ELRON ELECTRONIC INDUSTRIES LTD.

AND ITS SUBSIDIARIES

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

As of June 30, 2004

(Unaudited)

ELRON ELECTRONIC INDUSTRIES LTD.
AND ITS SUBSIDIARIES

CONDENSED INTERIM CONSOLIDATED

FINANCIAL STATEMENTS

AS OF JUNE 30, 2004

UNAUDITED

INDEX

- - - - - - - - - - - - - - - - - -

CONSOLIDATED BALANCE SHEETS

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

	June 30, 2004	December 31, 2003
	Unaudited	Audited
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 75,769	$ 83,906
Short-term investments	8,829	37,158
Trade receivables, net*	5,624	5,016
Other receivables and prepaid expenses*	1,753	2,516
Inventories and contracts-in-progress	2,238	1,471
Total current assets	94,213	130,067
LONG-TERM ASSETS		
Investments in affiliated companies (See Note 3h)	168,883	156,819
Investments in other companies and long-term receivables*	129,084	128,799
Debentures and bank deposits	-	700
Deferred taxes	-	1,871
Severance pay deposits	2,591	2,144
Total long-term assets	300,558	290,333
PROPERTY AND EQUIPMENT, NET	8,561	8,317
INTANGIBLE ASSETS		
Goodwill	12,019	12,019
Other intangible assets	10,396	9,968
	22,415	21,987
Total assets	$ 425,747	$ 450,704

* Includes receivables from related parties in the aggregate amount of $2,899 and $3,684 as of June 30, 2004 and December 31, 2003, respectively.

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

CONSOLIDATED BALANCE SHEETS

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

	June 30, 2004	December 31, 2003
	Unaudited	Audited
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term loans from banks and others	$ 19,519	$ 11,986
Current maturities of long-term loans from banks and others	11,821	44,021
Trade payables	2,753	3,408
Other payables and accrued expenses	18,085	13,620
Total current liabilities	52,178	73,035
LONG-TERM LIABILITIES		
Long-term loans from banks and others	4,044	17,221
Accrued severance pay and retirement obligations	3,668	2,850
Deferred taxes	39,979	40,684
Other	22	103
Total long-term liabilities	47,713	60,858
MINORITY INTEREST	22,501	20,681
SHAREHOLDERS' EQUITY:		
Ordinary shares of NIS 0.003 par value; Authorized - 35,000,000 shares as of June 30, 2004 and December 31, 2003; Issued and outstanding - 29,220,345 and 29,206,845 shares as of June 30, 2004 and December 31, 2003, respectively	9,572	9,572
Additional paid-in capital	267,518	267,113
Accumulated other comprehensive income	49,411	51,792
Accumulated deficit	(23,146)	(32,347)
Total shareholders' equity	303,355	296,130
Total liabilities and shareholders' equity	$ 425,747	$ 450,704

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Six months ended June 30, 2004	Six months ended June 30, 2003	Three months ended June 30, 2004	Three months ended June 30, 2003	Year ended December 31, 2003
	Unaudited				Audited
INCOME					
Net revenues*	$ 7,001	$ 7,831	$ 3,576	$ 4,044	$ 16,547
Equity in losses of affiliated companies	(2,098)	(6,873)	(1,709)	(3,919)	(8,698)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	27,901	1,259	21,821	888	25,754
Other income, net	4,187	6,060	1,750	7,283	14,665
	36,991	8,277	25,438	8,296	48,268
COSTS AND EXPENSES					
Cost of revenues	4,489	4,292	2,434	1,984	10,198
Research and development costs, net	1,570	2,437	556	1,166	3,787
Marketing and selling expenses, net	1,190	6,190	624	2,897	7,763
General and administrative expenses	7,644	5,911	2,989	3,067	13,923
Amortization of intangible assets	390	588	196	292	1,073
Financial expenses, net	102	1,012	57	788	753
	15,385	20,430	6,856	10,194	37,497
Income (loss) before income taxes	21,606	(12,153)	18,582	(1,898)	10,771
Income taxes	(8,154)	(1,838)	(7,512)	(2,204)	(6,834)
Income (loss) from continuing operations after income taxes	13,452	(13,991)	11,070	(4,102)	3,937
Minority interest in losses (income) of subsidiaries	(3,895)	3,653	(5,535)	1,681	(10,907)
Income (loss) from continuing operations	9,557	(10,338)	5,535	(2,421)	(6,970)
Loss from discontinued operations	(356)	(3,001)	(56)	(1,648)	(235)
Net income (loss)	$ 9,201	$ (13,339)	$ 5,479	$ (4,069)	$ (7,205)
Income (loss) per share:					
Basic :					
Income (loss) from continuing operations	$ 0.33	$ (0.35)	$ 0.19	$ (0.08)	$ (0.24)
Loss from discontinued operations	(0.01)	(0.10)	-	(0.06)	(0.01)
Net income (loss)	$ 0.32	$ (0.45)	$ 0.19	$ (0.14)	$ (0.25)
Diluted:					
Income (loss) from continuing operations	$ 0.32	$ (0.35)	$ 0.19	$ (0.08)	$ (0.24)
Loss from discontinued operations	(0.01)	(0.10)	-	(0.06)	(0.01)
Net income (loss)	$ 0.31	$ (0.45)	$ 0.19	$ (0.14)	$ (0.25)
Weighted average number of ordinary shares used in computing basic net income (loss) per share (thousands)	29,211	29,183	29,212	29,185	29,194
Weighted average number of ordinary shares used in computing diluted net income (loss) per share (thousands)	29,323	29,183	29,340	29,185	29,194

* Includes revenues from related parties in the amount of $4,303 and $448 for the six months ended June 30, 2004 and 2003, respectively, and $2,065 and $283 for the three months ended June 30, 2004 and 2003 respectively, and $4,156 for the year ended December 31, 2003.

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

STATEMENTS OF SHAREHOLDERS' EQUITY

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

	Number of shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income	Accumulated deficit	Total shareholders' equity	Total comprehensive income
Audited							
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)	
Amortization of deferred stock 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)
Unrealized loss on derivative instrument in affiliated company	-	-	-	(108)	-	(108)	(108)
Minimum pension liability in affiliated company	-	-	-	(172)	-	(172)	(172)
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							$ 37,058
Unaudited							
Exercise of options	13,500	-	93	-	-	93	
Amortization of deferred stock compensation	-	-	312	-	-	312	
Other comprehensive income (loss), net of tax:							
Unrealized gains on available-for-sale securities	-	-	-	552	-	552	$ 552
Reclassification adjustment for gain realized included in net income	-	-	-	(3,309)	-	(3,309)	(3,309)
Foreign currency translation adjustment	-	-	-	292	-	292	292
Unrealized gain on derivative instrument in affiliated company	-	-	-	84	-	84	84
Net income	-	-	-	-	9,201	9,201	9,201
Balance as of June 30, 2004	29,220,345	$ 9,572	**$** 267,518	$ 49,411	$ (23,146)	$ 303,355	
Total comprehensive income							$ 6,820
Unaudited							
Balance as of January 1, 2003	29,180,970	$ 9,572	**$** 267,482	$ 7,529	$ (25,142)	$ 259,441	
Exercise of options	22,500	-	154	-	-	154	
Changes in additional paid-in capital in affiliated companies	-	-	1,278	-	-	1,278	
Amortization of deferred stock compensation	-	-	126	-	-	126	
Other comprehensive income (loss), net of tax:							
Unrealized gains on available-for-sale securities	-	-	-	19,370	-	19,370	$ 19,370
Reclassification adjustment for gain realized included in net loss	-	-	-	(4,155)	-	(4,155)	(4,155)
Foreign currency translation adjustment	-	-	-	(353)	-	(353)	(353)
Unrealized gain on derivative instruments in affiliated company	-	-	-	427	-	427	427
Net loss	-	-	-	-	(13,339)	(13,339)	(13,339)
Balance as of June 30, 2003	29,203,470	$ 9,572	$ 269,040	$ 22,818	$ (38,481)	$ 262,949	
Total comprehensive income							$ 1,950

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

STATEMENTS OF SHAREHOLDERS' EQUITY (Cont.)

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

	Number of shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income	Accumulated deficit	Total shareholders' equity	Total comprehensive income
Unaudited							
Balance as of April 1, 2004	29,211,345	$ 9,572	$ 267,327	$ 54,096	$ (28,625)	$ 302,370	
Exercise of options	9,000	-	62		-	62	
Amortization of deferred stock compensation	-	-	129		-	129	
Other comprehensive income (loss), net of tax:							
Unrealized losses on available-for-sale securities	-	-	-	(3,406)	-	(3,406)	$ (3,406)
Reclassification adjustment for gain realized included in net income	-	-	-	(1,264)	-	(1,264)	(1,264)
Foreign currency translation adjustment	-	-	-	(117)	-	(117)	(117)
Unrealized gain on derivative instruments in affiliated companies	-	-	-	102	-	102	102
Net Income	-	-	-	-	5,479	5,479	5,479
Balance as of June 30, 2004	29,220,345	$ 9,572	$ 267,518	$ 49,411	$ (23,146)	$ 303,355	
Total comprehensive income							$ 794

	Number of shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income	Accumulated deficit	Total shareholders' equity	Total comprehensive income
Unaudited							
Balance as of April 1, 2003	29,180,970	$ 9,572	$ 267,817	$ 4,653	$ (34,412)	$ 247,630	
Exercise of options	22,500	-	154	-	-	154	
Changes in additional paid-in capital in affiliated companies	-	-	1,001	-	-	1,001	
Amortization of deferred stock compensation	-	-	68	-	-	68	
Other comprehensive income (loss), net of tax:							
Unrealized gains on available-for-sale securities	-	-	-	22,238	-	22,238	$ 22,238
Reclassification adjustment for gain realized included in net loss	-	-	-	(4,200)	-	(4,200)	(4,200)
Foreign currency translation adjustment	-	-	-	(300)	-	427	427
Unrealized gain on derivative instruments in affiliated companies	-	-	-	427	-	(300)	(300)
Net loss	-	-	-	-	(4,069)	(4,069)	(4,069)
Balance as of June 30, 2003	29,203,470	$ 9,572	$ 269,040	$ 22,818	$ (38,481)	$ 262,949	
Total comprehensive income							$ 14,096

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

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

	Six months ended June 30, 2004	Six months ended June 30, 2003	Year ended December 31, 2003
	Unaudited	Unaudited	Audited
Cash flows from operating activities			
Net income (loss)	$ 9,201	$ (13,339)	$ (7,205)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Equity in losses of affiliated companies	2,098	6,873	8,698
Dividend from affiliated companies	1,719	1,407	2,971
Minority interest in income (losses) of subsidiaries	3,895	(3,653)	10,907
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	(27,901)	(1,259)	(25,754)
Gain from sale of investments in available for sale securities	(4,995)	(7,100)	(17,924)
Gain from disposal of businesses including in discontinued operations	-	-	(4,137)
Depreciation and amortization	957	2,142	3,573
Decline in value of other investments	150	1,365	3,716
Equity in losses of partnerships	31	-	547
Amortization of deferred stock compensation and changes in liability in respect of call options	2,846	320	2,564
Deferred taxes, net	4,940	1,778	6,229
Changes in operating assets and liabilities			
Decrease in trade receivables	349	3,293	3,491
Decrease (increase) in other receivables and prepaid expenses	270	(347)	1,888
Increase in trading securities, net	3	(3)	(4)
Decrease (increase) in inventories and contracts–in-progress	79	(1,330)	589
Decrease in trade payables	(1,201)	(1,507)	(2,009)
Increase (decrease) in other payable and accrued expenses	2,807	(1,669)	(5,275)
Other	655	661	652
Net cash used in operating activities	(4,097)	(12,368)	(16,483)
Cash flows from investing activities			
Investment in affiliated companies	(9,899)	(7,505)	(13,384)
Proceeds from sale of KIT shares	5,706	-	-
Proceeds from sale of Given Imaging shares	9,073	8,899	13,878
Cash and cash equivalents resulting from newly consolidated subsidiaries (schedule a)	247	-	-
Net decrease in cash and cash equivalents upon sale of businesses and subsidiaries (schedule b)	-	-	(6,148)
Investment in other companies	(667)	-	(299)
Collection of long term receivables	-	-	772
Proceeds from sale of available for sale securities	6,999	22,911	46,143
Investments in held to maturity debentures and deposits	(5,332)	(5,821)	(10,877)
Proceeds from maturities of held to maturity debentures and deposits	28,682	3,257	8,975
Purchase of property and equipment	(436)	(336)	(547)
Proceeds from sale of property and equipment	75	170	329
Net cash provided by investing activities	34,448	21,575	38,842
Cash flows from financing activities			
Proceeds from options exercised	93	154	177
Receipt of long-term loans from banks	355	2,501	4,032
Repayment of long-term loans	(40,621)	(135)	(6,200)
Increase (decrease) in short-term bank loan, net	411	(4,293)	(4,076)
Repayment of loans from minority shareholders of a subsidiary	(444)	(2,499)	(4,246)
Receipt of short-term loans from minority shareholders of a subsidiary	316	-	904
Receipt of convertible loans and long-term loans from minority shareholders of a subsidiary	1,649	2,957	3,055
Issuance expenses in a subsidiary	(180)	-	-
Dividend to minority shareholders of a subsidiary	(67)	-	-
Net cash used in financing activities	(38,488)	(1,315)	(6,354)
Increase (decrease) in cash and cash equivalents	(8,137)	7,892	16,005
Cash and cash equivalents at the beginning of the period	83,906	67,901	67,901
Cash and cash equivalents at the end of the period	$ 75,769	$ 75,793	$ 83,906

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

CONSOLIDATED STATEMENTS OF CASH FLOWS (Cont.)

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

	Six months ended June 30, 2004	Six months ended June 30, 2003	Year ended December 31, 2003
	Unaudited	Unaudited	Audited
Supplemental cash flow information:			
Cash paid for:			
Income taxes	$ 92	$ 44	$ 96
Interest	$ 760	$ 698	$ 1,466

	Six months ended June 30, 2004 (Unaudited)
(a) Cash and cash equivalents resulting from newly consolidated subsidiaries	
Assets acquired and liabilities assumed at the purchase date:	
Working capital deficiency, net (except cash and cash equivalents)	1,071
Deposits	(31)
Property and equipment	(618)
Intangible assets	(1,350)
Long-term liabilities	354
Investment at equity prior to acquisition	678
Minority interests	143
Cash and cash equivalents acquired	$ 247

	Year ended December 31, 2003 (Audited)
(b) Net decrease in cash and cash equivalents upon sale of business and subsidiaries	
Assets and liabilities at date of sale:	
Working capital deficiency, net (except cash and cash equivalents)	$ (708)
Property and equipment	1,274
Intangible assets	6,532
Deferred tax liability	(907)
Gain resulting from sale of business	22,833
Securities received:	
Marketable securities	(5,400)
Other investments	(1,000)
Investment in affiliated company	(30,272)
Liability incurred	1,500
Cash and cash equivalents paid	$ (6,148)

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1:- GENERAL

The accompanying unaudited condensed interim consolidated financial statements have been prepared as of June 30, 2004, and for the six months and three months then ended in accordance with accounting principles generally accepted in the United States (U.S. GAAP) relating to the preparation of financial statements for interim periods. Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with U.S. GAAP but which are not required for interim reporting purposes, have been condensed or omitted. See Note 9 for the reconciliation from U.S. GAAP to accounting principles generally accepted in Israel ("Israeli GAAP").

These financial statements should be read in conjunction with the Company's annual financial statements and accompanying notes as of December 31, 2003 included in the Company's Annual Report on Form 20F ("the Company's annual financial statements").

Comparative data in these financial statements for the three months and six months ended June 30, 2003 have been restated - see Note 3(i).

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

Results for the three months and six months periods ended June 30, 2004, are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

a. The significant accounting policies followed in the preparation of these financial statements are identical to those applied in preparation of the latest annual financial statements , except as follows:

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" ("FIN 46"). In December 2003, the FASB modified FIN 46 to make certain technical corrections and address certain implementation issues that had arisen. 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 provides several exceptions to its scope, such as that an entity that is deemed to be a business need not be evaluated to determine if it is a VIE, unless one of the conditions specified in the Interpretation exists.

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.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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 in the first quarter of 2004. The adoption of FIN 46 did not have significant effect on the Company's financial statements. For additional information on the Company’s VIEs, see Note 4.

b. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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 if the Investor has the Ability to Exercise Significant Influence over the Operating and Financial Policies of the Investee" ("EITF 02-14"). EITF 02-14 states that the Company must apply the equity method of accounting to investments in common stock and 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 in the fourth quarter of 2004. The Company is currently evaluating the effects of the provisions of EITF 02-14 on its financial statements.

c. The financial statements have been prepared in U.S. dollars, since the functional currency of the Company and its principal subsidiaries is the U.S. dollar.

NOTE 3:- MAJOR TRANSACTIONS

a. **ChipX ("ChipX") (formerly : CHIP EXPRESS CORPORATION)**

On March 4, 2004, 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 interest in ChipX decreased from approximately 33% to approximately 27%. The aforementioned transaction had no effect on Elron's results of operations.

b. **K.I.T. eLEARNING B.V ("KIT")**

On March 31, 2004, Elron together with the other shareholders of KIT, Discount Investment Corporation Ltd. ("DIC"), a controlling shareholder of Elron (through approximately a 38.5% interest), and Kidum IT Ltd. (together "the sellers") completed the sale of KIT, then held 45% by Elron, to Online Higher Education B.V, a subsidiary of Laureate Education, Inc. (formerly: Sylvan Learning Systems) (Nasdaq: LAUR), a global leader in higher education, in consideration of $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.

NOTE 3:- MAJOR TRANSACTIONS (Cont.)

c. **Given Imaging Ltd. ("Given")**

1. In April 2004, RDC, our 49.6% held subsidiary, 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 (NASDAQ: GIVN). The number of shares of Given distributed 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%. This acquisition of an additional interest in RDC is accounted for by the purchase method. Accordingly, Elron has 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.

2. On June 23, 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. RDC sold 300,000 ordinary shares in consideration for approximately $9,000. Given Imaging received net proceeds of approximately $44,400.

   As a result of the sale of Given's shares by RDC and the decrease in Elron's direct and indirect interest in Given from approximately 16% to approximately 15%, Elron recorded a gain, of $15,200 ($6,700 net of tax and minority interest).

3. During August 2004 (through August 10, 2004), Elron purchased 550,000 ordinary shares of Given in consideration for approximately $19,300. As a result of the transaction, Elron's direct and indirect ownership interest in Given increased from approximately 15% to approximately 16.9%.

d. **A.M.T. Advanced Metal Technologies Ltd. ("AMT")**

On June 30, 2004, Elron completed an investment of $3,000, of which $245 were invested in the first quarter of 2004, in convertible notes of AMT, together with an international strategic partner which invested an additional $3,000. 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. The notes are convertible into preferred shares of AMT or into shares held by AMT in certain of its subsidiaries. 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 $19,120, 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 from approximately 28% to approximately 35% on a fully diluted basis (excluding warrants) and on an “as converted” basis.

NOTE 3:- MAJOR TRANSACTIONS (Cont.)

e. **NetVision Ltd. ("NetVision")**

During the first quarter of 2004, Elron and DIC each granted to NetVision a loan of $2,000 in order to enable NetVision to repay a portion of its line of credit to a lending bank. Following the delay of NetVision's initial public offering in the Tel-Aviv Stock Exchange, and in accordance with EITF 02-18 "Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition", Elron recognized previously suspended equity method losses in NetVision in the amount of the loan granted.
In July 2004 Elron and DIC each granted NetVision an additional loan of $1,900 in order to enable NetVision to repay the balance of the line of credit to the bank.

f. **ZIX**

During the six months ended June 30, 2004, Elron sold 634,228 shares of Zix in consideration for approximately $7,000 and recorded a gain of approximately $5,000 ($3,300 net of tax).

g. **Elron SW ("ESW") (Formerly: Elron Software Inc.)**

On September 2, 2003, Elron's majority owned subsidiary, ESW, sold substantially all of its assets and business to Zix (see Note 3d to the Company's annual financial statements).

The business sold by ESW represented a component of an entity as defined in SFAS No. 144 and since the criteria for reporting discontinued operations under SFAS No. 144 were met, comparative data have been reclassified as discontinued operations in the statements of operations.

h. **Elbit Systems Ltd. ("ESL")**

Subsequent to the balance sheet date, on July 8, 2004 Elron announced the signing of a definitive agreement for the sale of all of its holdings in 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 will record in the third quarter of 2004 a gain, net of tax, of approximately $80,000 which includes a reduction of approximately $10,000 in the tax expense as a result of a reversal of a valuation allowance previously recorded in respect of deferred tax assets relating to loss carryforwards. The tax benefit due to the change in the valuation allowance is included in the computation of the effective tax rate for the year and, accordingly, is recognized in proportion to the current period earnings and the expected earnings for subsequent interim periods of the year. As the sale of ESL was completed in the third quarter, the principal portion of the tax benefit referred to above will also be recorded in the third quarter.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 3:- MAJOR TRANSACTIONS (Cont.)

i. **Restatement**

As a result of the increase in holdings in Oren Semiconductor Inc. ("Oren") in July 2003 from 17% to 41% (see Note 7d(7) to the Company's annual financial statements), Elron is able to exercise significant influence in Oren. In accordance with APB 18, "The Equity Method of Accounting for Investments in Common Stock", Elron's interest in Oren, which had been previously accounted for by Elron at cost, was accounted for retroactively under the equity method of accounting ("step-by-step acquisition"). Implementing the step-by-step acquisition resulted in a restatement of Elron's financial statements for all prior periods in which Elron's investments in Oren were recorded at cost.

Following are the effects of the restatement for the periods of six months and three months ended June 30, 2003:

1. Consolidated statements of operations

	Six months ended June 30, 2003		
	As reported	**Effect of restatement**	**As restated**
Equity in losses of affiliated companies	(5,544)	(1,329)	(6,873)
Net loss	(12,010)	(1,329)	(13,339)
Basic and diluted net loss per share	(0.41)	(0.04)	(0.45)
2. Total comprehensive income	3,279	(1,329)	1,950

	Three months ended June 30, 2003		
	As reported	**Effect of restatement**	**As restated**
Equity in losses of affiliated companies	(3,249)	(670)	(3,919)
Net loss	(3,399)	(670)	(4,069)
Basic and diluted net loss per share	(0.12)	(0.02)	(0.14)
2. Total comprehensive income	14,766	(670)	14,096

NOTE 4:- VARIABLE INTEREST ENTITIES

a. Towards the end of 2003, RDC and ESL formed a new company, Starling Advanced Communications Ltd. ("Starling") in order to develop connectivity solutions for broadband access for commercial aircraft. RDC and ESL both contributed technologies in exchange for a 50% ownership interest each in Starling. In addition, RDC and ESL granted Starling convertible loans in the amount of $300 each. Upon the adoption of FIN 46 (see Note 2a), the Company has consolidated Starling as Starling was determined to be a variable interest entity and the Company its primary beneficiary.

b. In August 2002, Elron completed an investment of approximately $5,000 in AMT as part of an aggregate investment of $8,700. In June 2004, Elron invested an additional $3,000 in convertible notes as part of an aggregate investment of $6,000 and converted loans in the amount of approximately $1,600 (additional loans in the amount of $1,100 were converted by other existing shareholders of AMT) into convertible notes of AMT (see Note 3(d)). AMT, an Israeli private company, develops, markets and licenses technologies, through its group companies, for amorphous and nano-crystalline advanced materials, for a wide range of commercial applications. Currently, AMT is focusing on two of its group companies, namely A.H.T. Advanced Heating Technologies Ltd., which uses amorphous metals for heating products, and Confirm Technology Ltd. ("Confirm") (formerly: ACS Advanced Coding Systems Ltd.), which develops, markets and sells products using amorphous metals for brand protection against counterfeiting and diversion and anti-shoplifting electronic article surveillance. The investments were in the form of notes which are convertible into preferred shares of AMT or into shares held by AMT in certain of its subsidiaries. Elron is entitled to the rights attached to the convertible notes on an "as converted" basis as a shareholder of AMT and, in addition, has special voting rights in certain specified circumstances. As of June 30, 2004, Elron holds approximately 35% of AMT on a diluted basis (excluding warrants) and on an "as converted" basis.

   AMT is considered to be a variable interest entity, however the Company is not the primary beneficiary of AMT, and accordingly has not consolidated AMT.

   As of June 30, 2004, the Company’s maximum exposure to loss as a result of its involvement in AMT does not exceed the carrying value of its investment in AMT in the amount of approximately $6,400.

NOTE 5:- STOCK BASED EMPLOYEE COMPENSATION

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

Effective January 1, 2003, the Company adopted the fair value recognition provisions of FASB Statement No. 123 "Accounting for Stock-Based Compensation" ("SFAS No.123"). Under the prospective method of adoption selected by the Company in accordance with the provisions of FASB Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS No. 148"), the recognition provisions will be applied to all employee awards granted, modified, or settled after January 1, 2003.

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

NOTE 5:- STOCK BASED EMPLOYEE COMPENSATION (Cont.)

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

	Six months ended June 30,		Three months ended June 30,		Year ended December 31,
	2004	2003	2004	2003	2003
	Unaudited				Audited
Net income (loss), as reported	$ 9,201	$ (13,339)	$ 5,479	$ (4,069)	$ (7,205)
Add: Stock-based employee compensation expense included in reported net income (loss)	336	467	142	240	973
Deduct: Total stock-based compensation expense determined under the fair value based method for all awards	(445)	(698)	(215)	(344)	(1,377)
Pro forma net income (loss)	$ 9,092	$ (13,570)	$ 5,406	$ (4,173)	$ (7,609)
Income (loss) per share:					
Basic - as reported	$ 0.32	$ (0.45)	$ 0.19	$ (0.14)	$ (0.25)
Diluted – as reported	$ 0.31	$ (0.45)	$ 0.19	$ (0.14)	$ (0.25)
Basic - pro forma	$ 0.31	$ (0.46)	$ 0.19	$ (0.14)	$ (0.26)
Diluted – pro forma	$ 0.31	$ (0.46)	$ 0.18	$ (0.14)	$ (0.26)

The fair value for each award granted was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Six months ended June 30,		Three months ended June 30,		Year ended December 31,
	2004(*)	2003	2004(*)	2003	2003
	Unaudited				Audited
Average risk-free interest rate	-	1%	-	1%	1%
Average expected life (in years)	-	2.75	-	2.75	2.7
Volatility	-	53%	-	53%	53%
Dividend yield	-	0%	-	0%	0%

(*) No options were granted during the period.

NOTE 6:- CONTINGENT LIABILITIES

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

a. During September 1999, the Company received copies of two claims and a request to approve such claims as a class action on behalf of public shareholders of Elscint (formerly an affiliated company) against the Company and others. The allegation raised by the claimants related to the decision regarding the sale of Elscint's substantial assets. The request has been stayed pursuant to an arrangement reached by the parties pending the outcome of the appeal in the claim described in paragraph b below. The arrangement provides that if the appeal described in paragraph b below is accepted, then the proceedings to recognize the claims as a class action will proceed. Otherwise, the application to recognize the claims as a class action will be dismissed.

b. On November 2, 1999, the Company received a copy of a claim, and a request to approve such a claim, as a class action on behalf of some institutional investors and others and those who held shares in Elscint on September 6, 1999. The allegations raised against the Company and certain of its officers including former officers, among others, relate to the period prior to the sale of the Company's holdings in Elbit Medical Imaging ("EMI") (the parent company of Elscint and formerly an affiliated company). The claimants seek a court order pursuant to which EMI would be compelled to execute the alleged buy-out of Elscint's share at $14 per share or other remedies. On August 17, 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 new claim similar to the previous one but not as a class action.

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

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

NOTE 7:- INCOME TAXES

On June 29, 2004, the Israeli parliament approved an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision) (the "Amendment") which progressively reduces the corporate tax rate from 36% to 35% in 2004 and to a rate of 30% in 2007. The amendment was signed and published in July 2004 and is, therefore, considered enacted in July 2004. Accordingly, Elron will record a tax benefit as a result of the change in the tax rate in the amount of approximately $2,000 in the third quarter of 2004.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:- BUSINESS SEGMENTS

As of June 30, 2004, the Company operates in two business segments: (1) the Systems and Projects segment through its subsidiary ETI and (2) the "Other Holdings and Corporate Operations" segment which reflects the investments in companies engaged in various fields of advanced technology and includes corporate headquarters.

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

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

Prior to September 2, 2003, the Company operated indirectly through ESW in a third business segment – Internet Products – which has been sold and therefore its operations were reclassified as discontinued operations (See Note 3(g)). Segment information is as follows:

	Systems and Projects	Other holdings and corporate operations	Internet Products (Discontinued operations)	Adjustments	Total
For the six months ended June 30, 2004 (Unaudited):					
Net revenues	$ 3,440	$ 3,561	$ -	$ -	$ 7,001
Net income (loss)	(1,108)	10,665	(356)	-	9,201
As of June 30, 2004 (Unaudited):					
Total assets	13,280	417,043	42	(4,618)(*)	425,747
For the six months ended June 30, 2003 (Unaudited):					
Net revenues	$ 4,202	$ 3,629	$ -	$ -	$ 7,831
Net loss	(1,223)	(8,662)	(3,454)	-	(13,339)
For the three months ended June 30, 2004 (Unaudited):					
Net revenues	$ 1,784	$ 1,792	$ -	$ -	$ 3,576
Net income (loss)	(551)	6,086	(56)	-	5,479
For the three months ended June 30, 2003 (Unaudited):					
Net revenues	$ 2,127	$ 1,917	$ -	$ -	$ 4,044
Net loss	(661)	(1,760)	(1,648)	-	(4,069)
For the year ended December 31, 2003 (Audited):					
Net revenues	$ 7,390	$ 9,157	$ -	$ -	$ 16,457
Net loss	(2,074)	(4,442)	(689)	-	(7,205)
As of December 31, 2003 (Audited):					
Total assets	15,177	450,222	75	(14,770)(*)	450,704

(*) Inter-company balances.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 8:- BUSINESS SEGMENTS (Cont.)

The revenues relating to ESW's discontinued operations for the six months and three months ended June 30, 2003 and for the year ended December 31, 2003, were $3,765, $1,961 and $4,470, respectively, and the pre tax losses from operations were $3,450, $1,646 and $4,829, respectively.

NOTE 9:- RECONCILIATION TO ISRAELI GAAP

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

a. Effect on the statements of operations:

	Six months ended June 30, 2004		
	As reported	Adjustments	As per Israeli GAAP
		Unaudited	
Net income	$ 9,201	$ (1,004)	$ 8,197

	Six months ended June 30, 2003		
	As reported(*)	Adjustments	As per Israeli GAAP
		Unaudited	
Net loss	$ (13,339)	$ 12,527	$ (812)

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

	Three months ended June 30, 2003		
	As reported(*)	Adjustments	As per Israeli GAAP
		Unaudited	
Net income (loss)	$ (4,069)	$ 11,348	$ 7,279

	Year ended December 31, 2003		
	As reported	Adjustments	As per Israeli GAAP
		Audited	
Net income (loss)	$ (7,205)	$ 18,436	$ 11,231

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
U.S. dollars in thousands, except share and per share data

NOTE 9:- RECONCILIATION TO ISRAELI GAAP (Cont.)

b. Effect on the balance sheet:

	June 30, 2004		
	As reported	Adjustments	As per Israeli GAAP
		Unaudited	
Total assets	$ 425,747	$ (176,261)	$ 249,486
Total liabilities including minority interest	122,392	(62,321)	60,071
Total equity	303,355	(113,939)	189,416

	December 31, 2003		
	As reported	Adjustments	As per Israeli GAAP
		Unaudited	
Total assets	$ 450,704	$ (176,981)	$ 273,723
Total liabilities including minority interest	154,574	(61,289)	93,285
Total equity	296,130	(115,692)	180,438

c. Material adjustments:

The abovementioned adjustments result primarily from the differences between U.S. GAAP and Israeli GAAP as detailed in Note 29 to the Company's annual financial statements as well as from transactions and events which occurred during the period ended June 30, 2004, as follows:

1. As discussed in Note 7, under U.S. GAAP the effect of changes in tax rates is recorded in the period in which the tax law is enacted. Under Israeli GAAP, the effect of changes in tax rates is recorded in the period in which the law is enacted or substantively enacted. Accordingly, the effect of the change in the tax rate under Israeli GAAP, which amounted to an income taxes charge of approximately $400 has been recorded in the second quarter of 2004 while under U.S. GAAP the effect will be recorded in the third quarter of 2004.
2. 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 on net income according to U.S. GAAP in the six months and three months periods ended June 30, 2004, amounted to approximately $700 (net of tax and minority interest).
3. As described in Note 3c1 above, under U.S. GAAP the acquisition of the additional interest in RDC was accounted for by the purchase method. Accordingly, Elron has recorded the additional interest in RDC at fair value and recorded its share of the gain in 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 an 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 total effect of the abovementioned transaction on net income in the six months and three months periods ended June 30, 2004, amounted to approximately $900.

ANNEX TO THE FINANCIAL STATEMENTS
U.S. dollars in thousands

Details relating to major investments as of June 30, 2004:

	% of ownership interest [(1)]	Carrying value of the investment as of June 30, 2004 [(2)]	Market value of the publicly traded investments as of: June 30, 2004	August 9, 2004
Consolidated Companies:				
Elron Telesoft Inc.	99%	$ 8,989	$ -	$ -
Galil Medical Ltd. [(3)]	39%	564	-	-
3DV Systems Ltd. [(3)]	71%	(688)	-	-
Starling [(3)]	25%	-	-	-
SELA [(3)]	27%	549	-	-
Affiliated Companies (equity):				
Elbit Systems Ltd. (Nasdaq: ESLT)	19%	91,309	155,762	[(*)]
Given Imaging Ltd. (Nasdaq: GIVN) [(3)]	15%	25,826	143,739	154,784 [(**)]
NetVision Ltd.	46%	335	-	-
Wavion, Inc.	38%	2,098	-	-
ChipX	27%	4,364	-	-
Pulsicom Israel Technologies Ltd.	18%	374	-	-
Advanced Metal Technologies Ltd. (AMT)	40%	6,417	-	-
CellAct Ltd.	45%	374	-	-
Notal Vision, Inc.	26%	1,201	-	-
Oren Semiconductor Inc.	41%	1,909	-	-
Oncura [(4)]	10%	11,978	-	-
Available for sale:				
Partner (Nasdaq: PTNR)	9%	123,681	123,681	100,848
Zix Corporation (Nasdaq: ZIXI)	1%	1,662	1,662	595
EVS (Nasdaq: EVSNF.OB)	16%	994	2,462	2,039
Partnership:				
Gemini Israel Fund L.P.	5%	167	-	-
InnoMed Ventures L.P.	14%	2,434	-	-
Cost:				
Avantry (formerly:Witcom Ltd.) [(3)]	7%	506	-	-

(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 book

(*) On July 28, 2004, Elron sold all its holdings in ESL in consideration for approximately $197,000.
(**) During August 2004 (through August 10, 2004), Elron purchased 550,000 shares of Given Imaging for approximately $19,300.

\- - - - - - - - - - - - - - - - - -