company (NYSE:GE) ("GE")). According to an agreement signed on April 22, 2003, a new company, Oncura Inc. ("Oncura"), was incorporated. Oncura provides minimally invasive treatment options for prostate cancer using brachytherapy and cryotherapy technologies. At the closing, Amersham and Galil each contributed the assets necessary for Oncura to conduct the Cryotherapy business and the Brachytherapy business, respectively, in the urology field and in exchange, Amersham received 78% and Galil received 22% of the outstanding shares of Oncura. In addition, at the closing, Galil purchased 3% of Oncura from Amersham in consideration for \$4,500 resulting in Galil's owning an aggregate interest of 25% in Oncura.

Galil and Amersham each entered, separately, into supply and R&D service agreements pursuant to which Galil and Amersham provide Oncura with certain exclusive supply, manufacturing and R&D services, on a cost plus basis, according to terms and conditions stipulated in the relevant agreements.

Galil accounted for the transfer of its business in exchange for an interest in Oncura as a non-monetary exchange which was recorded at fair value. The fair value of the transaction was approximately \$150,000. As Galil retains an indirect interest in the tangible and intangible assets transferred to Oncura, the portion of the gain relating to the interest retained has been deferred. This deferred gain is realized according to the rate of amortization of the assets transferred by Galil to Oncura.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 3:- BUSINESS COMBINATIONS AND SALE OF BUSINESSES (Cont.)

a. Galil (Cont.)

Accordingly, the investment in Oncura, which is accounted for under the equity method, was recorded in the amount of approximately \$30,000.

As a result, a gain on the transaction of approximately \$21,200 was recorded in 2003 in the statement of operations under "Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net". The gain is net of realization of goodwill, related to the "Other Holdings and Corporate Operations" segment, in the amount of approximately \$500. Elron's share in the gain (net of minority interest and income taxes) amounted to approximately \$4,400.

The investment in Oncura as of the date of the transaction included amounts allocated to goodwill of approximately \$14,200, to other intangibles of \$23,800 and to deferred tax liabilities of \$ 9,100.

In 2005, due to an impairment of a certain agreement, the Company wrote down an amount of \$1,700 (\$ 800 net of minority interest), which is the unamortized portion of the investment amount allocated to the aforementioned intangible asset at the date of the investment in Oncura. In addition, in light of Oncura's results, the Company recorded in 2005 an impairment loss on the investment in Oncura in the amount of \$ 3,400 (\$ 1,400 net of minority interest), due to an other than temporary decline in value of such investment. The impairment losses were presented in the statement of operations in the line item "equity in losses of affiliated companies".

In 2003, Galil signed a loan agreement with Oncura, according to which Galil has committed to extend loans to Oncura up to an aggregate principal amount of \$2,000. As of December 31, 2005, Galil advanced \$875 to Oncura in respect of this agreement. The loan bears an interest rate of Libor+0.75% per annum and is to be repaid in March 2007.

Each of Galil and GE provided to Oncura a letter in which they confirmed their intention to continue providing financial support to Oncura through March 1, 2007 or such later date, as may be agreed by Oncura's shareholders.

b. ESW

On September 2, 2003, Elron's majority owned subsidiary, Elron Software Inc. ("ESI"), sold substantially all of its assets and business to Zix Corporation ("Zix"), a publicly traded company on NASDAQ (NASDAQ: ZIXI). In consideration for the assets and business sold, Zix issued to ESI 1,709,402 unregistered shares of its Common stock, with a market value of approximately \$ 6,000 and a convertible note bearing an interest rate of 5.75% ("the Note") in the amount of \$ 1,000. The Note was converted into 262,454 shares of Zix Common stock, in the fourth quarter of 2003. As part of the transaction, Zix assumed certain liabilities of ESI in the net amount of approximately \$1,000. Following the transaction, ESI changed its name to ELRON SW, INC. ("ESW").

In determining the gain on the sale of ESI's business, Elron valued the Zix Common stock at \$5,400 (a discount from market value of approximately 10% due to certain restrictions on their sale). Accordingly, Elron recorded a gain on the sale of approximately \$4,100, of which \$2,500 represents an elimination of a liability to minority shareholders previously recorded by Elron with respect to options granted to ESW's employees due to the expiration of the unexercised options.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 3:- BUSINESS COMBINATIONS AND SALE OF BUSINESSES (Cont.)

b. ESW (Cont.)

The business sold by ESW represents a component of an entity as defined in SFAS 144 and since the criteria for reporting discontinued operations under SFAS 144 is met, the results of operations of the business and the gain on the sale have been classified as discontinued operations in the statement of operations.

The Zix Common stock had been accounted for as available for sale securities in accordance with SFAS 115. Of the 1,971,856 shares received, 1,117,155 shares (including 262,454 shares which resulted from the conversion of the convertible note) were sold in 2003 in consideration for approximately \$ 9,000, resulting in a realized gain of approximately \$4,800 (\$ 3,200 net of tax) and 854,701 shares were sold in 2004 in consideration for approximately \$8,100 resulting in a realized gain of approximately \$5,400 (\$3,600 net of tax).

ESW was voluntarily dissolved in December 2004.

c. Mediagate

In December 2003, Mediagate signed an agreement, for the sale of its technology and related intellectual property assets. The closing of the transaction occurred on January 28, 2004 with no effect on the consolidated results of operations. According to the agreement, the consideration for the technology is in the form of royalties, up to a maximum of \$5,000 to be paid on future sales through December 31, 2009, of products that are based on Mediagate's technology.

As a result of the Company's revised estimate about the realizability of future royalties to be received, the Company recorded in 2004 an impairment loss of approximately \$4,200 (\$2,700 net of tax) in respect of the intangible asset relating to Mediagate's technology. This impairment loss is included as a separate line item in the statement of operations.

d. Elron Telesoft

On December 29, 2005, Elron sold all of its shares of Elron Telesoft to ECtel Ltd. (NASDAQ: ECRX) for \$2,500, of which \$2,100 paid in cash immediately and up to an additional \$400 shall be paid if certain milestones will be achieved during 2006. The above transaction resulted in an immaterial gain (due to previous impairment charges which were recorded on Elron Telesoft assets).

According to SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", when a component of an entity, as defined in SFAS 144, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on its disposal should be classified as discontinued operations when the operations and cash flows of the component have been eliminated from the Company's consolidated operations and the Company will no longer have any significant continuing involvement in the operations of the component. The business sold by Elron Telesoft met the criteria for reporting discontinued operations and therefore the 2005 results of operations of the business and the gain on the sale have been classified as discontinued operations in the statement of operations and prior periods results have been reclassified accordingly. In addition, the comparative data of the assets and liabilities have been reclassified as assets and liabilities attributed to discontinued operations in the balance sheets.



**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:- BUSINESS COMBINATIONS AND SALE OF BUSINESSES (Cont.)**

e. Enure

On October 2, 2005, Elron completed an investment of approximately \$4,000 in Enure, in consideration for 213,690 Series A preferred shares. Enure is an Israeli software company engaged in developing unique solutions in the field of broadband services management and home networks. Following Elron's investment, Elron holds approximately 44% of Enure, on a fully diluted and on an as converted basis (approximately 57% on an outstanding basis). Since the Company has control over Enure, Enure's financial statements have been consolidated in the Company's consolidated financial statements. The majority of the purchase price was allocated to cash and other monetary current assets and liabilities.

**NOTE 4:- CASH AND CASH EQUIVALENTS**

Includes mainly bank deposits in U.S. dollars, bearing an annual weighted average interest rate of 4.1% per annum (December 31, 2004 – 2.22%).

**NOTE 5: - SHORT-TERM INVESTMENTS**

	<b>Annual Weighted Average Interest rate as of December 31, 2005</b>	<b>December 31,</b>	
	<b>%</b>	<b>2005</b>	<b>2004</b>
Certificate of deposits		-	223
Bank deposits	3.77%	54,661	100,801
		<u>\$ 54,661</u>	<u>\$ 101,024</u>

**NOTE 6: - AVAILABLE FOR SALE MARKETABLE SECURITIES**

Available-for-sale securities: (1)			
U.S. government agencies and corporate debentures	3.68%	\$ 62,617	\$ 44,985
		62,617	44,985
(1) Includes unrealized losses		<u>\$ - *)</u>	<u>\$ 253</u>

\* ) In 2005 –the unrealized losses in the amount of \$909 were reclassified as finance income, net due to other than temporary decline in value

**Maturities**

As of December 31, 2005:

Available-for-sale securities:	
Due in one year or less	\$ 19,882
Due after one year to three years	35,755
Due after three years to five years	6,980
	<u>62,617</u>

**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:- INVESTMENTS IN AFFILIATED COMPANIES**

a. Affiliated companies are as follows:

	<u>Note</u>	<u>December 31,</u>	
		<u>2005</u>	<u>2004</u>
<u>Consolidated % of</u>			
<u>outstanding share capital</u>			
Elbit Systems ("ESL")	7d(1)	-	-
Given Imaging	7d(2)	24.2	24.7
ChipX	7d(3)	26.5	26.5
K.I.T eLearning	7d(4)	-	-
Wavion	7d(5)	37.8	37.5
Oren Semiconductors	7d(6)	-	40.9
NetVision	7d(7)	39.1	45.7
AMT	7d(8)	41.8	40.3
Oncura	3a	25.0	25.0
Pulsicom	-	18.2	18.2
Notal Vision	-	25.6	25.5
CellAct	-	45.0	45.0

b. Composition of investments: (1)(2)

	<u>December 31</u>	
	<u>2005</u>	<u>2004</u>
Given Imaging	68,956	71,748
Oncura	22,072	29,259
Netvision	5,549	3,542
Others	6,203	12,575
	<u>\$ 102,780</u>	<u>\$ 117,124</u>
<sup>(1)</sup> Includes loans and convertible loans (bearing a weighted average interest rate of 6.42% per annum (December 31, 2004 – 5.03%))	<u>\$ 1,417</u>	<u>\$ 7,122</u>
<sup>(2)</sup> Difference between the carrying amounts of investments and the Company's share in the net equity of affiliates, attributed to technology, goodwill and other intangible assets	<u>\$ 69,913</u>	<u>\$ 81,726</u>

c. Fair market value of marketable securities:

	<u>Stock Exchange</u>	<u>December 31</u>	
		<u>2005</u>	<u>2004</u>
<u>U.S. dollars in millions</u>			
Given Imaging	Tel-Aviv and NASDAQ	\$ 176	\$ 245
Netvision	Tel-Aviv	\$ 27.7	-

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)

d. Additional information

1. ESL

On July 8, 2004, Elron announced the signing of a definitive agreement for the sale of all of its holdings in Elbit Systems Ltd. ("ESL") (NASDAQ: ESLT) constituting approximately 19.6% of the outstanding share capital of ESL to Tadiran Communications Ltd., in consideration for approximately \$197,000. The closing of the transaction was subject to the right of first refusal of Federmann Enterprises Ltd. ("Federmann Enterprises"), the other major shareholder of ESL. On July 28, 2004, Federmann Enterprises exercised its right of first refusal, following which the shares were sold to Federmann Enterprises for approximately \$197,000. As a result, Elron recorded, in 2004, a gain of approximately \$104,600 which net of tax amounted to approximately \$91,500. The gain net of tax includes a reduction of approximately \$21,600 in the tax expense as a result of the reversal of a valuation allowance previously recorded in respect of deferred tax assets relating to loss carryforwards.

2. Given

- a. Given Imaging Ltd. ("Given"), a medical device company that develops, manufactures and markets innovative diagnostic systems for visualizing the gastrointestinal tract, using a disposable miniature swallowable video capsules.

In 2003, RDC, then a 48% held subsidiary sold 753,600 shares of Given for a total consideration of approximately \$7,800, resulting in a gain of approximately \$4,400 (\$70 net of tax and minority interest) as a result, Elron's directly and indirectly ownership interest in Given decreased to approximately 17% .

- b. In May 2003, a Share Purchase Agreement was signed between RDC, Elron and Rafael Armament Development Authority ("Rafael") (the other shareholder of RDC), according to which, RDC sold 2,000,000 unregistered shares of Given to Elron and Rafael (one million each) for a total consideration of \$12,184. RDC used \$5,000 of the proceeds to repay shareholders' loans to Rafael and Elron. This transaction did not have any effect on the Company's consolidated results of operations and the Company's direct and indirect interest in Given.

- c. In April 2004, RDC purchased from one of its shareholders (a former senior executive of RDC) treasury shares amounting to approximately 3% of its outstanding share capital. In consideration for the treasury shares, RDC distributed to the shareholder 200,000 shares of Given. The number of the distributed Given shares was calculated based on the relative fair values of the shares of RDC and of Given on the date the agreement to purchase the treasury shares was signed (May 2003). The transaction was completed in April 2004, after receipt of various approvals required under the agreement.

RDC recorded the purchase of the treasury shares based on the fair value of Given's shares on the date of distribution. Accordingly, RDC recorded a gain on the distribution of Given shares of approximately \$5,800. RDC's purchase of the treasury shares resulted in Elron increasing its interest in RDC by approximately 1.5% to approximately 49.6%. This acquisition of the additional interest in RDC was accounted for by the purchase method.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)

d. Additional information (Cont.)

2. Given (Cont.)

Accordingly, Elron recorded the additional interest in RDC at fair value of approximately \$1,900 and recorded its share of the gain in the distribution of Given shares in the amount of \$1,400, net of tax and minority interest.

The excess of the purchase price over the Company's share in the equity acquired amounted to approximately \$1,900 and was allocated mostly to RDC's remaining investment in Given.

- d. In June 2004, Given completed its secondary public offering of 2,880,750 ordinary shares at \$32.00 per share, comprising 1,500,000 shares issued by Given and 1,380,750 shares (including 375,750 shares as a result of the exercise of the underwriters' over allotment option) sold by existing shareholders. In the aforementioned offering, RDC sold 300,000 ordinary shares in consideration for approximately \$9,000. Given received net proceeds of approximately \$44,300. As a result of the sale of Given's shares by RDC and the issuance of shares by Given, Elron's directly and indirectly ownership interest in Given decreased from approximately 16% to approximately 15%, and Elron recorded a gain of \$15,200 (\$6,700 net of tax and minority interest).
- e. During the second half of 2004, Elron purchased 1,373,513 ordinary shares of Given in consideration for approximately \$43,900. As a result, Elron's direct and indirect ownership interest in Given increased from approximately 15% to approximately 20%. The excess of the purchase price over the Company's share in the equity acquired amounted to approximately \$39,500 and was allocated as follows: approximately \$30,400, net of deferred tax liability in the amount of \$ 1,900 to intangible assets other than goodwill, such as customer relationships and technology, approximately \$1,700 to in-process research and development activities ("IPR&D"), and approximately \$7,400 to goodwill.

Products which did not receive marketing clearance by regulatory authorities as of the acquisition date are considered to be incomplete and accordingly the amount allocated to such products is considered to be IPR&D. The amount allocated to IPR&D was charged immediately to the Company's results of operations in accordance with FASB Interpretation No. 4, "Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method" ("FIN 4"). The amounts allocated to intangible assets other than goodwill are amortized on a straight-line basis over their weighted average expected useful life of 12 years. The amortization of the identifiable intangible assets as well as the write-off of the IPR&D are included as part of the line item "Equity in losses of affiliated companies" in the statements of operations.

- f. During 2004, the Company's Chairman of the Board exercised options previously granted to him and purchased 21,751 shares of Given from the company, in consideration for approximately \$49 and the elimination of the related liability previously recorded in Elron's books. As a result, Elron recorded a gain of approximately \$600.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)

d. Additional information (Cont.)

During 2005 a former senior employee of RDC exercised options previously granted to him, and purchased from RDC 70,200 shares of Given in consideration for approximately \$12 and the elimination of the related liability previously recorded in RDC'S books. As a result, RDC recorded a gain of approximately \$1,200 (\$500 net of tax and minority interest).

3. ChipX

ChipX is a manufacturer of late stage programmable structured ASICs (application-specific integrated circuits). In March 2004, ChipX Incorporated ("ChipX") completed a private placement in which it issued 7,594,928 redeemable preferred shares in consideration for \$12,000. Elron purchased 1,632,564 redeemable preferred shares in consideration for approximately \$2,600. As a result, Elron's voting interest in ChipX decreased from approximately 33% to approximately 26%. The aforementioned transaction had no effect on Elron's results of operations.

4. KIT

In July 2003 Elron invested \$2,000 in K.I.T. eLearning B.V ("KIT"), in consideration for 1,243,396 Series B-2 preferred shares, as part of an aggregate investment of \$4,000, the balance of which was invested by DIC. KIT was previously held by Elron at a rate of approximately 29%.

In addition to this investment, Elron's loan to KIT in the amount of \$1,500 (which was granted during 2001 and 2002) was converted into 324,388 series B-1 preferred shares of KIT. Following the investment and the loan conversion, Elron held approximately 45% of KIT's outstanding shares.

In March 2004, Elron together with the other shareholders of KIT, DIC and Kidum IT Ltd. (together "the sellers") completed the sale of KIT, to Online Higher Education B.V, a subsidiary of Laureate Education, Inc. (NASDAQ: LAUR), a global leader in higher education, in consideration for \$9,400, of which Elron received approximately \$5,700. The gain resulting from the sale amounted to approximately \$5,300. In addition, the sellers are entitled to a future payment of up to \$10,000 based on future earnings of KIT in the years 2006 and 2007, from which Elron's share will be up to approximately \$5,700.

5. Wavion

In 2003, Elron invested \$3,000 in Wavion Inc. ("Wavion") in consideration for 3,575,686 Series B preferred shares, out of an aggregate amount of \$12,500 raised by Wavion in a private placement from Elron and new investors. In addition to this investment, Elron converted previously granted loans into 1,787,843 Series A1 preferred shares. In 2005, Elron invested \$1,424 in consideration for 1,696,728 Series B preferred shares, out of an aggregate amount of \$3,600. Wavion is a developer of broadband wireless access systems for Wi-Fi networks. As of December 31, 2005, Elron's holds approximately 38% of Wavion on a fully diluted and on an as converted basis.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)

d. Additional information (Cont.)

5. Wavion (Cont.)

Wavion is considered to be a variable interest entity, however, the Company is not the primary beneficiary of Wavion, and accordingly has not consolidated Wavion. As of December 31, 2005, the Company's maximum exposure to loss as a result of its involvement in Wavion does not exceed the carrying value of its investment in Wavion in the amount of approximately \$761.

6. Oren

- a. In July 2003, Elron purchased 6,581,671 preferred E2 shares of Oren Semiconductors Inc. ("Oren") in consideration for \$3,000, as part of an aggregate investment of \$8,000 of existing shareholders and of Zoran Corporation (NASDAQ: ZRAN) ("Zoran").

In addition to this investment, Elron and other existing shareholders converted all the loans previously granted to Oren, in the amount of approximately \$8,400, of which Elron's part was approximately \$4,400. Elron's loans were converted to 3,824,563 preferred E1 shares of Oren. Following the investment and the loan conversion, Elron's interest in Oren increased from approximately 17% to approximately 41% and accordingly Elron began applying retroactively the equity method of accounting to its investment in Oren.

- b. On June 10, 2005, Zoran completed the acquisition of Oren. 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). 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. As a result of the sale, Elron recorded a gain, in 2005, of approximately \$19,700 (approximately \$17,200 net of taxes).

In July 2005, Elron sold all shares of Zoran received by it in the aforementioned sale for approximately \$8,800 and recorded a gain of approximately \$1,100 (approximately \$700 net of tax).

7. NetVision

- a. NetVision provides Internet services and solutions in Israel and international telephony services through Voice over IP technology. During 2004, Elron and DIC each granted NetVision Ltd. ("NetVision") a loan of \$2,000 in order to enable NetVision to repay a portion of its line of credit to a lending bank. DIC is the other major shareholder of Netvision. In accordance with EITF 02-18, Elron recognized all previously suspended equity method losses in NetVision in the amount of the loan granted.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)

d. Additional information (Cont.)

7. NetVision (Cont.)

During the second half of 2004, Elron and DIC each granted NetVision additional loans of approximately \$3,300. The loans from Elron bore an interest rate of Libor + 2% per annum.

- b. 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 NIS 135 million (approximately \$31,000). Out of the proceeds received, an amount of approximately NIS 38 million (approximately \$8,600) was allocated to the shares and an amount of approximately NIS 97 million (approximately \$22,400) was allocated to the convertible securities based on the relative fair value of such securities. In addition, future proceeds from the exercise of options sold in the offering may amount to a maximum of approximately NIS 28.8 million (approximately \$6,600). 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 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% resulting in a gain of approximately \$3,000. If all convertible securities in Netvision are converted to shares, Elron's interest in Netvision will decrease to 27.4%.

8. AMT

The AMT group develops technologies and products based on amorphous metals. In June 2004, Elron completed an investment of \$3,000 in convertible notes of AMT then held 28% by Elron, together with an international strategic partner which also invested \$3,000 in AMT's convertible notes. In addition, existing AMT shareholders, including Elron, converted shareholder loans into convertible notes in the aggregate amount of approximately \$2,700, of which Elron converted approximately \$1,600. In addition, Elron and the other investors in AMT were issued warrants to purchase convertible notes of AMT for a total amount of up to approximately \$33,250, which may be exercised over various periods up to a maximum of 48 months from the closing date of the transaction. As a result of the transaction, Elron increased its ownership interest to approximately 35% on a fully diluted basis (excluding warrants) and on an "as converted" basis. The excess of the purchase price over the Company's share in the equity acquired amounted to approximately \$4,200 and was allocated as follows: approximately \$2,900 net of deferred tax liability in the amount of approximately \$300 to intangible assets other than goodwill with a weighted average useful life of 10 years, approximately \$1,100 to IPR&D and approximately \$140 to tangible assets.

In 2005, Elron invested additional \$900 in convertible notes and \$500 in loans bearing an interest rate of 8% per annum.

9. Oncura

Regarding the investments in Oncura, see Note 3(a)(1).

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)**

e. Summarized information

Summarized combined financial information is as follows:

	<u>Given</u>	<u>Others</u>
December 31, 2005:		
Balance sheet information:		
Current assets	\$ 108,976	\$ 81,546
Non-current assets	40,134	91,372
Total assets	149,110	172,917
Current liabilities	22,759	84,222
Non-current liabilities	24,246	56,701
Minority interest	61	143
Redeemable preferred stock	-	36,108
Shareholders' equity (deficiency)	102,044	(4,257)
Year Ended December 31, 2005:		
Statement of operations information:		
Revenues	\$ 86,776	\$ 167,770
Gross profit	64,706	57,042
Net income from continuing operations and net income	6,343	5,405
Net loss from continuing operations and net loss	-	(24,889)
	<u>Given</u>	<u>Others</u>
December 31, 2004:		
Balance sheet information:		
Current assets	\$ 110,433	\$ 66,990
Non-current assets	13,791	96,426
Total assets	124,224	163,419
Current liabilities	17,446	82,060
Non-current liabilities	10,984	49,278
Minority interest	1,177	493
Redeemable preferred stock	-	34,272
Shareholders' equity (deficiency)	94,617	(2,684)
Year Ended December 31, 2004:		
Statement of operations information:		
Revenues	\$ 65,020	\$ 158,965
Gross profit	47,286	53,494
Net income from continuing operations and net income	2,888	4,446
Net loss from continuing operations and net loss	-	(23,586)

Following is the summary of information from ESL's unaudited financial report as of June 30, 2004, which the Company used in order to record in 2004 its share in the equity and results of ESL until the date of sale of the investment in ESL (on July 28, 2004) and in order to determine the gain resulting from the aforementioned sale (see Note 7d1).



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands, except share and per share data****NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES (Cont.)**

## e. Summarized information

	<u>ESL</u>
June 30, 2004: (unaudited)	
Balance sheet information:	
Current assets	\$ 559,848
Non-current assets	452,190
Total assets	1,012,038
Current liabilities	358,671
Non-current liabilities	171,419
Minority interest	3,972
Shareholders' equity	477,976
Six months ended June 30, 2004 (unaudited):	
Statement of operations information:	
Revenues	\$ 445,317
Gross profit	115,438
Net income from continuing operations and net income	24,039

## f. Goodwill and intangible assets allocated to investments

The annual estimated amortization expense relating to intangible assets allocated to investments accounted for under the equity method, which will be included in the line item "Equity in losses of affiliated companies" in the statement of operations, for each of the five years in the period ending December 31, 2010 is approximately \$4,600.

The weighted average amortization period of the intangible assets is approximately 14 years.

At the balance sheet date, the Company has goodwill in the amount of \$20,650 allocated to investments accounted for under the equity method.

## g. Impairment

As a result of an other-than-temporary decline in value of certain investments, the Company recorded impairment losses with respect to affiliated companies of \$5,300, \$700 and \$500, in 2005, 2004 and 2003, respectively. Such impairment losses are included as part of the Company's equity in losses of affiliated companies.

**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 8:- INVESTMENTS IN OTHER COMPANIES AND LONG-TERM RECEIVABLES**

	<b>December 31</b>	
	<b>2005</b>	<b>2004</b>
Marketable securities presented as available- for- sale securities: (1)		
Partner (2)	\$ 25,998	\$ 136,208
Other	1,065	950
	27,063	137,158
Partnerships	3,698	3,176
Other investments and long-term receivables (3)(4)	43,170	15,595
	\$ 73,931	\$ 155,929
(1) Includes unrealized gains	\$ 17,540	\$ 90,484

(2) Partner Communications Company Ltd. ("Partner")

As of December 31, 2005 and 2004, Elbit holds 3,091,361 and 15,856,551 shares of Partner, respectively. In 2003, Elbit sold 6,278,226 shares of Partner in consideration for approximately \$29,300. As a result, Elron recorded a realized gain of approximately \$11,000 (\$7,100 net of tax). On April 20, 2005 Elbit completed the sale of 12,765,190 Partner shares to Partner for approximately \$94,000, as part of the sale together with the other Israeli founding shareholders of Partner, of approximately 33.3 million Partner shares to Partner. As a result of the sale, Elron recorded in the statement of operations, a gain of approximately \$56,400 (approximately \$45,400 net of tax).

The gain net of tax includes a reduction of approximately \$ 9,400 in the tax expense as a result of the reversal of a valuation allowance previously recorded in respect of deferred tax assets relating to loss carryforwards. See Note 14 (e).

Subsequent to the aforementioned sale and as of December 31, 2005, Elbit holds approximately 2% of the outstanding shares of Partner. This interest in Partner is no longer pledged to the banks providing financing to Partner.

On March 8, 2006, Elron announced the signing of a definitive agreement to acquire approximately 823,000 shares of Partner from one of the other Israeli founding shareholders of Partner for approximately \$5,300, reflecting approximately 15% discount from the market price, subject to adjustments in accordance with the terms of the agreement. Upon completion of the acquisition, we will hold approximately 2.6% of Partner. The completion of the acquisition is subject to the satisfaction of certain closing conditions including regulatory approval. There is no assurance that the acquisition will be completed.

Almost all of these shares are subject to transfer restrictions under Partner's license.

(3) During 2005, 2004 and 2003, Elron recorded impairment losses of approximately \$600, \$800 and \$3,700, respectively, in respect of certain investments and receivables.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:- INVESTMENTS IN OTHER COMPANIES AND LONG-TERM RECEIVABLES (Cont.)

(4) Other investments include mainly the following companies:

	Note	December 31,	
		2005	2004
% of outstanding share capital on an as converted basis			
Jordan Valley	8(4)(a)	27.8	27.8
Impliant	8(4)(b)	21.5	20.1
Nulens	8(4)(c)	21.6	-
Teledata	8(4)(d)	21.1	-
Brainsgate	8(4)(e)	22.3	-
Safend	8(4)(f)	-	-

(a) Jordan Valley

On October 21, 2004, Elron purchased 32,901 Preferred A shares of Jordan Valley Semiconductor Ltd. ("Jordan Valley"), in consideration for approximately \$6,700, as part of an aggregate investment of approximately \$9,000 raised by Jordan Valley. The balance of the aggregate investment in Jordan Valley was invested by Clal Industries and Investments Ltd. ("Clal") by way of conversion of previously granted loans. Jordan Valley is an Israeli private company engaged in developing solutions for advanced in-line thin film metrology for the semiconductor industry. Following the investment Elron holds 25% of Jordan Valley on a fully diluted basis and on an as converted basis. According to the agreement, Elron's holding percentage was subject to adjustment based on Jordan Valley's future performance and therefore Elron invested in October 2005 an additional \$1,400. Jordan Valley is also 40% owned (indirectly) by Clal, an entity under common control with DIC. Elron's investment in Jordan Valley was approved by the shareholders of Elron and Clal on October 21, 2004. Since the investment in preferred A shares is not considered to be an investment that is in-substance-common stock, the investment in Jordan Valley is accounted for under the cost method.

(b) Impliant

On December 28, 2004, Elron invested approximately \$7,300 in consideration for 19,962,500 Preferred C shares of Impliant Inc. ("Impliant") as part of a financing round of approximately \$18,000 from new and existing investors of Impliant. In 2005 Elron invested an additional \$1,000 in consideration for 2,682,907 Preferred C shares as part of a financing round of approximately \$5,400. Impliant is a privately held medical device company, engaged in the development of a novel posterior motion preservation system for spine surgery. Following the aforementioned investments, Elron holds approximately 20% of Impliant, on a fully diluted basis and on an as converted basis. Since the investment in preferred C shares is not considered to be an investment that is in-substance-common stock, the investment in Impliant is accounted for under the cost method.

(c) 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 device company operating in the field of intra-ocular lenses mainly for cataract and presbyopia procedures. Elron's investment was in two installments, the first of approximately \$1,700 was invested immediately for approximately 17% of NuLens on a fully diluted and on an

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 8:- INVESTMENTS IN OTHER COMPANIES AND LONG-TERM RECEIVABLES (Cont.)

(c) NuLens (Cont.)

as converted basis and an additional amount of approximately \$1,200 was invested on March 9, 2006, simultaneously with an additional investment of \$ 1,500, for 241,158 Series B preferred shares as part of a new round of investment in the aggregate amount of approximately \$6,000. The new round was led by Warburg Pincus, a leading global private equity fund. Following the above investments, Elron holds 25% of NuLens, on a fully diluted and on an as converted basis. Since the investments in preferred A and B shares are not considered to be an investment that is in-substance-common stock, the investment in NuLens is accounted for under the cost method

(d) 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 ("Infinity"), 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 in preferred A shares is not considered to be an investment that is in-substance-common stock, the investment in Teledata is accounted for under the cost method.

(e) BrainsGate

On August 8, 2005, Elron completed an investment of approximately \$6,900 in BrainsGate Ltd. ("BrainsGate"), in consideration for 1,733,141 Series B-1 preferred shares, as part of an aggregate investment of approximately \$17,000. BrainsGate is an Israeli company that is developing implantable medical devices to treat various central nervous system diseases (CNS) related pathologies. Following Elron's investment, Elron holds approximately 20% of BrainsGate, on a fully diluted and on an as converted basis. Since the investment is in preferred B-1 shares, which are not considered to be an investment that is in-substance- common stock, the investment in BrainsGate is accounted for under the cost method.

(f) Safend

On January 2, 2006 Elron completed an investment of approximately \$3,700 in Safend Ltd. ("Safend") of which \$200 were granted as a bridge loan in December 2005, in consideration for 1,942,261 Series B preferred shares, as part of an aggregate investment of approximately \$7,400. Following Elron's investment, Elron holds approximately 22% of Safend on a fully diluted and on an as converted basis. Safend is an Israeli company which develops comprehensive desktops and laptops endpoint security solutions.

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

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 9:- PROPERTY AND EQUIPMENT, NET**

	<b>December 31</b>	
	<b>2005</b>	<b>2004</b>
Land and Building	\$ 9,944	\$ 10,060
Leasehold improvements	2,508	2,389
Computers, furniture and machinery	4,176	3,691
Motor vehicles	561	521
	<u>17,189</u>	<u>16,661</u>
Less - accumulated depreciation	9,380	8,604
Property and equipment, net	<u>\$ 7,809</u>	<u>\$ 8,057</u>

Depreciation expenses amounted to approximately \$1,016, \$1,013 and \$1,336 for the years ended December 31, 2005, 2004 and 2003, respectively.

Depreciation expenses included in the discontinued operations, amounted approximately \$10, \$124 and \$254 for the years ended December 31, 2005, 2004 and 2003, respectively.

**NOTE 10:- GOODWILL AND OTHER INTANGIBLE ASSETS**

	<b>Period of amortization years</b>	<b>December 31</b>	
		<b>2005</b>	<b>2004</b>
Cost:			
Technology and other intangible assets (1)	14	\$ 425	\$ 383
Accumulated amortization:			
Technology and other intangible assets (1)		236	174
		<u>189</u>	<u>209</u>
Intangible assets with indefinite useful life		2,629	2,629
Goodwill		2,742	6,657
Amortized cost		<u>\$ 5,560</u>	<u>\$ 9,495</u>

- The annual estimated amortization expense relating to Elron's amortizable intangible assets existing as of December 31, 2005, for each of the five years in the period ending December 31, 2010 is approximately \$40.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 10:- GOODWILL AND OTHER INTANGIBLE ASSETS (Cont.)**

2. The changes in the carrying amount of goodwill for the years ended December 31, 2005, 2004 and 2003 are as follows:

	<b>Other Holdings and Corporate operations</b>
Balance as of January 1, 2003	\$ 14,862
Goodwill write-off relating to sale of business	(781)
Adjustment of goodwill due to reversal of valuation allowance in respect to deferred tax assets (4)	(7,653)
Balance as of December 31, 2003	\$ 6,428
Newly consolidated companies	229
Balance as of December 31, 2004	\$ 6,657
Adjustment of goodwill due to reversal of valuation allowance in respect to deferred tax assets (4)	(3,915)
Balance as of December 31, 2005	<u>\$ 2,742</u>

3. Amortization expenses amounted to approximately \$61, \$142 and \$299 for the years ended December 31, 2005, 2004 and 2003, respectively.
4. In 2003, Elbit recorded a tax benefit in the amount of approximately \$ 7,700, and reduced its valuation allowance in respect of deferred tax assets. Since the tax benefit was in respect of losses carryforward of Elbit at the date of Elbit's merger with Elron (May 2002) ("the merger"), Elron recorded the tax benefit as a reduction from goodwill that had resulted from the merger.

With respect to 2005 – see Note 14 (e).

5. Regarding the write down of an intangible asset relating to Mediagate, see Note 3c.

**NOTE 11:- SHORT-TERM LOANS FROM BANKS AND OTHERS**

	<b>Weighted Average Interest rate December 31, 2005</b>	<b>December 31</b>	
	<b>%</b>	<b>2005</b>	<b>2004</b>
Short-term loans from banks denominated in NIS	-	\$ -	\$ 9
Short-term loans from banks denominated in U.S. dollars	6.62%	<u>3,808</u>	<u>380</u>
		<u>\$ 3,808</u>	<u>\$ 389</u>

As of December 31, 2005, the balance also includes a bank loan to Mediagate in the amount of approximately \$2,600 bearing an annual interest rate of the Wholesale Interest Rate plus 1% (the Wholesale Interest Rate as of December 31, 2005 and 2004 was approximately 5.3% and 3.3%, respectively). In 2004 the loan was represented as long term loan. In February 2006, the loan (including accrued interest) was extinguished for a consideration of \$100. As a result Elron will record in the first quarter of 2006 a gain of approximately \$2,700.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 12:- OTHER PAYABLES AND ACCRUED EXPENSES**

	<b>December 31</b>	
	<b>2005</b>	<b>2004</b>
Payroll and related expenses <sup>(1)</sup>	\$ 2,502	\$ 2,559
Provision for income taxes	4,252	19,044
Accrued expenses	850	348
Deferred revenues	-	89
Employees call options <sup>(2)</sup>	836	3,835
Provision for rent	-	1,007
Provision for Professional expenses	455	314
Chief Scientist	443	525
Others	1,687	1,960
	\$ 11,025	\$ 29,681
(1) Includes provision for vacation pay	\$ 958	\$ 818

**(2) EMPLOYEE CALL OPTIONS**

- a. The Company's Chairman of the Board has options to acquire up to 1.5% of any shares or other securities acquired by the Company in Wavion and up to 0.75% of any shares or other securities acquired directly and indirectly by the Company in Galil. These options shall be exercisable at the weighted average price of investments made by the Company with respect to any of those two companies until the date of exercise of the options. The options shall be exercisable for a period of three years commencing on the later of January 1, 2000 or the date of the latest investment by the Company in the relevant entity.
- b. During 2001, the Board of directors approved the grant of options to certain officers of the Company to acquire between 1% to 2% of Elron's investments in certain private companies. The options are exercisable at the weighted average price of the investments made by Elron. The options vest ratably over a three year period and are exercisable for an additional three years.
- c. In 1999, RDC granted two former senior employees with call options to purchase up to 5% of the investments held by RDC at that date at an exercise price as determined in the call option agreement. During 2005, a former senior employee of RDC exercised a call option with respect to 70,200 shares of Given at an exercise price of \$ 0.17 per share (See Note 7d(2)).
- d. In 2004, RDC granted to a key employee call options to purchase up to 0.75% of RDC's investment in Starling at an exercise price as determined in the call option agreement. Approximately 67% of the options vest ratably over a period of 4 years and the balance are fully vested.

All aforementioned options were recorded at fair value. The fair value of each option granted (as described in paragraphs a - d above) is estimated using the Black and Scholes option pricing model with the following weighted average assumptions for the years ended December 31, 2005, 2004 and 2003, respectively: (1) expected life of the option of 1.8, 4 and 3.89, respectively; (2) dividend yield of 0% for all periods; (3) expected volatility of the options of 50%, 50% and 0% to 65%, respectively; and (4) risk-free interest rate of 4.6%, 2.5% and 1%, respectively.

In respect of the aforementioned call options, compensation expense (income) amounted to \$(1,041), \$1,414 and \$957 for the years ended December 31, 2005, 2004 and 2003, respectively. These compensation expenses are included in General and administrative expenses.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 13:- LONG-TERM LOANS FROM BANKS AND OTHERS**

a. COMPOSITION

	<b>December 31</b>	
	<b>2005</b>	<b>2004</b>
Long-term loans from banks (1)	\$ 23	\$ 3,420
Long-term loans from others (2)	3,519	3,626
	3,542	7,046
Less-current maturities (2)	(2,065)	(2,974)
	\$ 1,477	\$ 4,072

(1) In 2004, with respect to Mediagate's loan see Note 11.

(2) As of December 31, 2005 and 2004 an amount of \$2,058 and \$2,199, respectively, represents loans from Rafael to RDC which are denominated in New Israeli Shekel ("NIS") and do not bear interest or linkage. These amounts are included in current maturities of long term loans.

As of December 31, 2005, the amount also includes a loan of approximately \$1,379 from the minority shareholders of Galil. The loan bears interest at a rate of Libor plus 3%.

b. The maturities of long-term loans for years subsequent to the balance sheet date are as follows:

First year (current maturities)	\$ 2,065
Second year	1,469
Third year	8
	\$ 3,542

**NOTE 14:- INCOME TAXES**

a. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

In accordance with the above law, results for tax purposes are measured and reflected in real terms in accordance with the change in the Israeli CPI. As explained in Note 2b, the consolidated financial statements are presented in U.S. dollars. The differences between the change in the Israeli CPI and in the NIS/U.S. dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS 109, the Company has not provided deferred income taxes on this difference between amounts in the reporting currency and the tax bases of assets and liabilities.

b. Tax benefits under Israel's Law for the Encouragement of Industry (Taxation), 1969:

Certain of the Company's subsidiaries in Israel are "industrial companies", as defined by the Law for the Encouragement of Industry (Taxation), 1969, and as such, are entitled to certain tax benefits, mainly accelerated depreciation and the right to claim public issuance expenses and amortization of costs relating to intangible assets and patents as deductible expenses for tax purposes.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 14:- INCOME TAXES (Cont.)**

- c. Tax benefits under the Law for the Encouragement of Capital Investments, 1959:

Some of the Company's subsidiaries have been granted an "Approved Enterprise" status for their production facilities in Israel under the Law for the Encouragement of Capital Investments, 1959. The main benefit to which these subsidiaries are entitled, conditional upon the fulfilling of certain conditions stipulated by the above law, is a ten-year exemption from tax on income derived from their production facilities in Israel. The ten-year period is limited to the earlier of twelve years from the commencement of production, or fourteen years from the approval date.

- d. In 2004, the Israeli parliament approved on amendment to the Income Tax Ordinance (No. 140 and Temporary Provision) which reduces the corporate tax rate from 36% to 35% in 2004 and progressively to a rate of 30% in 2007. As a result, Elron recorded in 2004 a tax benefit in the amount of approximately \$2,900.

On July 25, 2005, the Israeli parliament approved the Law for the Amendment of the 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"). The amendment had no material effect on the Company's financial position and results of operations in 2005.

- e. Taxes on income (tax benefit) are comprised as follows:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Current taxes*	\$ 19,031	\$ 16,363	\$ 385
Adjustments of deferred tax assets and liabilities for enacted changes in tax rates	116	(2,917)	-
Deferred income taxes	(7,404)	508	6,229
Taxes in respect of prior years	(1,282)	1,147	182
	<u>\$ 10,461</u>	<u>\$ 15,101</u>	<u>\$ 6,796</u>
Domestic	<u>\$ 10,461</u>	<u>\$ 15,101</u>	<u>\$ 6,796</u>
Foreign	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

\* In 2005, Elbit received final tax assessments for the years 2002 to 2004, according to which certain prior year losses are to be offset from certain gains. Consequently, Elbit reversed a valuation allowance previously recorded in respect of deferred tax assets relating to loss carryforwards. This reversal resulted in a tax benefit of \$14,500. Since a portion of the valuation allowance reversed was in respect of loss carryforwards of Elbit existing at the date of the merger, Elron recorded a tax benefit in the amount of \$3,900 relating to such portion as a reduction of the remaining goodwill.

- f. Deferred income taxes:

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets are as follows:

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f. Deferred income taxes:

	<u>Deferred Tax Asset</u>		<u>Deferred Tax Liability</u>		<u>Total</u>
	<u>Non current</u>	<u>Current</u>	<u>Current</u>	<u>Non current</u>	
As of December 31, 2005					
Deferred tax assets:					
Provision for doubtful accounts, vacation and others	\$ -	\$ 201	\$ -	\$ -	\$ 201
Accrued severance pay, net	156	-	-	-	156
Trading marketable securities	-	22	-	-	22
Investments in subsidiaries, affiliates and other companies, net	31,946	-	-	(1,848)	30,098
Property and equipment and intangible assets	28	-	-	(744)	(716)
Tax loss carryforwards	36,505	-	-	955	37,460
Other	-	356	-	-	356
	<u>\$ 68,635</u>	<u>\$ 579</u>	<u>\$ -</u>	<u>\$ (1,637)</u>	<u>\$ 67,577</u>
Deferred tax liabilities:					
Available-for-sale marketable securities	-	-	-	(7,857)	(7,857)
Valuation allowance <sup>(1)</sup>	(62,114)	(579)	-	-	(62,693)
	<u>\$ 6,521</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (9,494)</u>	<u>\$ (2,973)</u>

	<u>Deferred Tax Asset</u>		<u>Deferred Tax Liability</u>		<u>Total</u>
	<u>Non current</u>	<u>Current</u>	<u>Current</u>	<u>Non current</u>	
As of December 31, 2004					
Deferred tax assets:					
Provision for doubtful accounts, vacation and others	\$ -	\$ 341	\$ -	\$ -	\$ 341
Accrued severance pay, net	363	-	-	-	363
Trading marketable securities	-	20	-	-	20
Investments in subsidiaries, affiliates and other companies, net	39,801	-	-	(1,659)	38,142
Property and equipment and intangible assets	184	-	-	(811)	(627)
Tax loss carryforwards	72,545	-	-	6,473	79,018
Other	-	1,151	-	-	1,151
	<u>\$ 112,893</u>	<u>\$ 1,512</u>	<u>\$ -</u>	<u>\$ 4,003</u>	<u>\$ 118,408</u>
Deferred tax liabilities:					
Available-for-sale marketable securities	-	-	-	(45,236)	(45,236)
	112,893	1,512	-	(41,233)	73,172
Valuation allowance	(107,400)	(1,512)	-	-	(108,912)
	<u>\$ 5,493</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (41,233)</u>	<u>\$ (35,740)</u>

(1) As of December 31, 2005, the valuation allowance for deferred tax assets, for which their reversal will be allocated to reduce other non-current intangible assets, aggregated approximately \$1,800.

g. A reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory tax rate applicable to income of the Company and the actual tax expense as reported in the statement of income, is as follows:

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 14:- INCOME TAXES (Cont.)**

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Income (loss) before taxes as reported in the consolidated statements of operations	\$ 56,486	\$ 111,734	\$ 12,807
Statutory tax rate	34%	35%	36%
Theoretical tax expense (income)	\$ 19,205	\$ 39,107	\$ 4,611
Equity in losses of affiliated companies	6,076	3,672	3,131
Tax exempt and reduced tax rate	173	22	(36)
Non-deductible expenses	(812)	834	1,550
Differences arising from the basis of measurement for tax purposes	1,233	(1,024)	2,783
Deferred taxes on losses for which valuation allowance was provided	5,370	2,940	1,977
Reversal of valuation allowance	(19,618)	(28,680)	(7,402)
Taxes in respect of previous years	(1,282)	1,147	182
Effect of change in tax rate	116	(2,917)	-
Actual tax expenses	\$ 10,461	\$ 15,101	\$ 6,796
Effective tax rate	18.5%	13.5%	53.1%

- h. As of December 31, 2005 the Company had tax loss carryforwards of approximately \$69,000, its Israeli subsidiaries had tax loss carryforwards of approximately \$51,000. Carryforward tax losses in Israel may be carryforward indefinitely and may be set against future taxable income.
- i. Income before taxes on income is comprised as follows:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Domestic	\$ 56,486	\$ 111,576	\$ 20,671
Foreign	-	158	(7,864)
	\$ 56,486	\$ 111,734	\$ 12,807

**NOTE 15:- CONTINGENT LIABILITIES, PLEDGES AND COMMITMENTS**

- a. The Company and its subsidiaries have operating lease agreements in respect of their premises for periods ending through 2011. Rent expenses amounted to approximately \$593, \$534 and \$456 for the years ended December 31, 2005, 2004 and 2003, respectively. The future minimum rental payments under these agreements in the years following the balance sheet date are as follows:

First year	\$ 797
Second year	686
Third year	387
Fourth year	201
Fifth year and thereafter	258
	<u>\$ 2,329</u>

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**NOTE 15:- CONTINGENT LIABILITIES, PLEDGES AND COMMITMENTS (Cont.)**

- b. Certain of the Company's subsidiaries are required to pay royalties to the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade and other institutions at the rate of 3%-5% of revenues derived from research and development projects in which the Government of Israel or the other institutions participated in financing up to an amount equal to 100% of the amount received by each company and in certain cases plus interest of Libor. As of December 31, 2005, the aggregate contingent obligation royalty amounted to approximately \$3,868.
- c. Legal proceedings:
  - 1. 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 2 below. The arrangement provides that if the appeal as described in paragraph 2 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.
  - 2. 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 District 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. It has not been determined when the defendants are required to file their statements of defense to the claim. The claimants and the defendants are currently involved in various proceedings, mostly regarding the disagreement concerning the court fees.

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.

**NOTE 16:- SHAREHOLDERS' EQUITY**

- a. Share capital

An ordinary share confers upon its holder voting rights, the right to receive dividends and the right to share in excess assets upon liquidation of the Company.

- b. Dividend

On September 5, 2005, Elron has declared a cash dividend of \$3.00 per share, totaling approximately \$88,500. The dividend was paid on September 27, 2005.

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NOTE 16:- SHAREHOLDERS' EQUITY (Cont.)

c. Options to employees

1. Options to Elron's Employees

The Company has various stock option plans under which the Company may grant options to purchase the Company's shares to officers, directors and employees of the Company. Such options have been granted mainly with exercise prices below market price at the date of the grant. Generally, the options vest over a four-year period from the date of grant in four equal annual portions. The options expire after 5 to 7 years from the date of grant.

In May 2003, the Board of directors of the Company approved an option plan (the "2003 Option Plan") providing for the grant of 500,000 options to purchase 500,000 ordinary shares of the Company to eligible employees, directors and officers of the Company or of any subsidiaries of the Company. According to the option plan the exercise price is to be reduced in the event of a distribution of a dividend in the amount the dividend distributed.

As of December 31, 2005, 388,000 options were granted under the 2003 Option Plan at an average exercise price of \$6.37 per share. The exercise price was adjusted to reflect the abovementioned dividend. The options vest over a period of four years in four equal annual portions and expire after 5 years from date of grant.

	2005		2004		2003	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding-beginning of the year	574,702	\$ 12.44	791,777	\$ 12.01	557,880	\$ 13.92
Granted	120,000	9.69	20,000	12.41	291,333	8.03
Exercised	(69,031)	10.11	(218,290)	10.35	(25,875)	6.84
Forfeited	(85,236)	13.95	(18,785)	13.39	(31,561)	13.10
Outstanding - end of the year	<u>540,435</u>	<u>\$ 9.53(*)</u>	<u>574,702</u>	<u>\$ 12.44</u>	<u>791,777</u>	<u>\$ 12.01</u>
Options exercisable at the end of the year	<u>281,435</u>	<u>\$ 11.88(*)</u>	<u>259,369</u>	<u>\$ 16.56</u>	<u>313,320</u>	<u>\$ 15.66</u>

(\*) After an adjustment as a result of the dividend distributed of \$3 per share (see Note 16(b)).

The weighted average fair values and weighted average exercise prices of options granted during the years ended December 31, 2005, 2004 and 2003 were as follows:

	For options with an exercise price on the grant date that:					
	Exceeds market price			Less than market price		
	Year ended December 31,			Year ended December 31,		
	2005	2004	2003	2005	2004	2003
Weighted average exercise prices	\$ -	\$ -	\$ 8.44	\$ 9.69	\$ 12.41	\$ 8.00
Weighted average fair values on grant date	\$ -	\$ -	\$ 1.3	\$ 4.18	\$ 5.51	\$ 2.95

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 16:- SHAREHOLDERS' EQUITY (Cont.)

c. Options to employees (Cont.)

2. The following table summarizes information regarding outstanding and exercisable options as of December 31, 2005:

Exercise price	Options outstanding			Options exercisable	
	Number outstanding at December 31, 2005	Weighted-average remaining contractual life (years)	Weighted-average exercise price	Number outstanding at December 31, 2005	Weighted-average exercise price
\$ 5-7.838	307,333	2.67	\$ 5.4	143,333	\$ 5.06
\$ 9.12-10.01	119,384	4.09	\$ 9.31	24,384	\$ 9.89
\$ 15.76-18.87	80,718	1.42	\$ 17.45	80,718	\$ 17.45
\$ 29.38	33,000	1.83	\$ 29.38	33,000	\$ 29.38
	<u>540,435</u>			<u>281,435</u>	

3. In December 1999, the Company's shareholders approved a plan whereby the Chairman of the Board and the then Chief Executive Officer of the Company were granted options to purchase up to 58,154 ordinary shares of the Company (the "1999 grant"). The options were granted ratably over a period of 3 years commencing February 2000 and are exercisable for a period of three years, commencing two years after the date of the grant. On February 2005, the first portion expired. The exercise prices of the options granted in February 2001 and 2002 were \$15.76 and \$10.01, respectively, as adjusted for the abovementioned dividend distributed in 2005.

In March 2001, the Company's shareholders approved a plan whereby the Chairman of the Board and the then Chief Executive Officer of the Company were granted options to purchase up to 58,000 ordinary shares of the Company (the "2001 grant"). The options were granted ratably over a period of 3 years commencing June 2001 and are exercisable for a period of three years, from the date of the grant. The exercise prices of the options granted in June 2001 and 2003 were \$16.05 and \$5.437, respectively as adjusted for the abovementioned dividend distributed in 2005.

In December 2004, 19,333 options at an exercise price per share of \$8.34 from the 2001 grant were exercised into 8,623 shares.

As of grant date, the weighted average fair value of the remaining 1999 grant and the remaining 2001 grant was \$ 7.62 and \$ 2.64 per share, respectively. The fair value was calculated using the Black & Scholes option-pricing model (see Note 2s for the assumptions used in the calculation).

Upon exercise of the options, the option holder will be granted a number of shares reflecting the intrinsic value of the options exercised, as calculated at the exercise date, in consideration for their par value only. These plans are considered to be variable plans as defined in APB 25 (except for the third portion of the 2001 grant which is accounted for under SFAS 123, See Note 2s). For options accounted under APB 25, compensation expense is estimated based on the quoted market price of the Company's stock at the end of each reporting period and is amortized over the remaining vesting period of the options.

**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 16:- SHAREHOLDERS' EQUITY (Cont.)**

c. Options to employees (Cont.)

4. Compensation expense recorded during 2005 amounted to \$ 405 (2004- \$ 545, 2003- \$ 386).
5. The balance of deferred compensation as of December 31, 2005 amounted to \$856.

**NOTE 17:- INCOME (LOSS) PER SHARE**

Income (loss) per share is computed as follows:

	Year Ended December 31								
	<u>income</u>	<u>2005 Number of shares (in thousands)</u>	<u>Per share amount</u>	<u>Income</u>	<u>2004 Number of shares (in thousands)</u>	<u>Per share amount</u>	<u>Loss</u>	<u>2003 Number of shares (in thousands)</u>	<u>Per share amount</u>
Basic	\$47,335		\$ 1.61	\$84,133	29,266	\$2.87	\$(7,205)	29,194	\$(0.25)
Effect of options of investees	(20)	-		(95)	-		(200)	-	
Effect of dilutive stock options		113		-	119		-	-	
Diluted	<u>47,315</u>	<u>29,550</u>	<u>\$ 1.60</u>	<u>84,038</u>	<u>29,385</u>	<u>\$2.86</u>	<u>(7,405)</u>	<u>29,194</u>	<u>\$(0.25)</u>

In 2003 all stock options issued by Elron were not included in the computation of diluted loss per share because their effect was anti-dilutive.

**NOTE 18:- EQUITY IN LOSSES OF AFFILIATED COMPANIES**

	Year ended December 31,		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Affiliated companies:			
ESL(1)	-	4,706	9,110
Given	(2,036)	(2,573)	(3,184)
Others(2)	(15,486)	(12,625)	(14,624)
	<u>\$ (17,522)</u>	<u>\$ (10,492)</u>	<u>\$ (8,698)</u>

The equity in losses includes amortization of intangible assets allocated to the investments in affiliated companies.

(1) Through the sale date, see Note 7d(1).

(2) Including equity in net losses of consolidated entities through the dates of commencement of consolidation.

**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 19:- GAIN FROM DISPOSAL OF BUSINESSES AND AFFILIATED COMPANIES AND CHANGES IN HOLDINGS IN AFFILIATED COMPANIES, NET**

	Year ended December 31,		
	2005	2004	2003
Netvision (See Note 7d(7))	2,989	-	-
Oren (See Note 7d(6))	19,673	-	-
ESL (See Note 7d(1))	\$ -	\$ 105,171	\$ (35)
Given (See Note 7d(2))	666	21,667	4,548
KIT (See Note 7d(4))	-	5,302	-
Galil Medical's urology business (See Note 3a)	-	-	21,241
Others	-	256	-
	<u>\$ 23,328</u>	<u>\$ 132,396</u>	<u>\$ 25,754</u>

**NOTE 20:- OTHER INCOME, NET**

	Year ended December 31,		
	2005	2004	2003
Gain (loss) from sale and increase (decrease) in market value of: (see a and b below)			
Partner shares (see Note 8(2))	\$ 56,423	\$ -	\$ 11,071
24/7 shares	-	-	2,019
Zix shares (see Note 3(b))	-	5,360	4,815
Zoran shares (see Note 7(d)(6))	1,053	-	-
Kana shares <sup>(1)</sup>	(4)	(5)	4
Other companies, net	137	-	19
Other than temporary decline in investments	(568)	(803)	(3,716)
Equity in losses of partnerships	174	(7)	(547)
Other income, net	1,433	204	972
	<u>\$ 58,648</u>	<u>\$ 4,749</u>	<u>\$ 14,637</u>

<sup>(1)</sup> Realized gains and losses on trading securities.

Realized gains from sale of available-for-sale securities amounted to approximately \$57,500, \$5,400 and \$17,900 in the years ended December 31, 2005, 2004 and 2003, respectively. The proceeds from such sales amounted to approximately \$103,000, \$8,000 and \$46,100 for the years ended December 31, 2005, 2004 and 2003, respectively.

Regarding an other than temporary decline in value of other investments see Note 8(3).

**NOTE 21:- FINANCING INCOME, NET**

	Year ended December 31,		
	2005	2004	2003
Income:			
Interest on cash equivalents, bank deposits, debentures and loans	\$ 6,473	\$ 2,577	\$ 1,403
Foreign currency gains	1,532	862	615
	<u>8,005</u>	<u>3,439</u>	<u>2,018</u>
Expenses:			
Interest on short-term credit, long-term loans and others	1,333	586	767
Foreign currency losses	88	1,420	500
	<u>1,421</u>	<u>2,006</u>	<u>1,267</u>
Loss from sale of debentures	192	-	-
Other than temporary decline in value of Available for sale Debentures	909	-	-
	<u>\$ 5,483</u>	<u>\$ 1,433</u>	<u>\$ 751</u>



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**NOTE 22:- DISCONTINUED OPERATIONS**

During 2003 and 2005, the Company disposed of certain subsidiaries and businesses, which met the definition of a component under SFAS 144. Accordingly, the results of operations of these subsidiaries and businesses and the gain resulting from the disposals have been classified as discontinued operations in the statement of operations and prior periods results have been reclassified accordingly. In addition comparative data of the assets and liabilities attributed to the discontinued operations have been reclassified in the balance sheet.

a. The following is the composition of discontinued operations:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Loss from operations of discontinued components			
ET group (See Note 3d): *			
Impairment of goodwill	(1,329)	(1,980)	-
Impairment of intangible assets and property and equipment	-	(2,904)	-
Operating losses	(2,734)	(3,027)	(2,074)
	<u>\$ (4,063)</u>	<u>\$ (7,911)</u>	<u>\$ (2,074)</u>
ESW (see Note 3b) *	-	(454)	\$ (4,825)
Vflash *	-	-	453
	<u>(4,063)</u>	<u>(8,365)</u>	<u>(6,446)</u>
Gain on disposal			
ESW (see Note 3b)	-	-	4,137
ET group(See Note 3d)	213	-	-
	<u>213</u>	<u>-</u>	<u>4,137</u>
	<u>\$ (3,850)</u>	<u>\$ (8,365)</u>	<u>\$ (2,309)</u>
* Pre tax loss of ET group	<u>\$ (4,063)</u>	<u>\$ (7911)</u>	<u>\$ (2,074)</u>
* Pre-tax loss of ESW	<u>\$ -</u>	<u>\$ (454)</u>	<u>\$ (4,829)</u>
* Pre-tax income of Vflash	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 453</u>

Revenues relating to discontinued operations for the years ended December 31, 2005, 2004 and 2003 were as follows:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
ET group	\$ 2,954	\$ 5,065	\$ 7,390
ESW	\$ -	-	\$ 4,740
	<u>\$ 2,954</u>	<u>\$ 5,065</u>	<u>\$ 12,130</u>

b. The breakdown of assets and liabilities attributed to discontinued operations of the ET group as of December 31, 2004 was as follows:

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

**NOTE 22:- DISCONTINUED OPERATIONS (Cont.)**

	<u>December 31, 2004</u>
Assets:	
Cash and cash equivalents	\$ 514
Trade receivables, net	2,414
Other receivables and prepaid expenses	441
Contract-in-progress	23
Severance fund	501
Property and equipment, net	9
Goodwill	3,610
Other intangible assets	140
	<u>\$ 7,652</u>
	<u>December 31, 2004</u>
Liabilities:	
Short-term loans from banks	\$ 1,690
Trade payables	1,435
Other payables and accrued expenses	1,653
Accrued severance pay	802
Other	22
	<u>\$ 5,602</u>

ESW's assets and liabilities were not material as of December 31, 2004.

**NOTE 23:- RELATED PARTY TRANSACTIONS**

a. Balances with related parties:

	<u>December 31</u>	
	<u>2005</u>	<u>2004</u>
Trade receivables:		
Affiliated companies	\$ 4,984	\$ 2,271
Other receivables:		
Affiliated companies	9	21
Other companies	50	-
	<u>59</u>	<u>21</u>
Long-term receivables:		
Other companies	434	405
	<u>\$ 5,477</u>	<u>\$ 2,697</u>

b. Income and expenses from affiliated and other companies:

	<u>Year ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Income:			
Revenues	\$ 8,046	\$ 7,182	\$ 3,535
Interest and commission for guarantees	235	142	110
Participation in Directors' remuneration	68	38	35
Participation in expenses	25	89	76
Costs and Expenses:			
Participation in expenses	19	40	191
Directors' remuneration	91	30	33

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

**NOTE 23:- RELATED PARTY TRANSACTIONS (Cont.)**

- c. Option to the Chairman of the Board - see Note 16c(3).
- d. The Company holds certain investments together with DIC as of December 31, 2005, the significant are as follows:

	% holding by	
	DIC	Elron and RDC
Galil	21.9	59.1
Netvision	39.1	39.1
Given	12.4	24.1

**NOTE 24:- ACCUMULATED OTHER COMPREHENSIVE INCOME**

	<u>Unrealized gains on securities</u>	<u>Foreign currency translation adjustments</u>	<u>Minimum pension liability in an affiliated company</u>	<u>Unrealized loss on derivatives in an affiliated company</u>	<u>Total</u>
Balance as of January 1, 2004 (net of tax effect of \$29,430)	\$ 53,306	\$ (637)	\$ (769)	\$ (108)	\$ 51,792
Unrealized gains on available for sale securities (net of tax effect of \$4,049)	8,489	-	-	-	8,489
Reclassification adjustment for realized gain included in net loss (net of tax effect of \$1,179)	(3,582)	-	-	-	(3,582)
Unrealized loss on derivative instruments in an affiliated company	-	-	-	84	84
Foreign currency translation adjustment	-	202	-	-	202
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	-	(61)	769	24	732
Balance as of December 31, 2004 (net of tax effect of \$32,300)	58,213	(496)	-	-	57,717
Unrealized gains on available for sale securities (net of tax effect of \$5,359)	(10,450)	-	-	-	(10,450)
Reclassification adjustment for realized gain and other than temporary impairment included in net income (net of tax effect of \$20,601)	(36,335)	-	-	-	(36,335)
Unrealized loss on derivative instruments in an affiliated company	-	-	-	-	-
Foreign currency translation adjustments	-	(191)	-	-	(191)
Balance as of December 31, 2005 (net of tax effect of \$6,340)	<u>\$ 11,428</u>	<u>\$ (687)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,741</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 25:- BUSINESS SEGMENT**

- a. Subsequent to the sale of ET group (see Note 3d) the Company operates in one segment, namely the "Other Holdings and Corporate Operations" in which the Company is directly engaged. This segment includes corporate headquarters and reflects the investments in companies that operate in the fields of medical devices, information and communication technology, semiconductors and advanced materials.

The ET group, which comprised the system and projects segment was sold on December 29, 2005 and therefore has been reclassified as discontinued operations. The operations of the System and Projects segment included development and supply of software solutions for the management of large and complex communication and internet networks.

Prior to September 2, 2003, the Company operated indirectly through ESW in a third business segment – Internet Products – which has been sold and therefore classified as discontinued operations (see Note 3b).

- b. Revenues according to location of customers are as follows:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Israel	\$ 271	\$ 49	\$ 857
USA	9,781	8,688	6,474
Europe	802	511	565
Asia	1,792	2,017	1,261
	\$ 12,646	\$ 11,265	\$ 9,157

- c. Revenues from major customers were as follows:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
In the Other Holdings and Corporate Operations segment:			
Oncura (See Note 23)	64%	64%	39%

- d. The majority of the long-lived assets are located in Israel.

**NOTE 26:- RECONCILIATION TO ISRAELI GAAP**

The consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the U.S. Had the consolidated financial statements been prepared in accordance with accounting principles generally accepted in Israel ("Israeli GAAP"), the effects on the financial statements would have been as follows:

- a. Effect on the statement of operations:

	<b>As reported</b>	<b>Adjustments</b>	<b>As per Israeli GAAP</b>
For the year ended December 31, 2005:			
Net income	\$ 47,335	\$ 7,147	\$ 54,482
Basic net income per share	1.61	0.24	1.85
Diluted net income per share	1.60	0.24	1.84

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 26:- RECONCILIATION TO ISRAELI GAAP (Cont.)**

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

For the year ended December 31, 2004:

Net income	\$ 84,133	\$ 7,896	\$ 92,029
Basic net income per share	2.87	0.27	3.14
Diluted net income per share	2.86	0.27	3.13

For the year ended December 31, 2003:

Net income (loss)	\$ (7,205)	\$ 18,436	\$ 11,231
Basic net income (loss) per share	(0.25)	0.63	0.38
Diluted net income (loss) per share	(0.25)	0.63	0.38

b. Effect on the balance sheet:

	<u>As reported</u>	<u>Adjustments</u>	<u>As per Israeli GAAP</u>
As of December 31, 2005:			
Investments in other companies and long term receivables	\$ 73,931	\$ (67,694)	\$ 6,237
Investment in affiliated companies	102,780	4,630	107,410
Total assets	353,773	(75,361)	278,412
Deferred taxes	9,494	(9,774)	(280)
Retained earnings	10,671	36,605	47,276
Total equity	302,116	(54,216)	247,900
As of December 31, 2004:			
Investments in other companies and long term receivables	\$ 155,929	\$ (150,142)	\$ 5,787
Investment in affiliated companies	117,124	(14,684)	102,440
Total assets	501,156	(176,476)	324,680
Deferred taxes	41,233	(46,545)	(5,312)
Retained earnings	51,786	29,458	81,244
Total equity	389,080	(113,500)	275,580

c. Material adjustments:

The abovementioned adjustments result mainly from the differences between U.S. GAAP and Israeli GAAP detailed below:

- As described in Note 2i, under U.S. GAAP the equity method of accounting is no longer being applied in investments that are not common stock or in-substance common stock, regardless of the Company's ability to significantly influence the investee's operational and financial policies. Under Israeli GAAP, if the investor is able to exercise significant influence over the investee's operational and financial policies, the equity method of accounting shall be applied. The effect of the aforementioned difference on net income for 2005 and 2004 was a decrease in net income under Israeli GAAP of approximately \$7,900 and \$300, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 26:- RECONCILIATION TO ISRAELI GAAP (Cont.)

c. Material adjustments: (Cont.)

2. In 2005 and 2003 Elbit reversed valuation allowance in respect of deferred tax assets of approximately \$14,500 (of which approximately \$3,900 was recorded as a reduction of goodwill) and \$9,700, respectively, relating to carryforward losses. According to U.S. GAAP, when at the acquisition date, a full valuation allowance is recorded to offset deferred tax assets in respect of loss carryforwards and subsequent to that date, the valuation allowance is reduced by recording a tax benefit in respect of those loss carryforwards, the entire tax benefit should be recorded as an adjustment to goodwill and other intangible assets. Under Israeli GAAP, only the portion of the tax benefit relating to the interest acquired was recorded as an adjustment to additional paid-in capital while the portion relating to the interest previously held by the company was recorded as a tax benefit in net income. The effect on net loss in 2005 and 2003 amounted to a reduction in losses of approximately \$1,500 and \$3,800, respectively.

3. As a result of the investments in Oren in 2003, Elron's aggregate interest in Oren has increased and enabled Elron to exercise significant influence in Oren. In accordance with U.S. GAAP, Elron's direct holdings in Oren, which had been accounted for by Elron at cost, were accounted for retroactively under the equity method of accounting ("step-by-step acquisition") which resulted in a restatement of Elron's financial statements for 2003. According to Israeli GAAP, the equity method should be applied only from the first time Elron could exercise significant influence in Oren.

Under Israeli GAAP, the excess of the investment over the equity acquired ("excess cost") in Oren in the amount of approximately \$8,800 was assigned to intangible assets and amortized over a period of five years. Under U.S. GAAP no such excess cost exists. The effect on net income (loss) in 2005, 2004 and 2003 amounted to an increase (decrease) in expenses of approximately \$700, \$1,800 and \$(400), respectively.

As described in Note 7(d)(6), Elron sold all of its holdings in Oren in the second quarter of 2005. As a result of the difference described above, Elron's investment in Oren at the date of sale under US GAAP was lower by \$5,000 than such investment under Israeli GAAP. 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.

4. As discussed in Note 7d(1), on July 28, 2004 Elron sold its shares in ESL. Due to the difference in the carrying amount of the investment in ESL between Israeli GAAP and U.S. GAAP (resulting mainly from the merger of ESL and EL-OP in 2000, which was accounted for by the purchase method under U.S. GAAP and as a non-monetary exchange of similar assets under Israeli GAAP), the gain resulting from the sale of ESL under U.S. GAAP is different than the aforementioned gain under Israeli GAAP. The gain recorded under Israeli GAAP amounted to \$116,000, which net of tax was \$102,900.
5. As described in Note 8(2), Elbit sold in 2005 and 2003 12,765,190 and 6,278,226 shares of Partner, respectively. According to accepted practice in Israel, the merger between Elron and Elbit which occurred in May 2002, was considered 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. The carrying value of the Partner shares was approximately \$30 and \$15 respectively, and therefore the gain after tax recorded in respect of the above sale of Partner shares based on Israeli GAAP in 2005 and 2003 amounted to approximately \$69,700 and \$18,700, respectively, as compared to approximately \$45,400 and \$7,100 under US GAAP, respectively.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 26:- RECONCILIATION TO ISRAELI GAAP (Cont.)**

c. Material adjustments: (Cont.)

- 6.a. As described in Note 7d(2), in 2003 RDC sold 753,600 shares of Given. According to accepted practice in Israel, the purchase of DEP which occurred in May 2002, was considered a transaction with controlling shareholders and therefore the investment in Given was recorded according to its carrying value in DEP at the purchase date. Accordingly, the sale of Given shares in 2003 resulted in an additional gain of approximately \$2,000.
- b. According to U.S. GAAP, the gain arising from the initial public offering of Given was accounted for as an equity transaction, as Given was a development stage company at the time. According to Israeli GAAP, this gain was recognized in the statement of operations over three years from the date of the public offering. The effect on net income (loss) in 2004 and 2003 amounted to an increase in income under Israeli GAAP of approximately \$2,300 and \$1,900, respectively.
7. According to U.S. GAAP the transfer of Galil's business in exchange for an interest in Oncura was recorded in 2003 at fair value and as a result Elron recognized a gain on the transaction (net of minority interest and income taxes) in the amount of \$4,400 and recorded the investment in Oncura at fair value. According to Israeli GAAP, the aforementioned exchange is accounted for as an exchange of similar productive assets. Accordingly, the investment in Oncura was recorded at the carrying value of the assets transferred and no gain was recognized.

As described in Note 3(a)(1), under US GAAP the company recorded impairment losses on the investment in Oncura in the amount of \$5,100 (\$2,100 net of minority interest) during 2005. Under Israeli GAAP, since the investment in Oncura was recorded at the carrying value of the assets transferred, no impairment was recorded.

8. Pursuant to SFAS 115, marketable securities which are available-for-sale are presented on the basis of their market value and changes in such value are charged (or credited) to other comprehensive income. According to Israeli GAAP non-current investments in marketable securities are presented at cost, while current investments in marketable securities are presented at fair value, with changes in fair value charged (or credited) to the income statement. The effect on net income (loss) in 2005, 2004 and 2003 amounted to an increase in income of approximately \$0, (\$3,000) and \$3,700, respectively.
9. According to US GAAP goodwill and intangible assets with indefinite lives are not amortized periodically but are reviewed annually for impairment (or more frequently if impairment indicators arise). According to Israeli GAAP, up until January 1, 2006, all intangibles, including goodwill should be amortized.

In 2005 and 2004 the Company tested a portion of its goodwill for impairment and as a result, recorded an impairment loss, which is presented in the discontinued operations, in the amount of approximately \$1,300 and \$2,000 respectively. Under Israeli GAAP no impairment loss in respect of goodwill was required to be recorded, mainly, since the carrying amount of goodwill had already been amortized.

10. According to U.S. GAAP the fair value of options granted to employees to acquire shares of affiliated companies held by Elron and RDC is recorded as a liability. According to Israeli GAAP, no liability should be recorded if the exercise of the options would not result in a loss.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 26:- RECONCILIATION TO ISRAELI GAAP (Cont.)**

c. Material adjustments: (Cont.)

11. As discussed in Note 14d, corporate tax rates were progressively reduced in Israel. The effect of the change in the tax rate under Israeli GAAP amounted to an income taxes charge in 2005 and in 2004 of approximately \$0 and \$400, respectively, while under U.S. GAAP the effect of this change amounted to a tax benefit in 2005 and 2004 of \$200 and \$3,000, respectively. The difference resulted mainly from the difference between the deferred tax liability under Israeli and U.S. GAAP.
12. Under U.S. GAAP, deferred taxes are provided in respect of all temporary differences relating to equity method investments. Under Israeli GAAP, deferred taxes are not provided in respect of temporary differences relating to taxes arising on disposal of equity method investments, if the disposal is not probable to occur in the foreseeable future. The effect of the aforementioned difference on net income according to U.S. GAAP was an additional tax expense in 2005 and 2004 in the amount of approximately \$60 and \$1,300, respectively (net of minority interest).
13. As described in Note 7d(2), under U.S. GAAP the acquisition of the additional interest in RDC was accounted for by the purchase method. Accordingly, Elron recorded the additional interest in RDC at fair value and as a result recorded its share in the gain resulted from the distribution of Given shares. According to Israeli GAAP, the gain recorded is limited to the effective decrease in the investment in Given in Elron's accounts (subsequent to the distribution and the relating acquisition of the additional interest in RDC) and accordingly only the portion relating to the additional interest acquired in other net assets of RDC (except Given) was recorded at fair value. The effect of the aforementioned difference on net income for 2004 was an increase in net income under U.S. GAAP of approximately \$900.
14. Under U.S. GAAP, a valuation allowance is recorded to reduce amounts of deferred tax assets when it is not more likely than not that assets will be realized. Under Israeli GAAP, deferred tax assets are recorded only if it is probable that the Company will have, in the future, sufficient taxable income in order to realize the deferred tax assets. The aforementioned difference under U.S. GAAP resulted in an increase in net income in 2005 of \$5,170.

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ANNEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

ANNEX TO THE FINANCIAL STATEMENTS

U.S dollars in thousands

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

	% of ownership interest <sup>(1)</sup>	Carrying value of the investment as of December 31, 2005 <sup>(2)</sup>	Market value of the publicly traded investments as of	
			December 31, 2005	March 13, 2005
<b><u>Consolidated Companies:</u></b>				
Galil Medical Ltd. <sup>(3)</sup>	40%	1,999	-	-
3DV Systems Ltd. <sup>(3)</sup>	62%	(302)	-	-
Starling <sup>(3)</sup>	50%	941	-	-
SELA <sup>(3)</sup>	39%	1,150	-	-
Enure (formerly: Gaia)	57%	3,492	-	-
Medingo <sup>(3)</sup>	50%	47	-	-
<b><u>Affiliated Companies (equity):</u></b>				
Given Imaging Ltd. (NASDAQ: GIVN) <sup>(3)</sup>	19%	64,203	141,376	121,605
NetVision Ltd. (TASE: NTSN)	39%	5,549	27,692	31,481
ChipX	26%	2,287	-	-
CellAct Ltd.	45%	451	-	-
Oncura <sup>(4)</sup>	10%	8,827	-	-
AMT	42%	2,780	-	-
Wavion, Inc.	38%	761	-	-
Pulsicom Israel Technologies Ltd.	18%	17	-	-
Notal Vision, Inc.	26%	-	-	-
<b><u>Available for sale:</u></b>				
Partner (NASDAQ: PTNR)	2%	25,998	25,998	23,494
EVS (NASDAQ: EVSNF.OB)	10%	1,499	2,030	2,393
<b><u>Partnership:</u></b>				
Gemini Israel Fund L.P.	5%	33	-	-
InnoMed Ventures L.P.	14%	3,665	-	-
<b><u>Cost:</u></b>				
Avantry (formerly: Witcom Ltd.) <sup>(3)</sup>	7%	2	-	-
Jordan Valley	28%	8,137	-	-
Impliant Inc.	22%	8,340	-	-
Teledata Ltd.	21%	16,000	-	-
Nulens Ltd.	22%	1,722	-	-
Brainsgate	22%	6,947	-	-

(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.