



**CONDENSED INTERIM CONSOLIDATED  
FINANCIAL STATEMENTS**

**As of June 30, 2002**  
(Unaudited)



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## CONSOLIDATED BALANCE SHEETS

In thousands of U.S. Dollars

	<b>June 30 2002 (Unaudited)</b>	<b>December 31 2001 (Audited)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	84,967	90,404
Debentures and deposits	21,127	15,465
Marketable securities	2,553	237
Trade receivables (net of allowance for doubtful accounts of \$606 and \$252 at June 30, 2002 and December 31, 2001, respectively)	12,659	9,627
Other receivables and prepaid expenses	8,048	4,395
Inventories and work-in-progress	1,989	1,671
Total current assets	131,343	121,799
Long-term assets:		
Investments in affiliated companies	142,099	162,260 <sup>(*)</sup>
Other investments	107,068	7,504 <sup>(*)</sup>
Long-term debentures and loans	5,526	6,689
Deferred taxes	-	973 <sup>(*)</sup>
Severance pay fund	1,791	2,313
Total long-term assets	256,484	179,739
Property and equipment, net	12,292	4,971
Other assets (net of accumulated amortization of \$8,776 and \$9,834 at June 30, 2002 and December 31, 2001, respectively)	40,921	19,801
Total assets	441,040	326,310

(\*) Restated – see Note 3D.

The accompanying notes to the consolidated financial statements form an integral part thereof.

**CONSOLIDATED BALANCE SHEETS (Cont.)**

In thousands of U.S. Dollars, except share data

	<b>June 30 2002 (Unaudited)</b>	<b>December 31 2001 (Audited)</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Short-term loans and current maturities of long-term loans	64,526	16,617
Trade payables	5,129	4,514
Other payables and accrued expenses	23,778	9,321
Total current liabilities	93,433	30,452
Long-term liabilities:		
Long-term loans	14,885	51,808
Retirement obligations	2,384	3,914
Deferred taxes	35,120	_ <sup>(*)</sup>
Other long term liabilities	355	383
Total long-term liabilities	52,744	56,105
Minority interests	2,774	1,040
Shareholders' equity:		
Ordinary shares of NIS 0.003 par value; Authorized – 31,500,000 shares; Issued and outstanding – 29,158,358 shares (December 31, 2001 - 21,213,664 shares)	9,572	9,567
Capital surplus	267,295	165,680 <sup>(*)</sup>
Accumulated other comprehensive income	17,403	42,231 <sup>(*)</sup>
Retained earnings (accumulated deficit)	(2,181)	21,235 <sup>(*)</sup>
Total shareholders' equity	292,089	238,713 <sup>(*)</sup>
Total liabilities and shareholders' equity	441,040	326,310

(\*) Restated – see Note 3D.

The accompanying notes to the consolidated financial statements form an integral part thereof.

**CONSOLIDATED STATEMENTS OF OPERATIONS**

In thousands of U.S. Dollars, except share and per share data

	For the six months ended June 30		For the three months ended June 30		For the year ended December 31 2001
	2002	2001	2002	2001	2001
	(Unaudited)		(Unaudited)		(Audited)
Income					
Revenues	11,762	19,852	5,856	10,249	32,859
Net loss from equity investments	(15,273)	(8,163) <sup>(*)</sup>	(9,593)	(5,351) <sup>(*)</sup>	(27,242) <sup>(*)</sup>
Gain (loss) from disposal and changes in holdings in related companies, net	2,032	(171)	1,892	(27)	3,179
Other income (expenses), net	284	(2,725)	(204)	485	(4,885) <sup>(*)</sup>
Finance income	1,524	2,720	617	926	5,215
	<u>329</u>	<u>11,513</u>	<u>(1,432)</u>	<u>6,282</u>	<u>9,126</u>
Costs and Expenses					
Cost of revenues	5,829	13,783	2,809	6,949	22,048
Research and development expenses	4,182	4,799	2,259	2,454	8,979
Marketing and selling expenses	5,244	5,616	2,806	2,435	10,587
General and administrative expenses	5,150	5,826	2,789	2,661	11,810
Amortization of other assets	895	1,962	460	979	3,734
Finance expenses	1,782	2,289	1,107	1,053	3,964
Restructuring charges, net	2,061	926	2,039	926	2,203
	<u>25,143</u>	<u>35,201</u>	<u>14,269</u>	<u>17,457</u>	<u>63,325</u>
Loss before tax benefit	(24,814)	(23,688)	(15,701)	(11,175)	(54,199)
Tax benefit	1,164	2,447	431	27	2,947
Loss after tax benefit	(23,650)	(21,241)	(15,270)	(11,148)	(51,252)
Minority interest	234	210	115	92	438
Net loss	<u>(23,416)</u>	<u>(21,031)<sup>(*)</sup></u>	<u>(15,155)</u>	<u>(11,056)<sup>(*)</sup></u>	<u>(50,814)<sup>(*)</sup></u>
Net loss per share:					
Basic per share data -					
Basic net loss per share	<u>(1.00)</u>	<u>(0.99)<sup>(*)</sup></u>	<u>(0.59)</u>	<u>(0.52)<sup>(*)</sup></u>	<u>(2.40)<sup>(*)</sup></u>
Weighted average number of shares used in computing per share amounts (thousands)	<u>23,382</u>	<u>21,189</u>	<u>25,552</u>	<u>21,189</u>	<u>21,191</u>
Diluted per share data -					
Diluted net loss per share	<u>(1.00)</u>	<u>(0.99)<sup>(*)</sup></u>	<u>(0.59)</u>	<u>(0.52)<sup>(*)</sup></u>	<u>(2.41)<sup>(*)</sup></u>
Weighted average number of shares used in computing per share amounts (thousands)	<u>23,382</u>	<u>21,189</u>	<u>25,552</u>	<u>21,189</u>	<u>21,191</u>

(\*) Restated – see Note 3D.

The accompanying notes to the consolidated financial statements form an integral part thereof.

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME**

In thousands of U.S. Dollars, except share data

	Number of shares	Share capital	Capital surplus	Accumulated other comprehensive income	Retained earnings (accumulated deficit)	Total shareholders' equity	Total comprehensive income (loss)
<b>Audited</b>							
Balance as of January 1, 2001	21,188,664	9,567	158,898 <sup>(*)</sup>	36,459	72,049 <sup>(*)</sup>	276,973	
Options exercised	25,000	-	306	-	-	306	
Other comprehensive income, net of tax:							
Unrealized gains on securities	-	-	-	6,850 <sup>(*)</sup>	-	6,850	6,850
Reclassification adjustment for net amounts included in net income	-	-	-	(1,056)	-	(1,056)	(1,056)
Foreign currency translation adjustment	-	-	-	(22)	-	(22)	(22)
Changes in capital surplus in affiliated companies	-	-	2,899 <sup>(*)</sup>	-	-	2,899	-
Deferred gain from changes in holdings in a related company	-	-	3,583 <sup>(*)</sup>	-	-	3,583	-
Amortization of deferred stock compensation	-	-	(6)	-	-	(6)	-
Net loss	-	-	-	-	(50,814) <sup>(*)</sup>	(50,814)	(50,814)
Balance as of December 31, 2001	21,213,664	9,567	165,680	42,231	21,235	238,713	(45,042)
<b>Unaudited</b>							
Balance as of January 1, 2002	21,213,664	9,567	165,680 <sup>(*)</sup>	42,231	21,235 <sup>(*)</sup>	238,713	
Option exercised	65,250	-	449	-	-	449	
Other comprehensive income, net of tax:							
Unrealized losses on securities	-	-	-	(23,444)	-	(23,444)	(23,444)
Reclassification adjustment for net amounts included in net income	-	-	-	(1,396)	-	(1,396)	(1,396)
Foreign currency translation adjustment	-	-	-	12	-	12	12
Changes in capital surplus in affiliated companies	-	-	398	-	-	398	-
Issuance of shares pursuant to the merger with Elbit	5,617,601	4	71,191	-	-	71,195	-
Issuance of shares pursuant to the purchase of DEP	2,261,843	1	29,448	-	-	29,449	-
Amortization of deferred stock compensation	-	-	129	-	-	129	-
Net loss	-	-	-	-	(23,416)	(23,416)	(23,416)
Balance as of June 30, 2002	29,158,358	9,572	267,295	17,403	(2,181)	292,089	(48,244)
<b>Balance as of January 1, 2001</b>							
Balance as of January 1, 2001	21,188,664	9,567	158,898 <sup>(*)</sup>	36,459	72,049 <sup>(*)</sup>	276,973	
Other comprehensive income, net of tax:							
Unrealized losses on securities	-	-	-	(7,759)	-	(7,759)	(7,759)
Reclassification adjustment for net amounts included in net income	-	-	-	(945)	-	(945)	(945)
Foreign currency translation adjustment	-	-	-	(11)	-	(11)	(11)
Changes in capital surplus in affiliated companies	-	-	(163) <sup>(*)</sup>	-	-	(163)	-
Amortization of deferred stock compensation	-	-	(92)	-	-	(92)	-
Net loss	-	-	-	-	(21,031) <sup>(*)</sup>	(21,031)	(21,031)
Balance as of June 30, 2001	21,188,664	9,567	158,643	27,744	51,018	246,972	(29,746)

(\*) Restated – see Note 3D.

**The accompanying notes to the consolidated financial statements form an integral part thereof.**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (Cont.)**

In thousands of U.S. Dollars, except share data

	Number of shares	Share capital	Capital surplus	Accumulated other comprehensive income	Retained earnings (accumulated deficit)	Total shareholders' equity	Total comprehensive income (loss)
<b>Unaudited</b>							
Balance as of April 1, 2002	21,213,664	9,567	165,747 <sup>(*)</sup>	28,783 <sup>(*)</sup>	12,974 <sup>(*)</sup>	217,071	
Option exercised	65,250	-	449	-	-	449	-
Other comprehensive income, net of tax:							
Unrealized losses on securities	-	-	-	(11,317)	-	(11,317)	(11,317)
Reclassification adjustment for net amounts included in net income	-	-	-	(65)	-	(65)	(65)
Foreign currency translation adjustment	-	-	-	2	-	2	2
Changes in capital surplus in affiliated companies	-	-	387	-	-	387	-
Issuance of shares pursuant to the merger with Elbit	5,617,601	4	71,191	-	-	71,195	-
Issuance of shares pursuant to the purchase of DEP	2,261,843	1	29,448	-	-	29,449	-
Amortization of deferred stock compensation	-	-	73	-	-	73	-
Net loss	-	-	-	-	(15,155)	(15,155)	(15,155)
Balance as of June 30, 2002	<u>29,158,358</u>	<u>9,572</u>	<u>267,295</u>	<u>17,403</u>	<u>(2,181)</u>	<u>292,089</u>	<u>(26,535)</u>
Balance as of April 1, 2001	21,188,664	9,567	160,098 <sup>(*)</sup>	25,055	62,074 <sup>(*)</sup>	256,794	
Other comprehensive income, net of tax:							
Unrealized gains on securities	-	-	-	2,661	-	2,661	2,661
Foreign currency translation adjustment	-	-	-	28	-	28	28
Changes in capital surplus in affiliated companies	-	-	(1,486) <sup>(*)</sup>	-	-	(1,486)	-
Amortization of deferred stock compensation	-	-	31	-	-	31	-
Net loss	-	-	-	-	(11,056) <sup>(*)</sup>	(11,056)	(11,056)
Balance as of June 30, 2001	<u>21,188,664</u>	<u>9,567</u>	<u>158,643</u>	<u>27,744</u>	<u>51,018</u>	<u>246,972</u>	<u>(8,367)</u>

(\*) Restated – see Note 3D.

**The accompanying notes to the consolidated financial statements form an integral part thereof.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

In thousands of U.S. Dollars

	For the six months ended June 30		For the year ended December 31 2001 (Audited)
	2002 (Unaudited)	2001	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net loss	(23,416)	(21,031) <sup>(*)</sup>	(50,814) <sup>(*)</sup>
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Income and expenses not affecting operating cash flows:			
Net loss from equity investments	15,273	8,163 <sup>(*)</sup>	27,242 <sup>(*)</sup>
Dividend from affiliated companies	1,312	12,462	13,805
Minority interest	(234)	(210)	(438)
Loss (gain) from disposal and changes in holdings in related companies, net	(2,032)	171	(3,179)
Gain on sale of other investments	(605)	(999)	(999)
Depreciation and amortization	1,408	3,233	6,362
Decrease in other investments and accrued interest	344	14	1,247 <sup>(*)</sup>
Amortization of deferred stock compensation	(160)	(448)	29
Deferred taxes	(1,148)	(2,620)	(2,796)
Other	457	88	(568)
Changes in operating assets and liabilities-			
Decrease (increase) in trade receivables	(1,232)	(477)	2,328
Decrease (increase) in other receivables and prepaid expenses	2,326	(482)	(1,305)
Decrease in trading account securities	225	14,996	16,652
Decrease (increase) in inventories	675	35	(1,310)
Increase (decrease) in trade payables	(1,298)	64	1,436
Decrease in other payables and accrued expenses	(4,432)	(5,112)	(7,711)
Net cash provided by (used in) operating activities	<u>(12,537)</u>	<u>7,847</u>	<u>1,117</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Investment in affiliated companies	(11,459)	(13,176) <sup>(*)</sup>	(17,681) <sup>(*)</sup>
Merger costs	-	-	(250)
Cash and cash equivalents resulting from the merger with Elbit (Schedule A)	14,907	-	-
Cash and cash equivalents resulting from the share purchase of DEP (Schedule B)	284	-	-
Cash and Cash equivalents resulting from the purchase of Galil Medical (Schedule C)	2,270	-	-
Other investments	(2,200)	(1,000) <sup>(*)</sup>	(1,900) <sup>(*)</sup>
Proceeds from sale of other investments	24	-	1,115
Proceeds from sale of available for sale securities	789	1,270	1,332
Proceeds from sale of Elbit Systems shares	-	-	6,655
Proceeds from sale of Given Imaging shares	2,587	-	-
Investments in held to maturity debentures and deposits	(6,406)	-	(12,213)
Proceeds from deposits and maturities of held to maturity debentures	2,147	43,813	39,357
Purchase of property and equipment	(284)	(1,071)	(1,132)
Proceeds from sale of property and equipment	63	160	311
Net proceeds from sale of activities	6,110	-	3,430
Net cash provided by investing activities	<u>8,832</u>	<u>29,996</u>	<u>19,024</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from options exercised	449	-	306
Proceeds from options exercised in a subsidiary	2	32	71
Long-term loans received from banks	-	-	9,540
Repayment of loans from shareholder	(1,378)	-	-
Repayment of long-term loans	(193)	(308)	(630)
Increase (decrease) in short-term bank credit, net	(612)	6,671	401
Net cash provided by (used in) financing activities	<u>(1,732)</u>	<u>6,395</u>	<u>9,688</u>
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	(5,437)	44,238	29,829
<b>CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD</b>	<u>90,404</u>	<u>60,575</u>	<u>60,575</u>
<b>CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD</b>	<u>84,967</u>	<u>104,813</u>	<u>90,404</u>

(\*) Restated – see Note 3D.

**The accompanying notes to the consolidated financial statements form an integral part thereof.**



**CONSOLIDATED STATEMENTS OF CASH FLOWS (Cont.)**

In thousands of U.S. Dollars

	<b>For the six months ended June 30</b>		<b>For the year ended December 31</b>
	<b>2002</b>	<b>2001(*)</b>	<b>2001(*)</b>
	<b>(Unaudited)</b>		<b>(Audited)</b>
Supplemental cash flow information:			
Cash paid for:			
Income taxes	78	5,396	6,025
Interest	791	2,173	4,202

**SCHEDULE A:**

**Cash and cash resulting from the merger  
with Elbit**

Assets acquired and liabilities assumed  
on the merger date:

Working capital (except cash and cash equivalents)	6,970
Property and equipment	(9,225)
Investments in affiliated companies	(5,423)
Other investments	(111,482)
Other long term assets	(1,820)
Goodwill	(18,920)
Long-term liabilities	40,123
Investment at equity prior to merger	43,408
Minority interests	82
Issuance of shares	71,194
Cash and cash equivalents acquired	14,907

**SCHEDULE B:**

**Cash and cash equivalents resulting from  
the share purchase of DEP**

Assets acquired and liabilities assumed at  
the share purchase date:

Working capital (except cash and cash equivalents)	19,115
Property and equipment	(28)
Investments in affiliated companies	(40,493)
Other investments	(3,315)
Other assets	(5,486)
Long-term liabilities	1,451
Investment at equity prior to acquisition	385
Minority interests	(794)
Issuance of shares	29,449
Cash and cash equivalents acquired	284

(\*) Restated – see note 3D.

**The accompanying notes to the consolidated financial statements form an integral part thereof.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Cont.)**

In thousands of U.S. Dollars

	<b>For the six months ended June 30 2002 (Unaudited)</b>
<b>SCHEDULE C:</b>	
<b>Cash and cash equivalents resulting from the purchase of Galil Medical</b>	
Assets acquired and liabilities assumed at the purchase date:	
Working capital (except cash and cash equivalents)	(1,064)
Property and equipment	(1,449)
Goodwill	(260)
Other assets	(4,747)
Deferred taxes	1,667
Accrued severance pay, net	20
Investment at equity prior to acquisition	5,994
Minority interests	2,109
Cash and cash equivalents acquired	2,270

**The accompanying notes to the consolidated financial statements form an integral part thereof.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

In thousands of U.S. Dollars  
(Unaudited)

**Note 1 - GENERAL**

The accompanying unaudited condensed interim consolidated financial statements have been prepared as of June 30, 2002, and for the six months and three months then ended in accordance with accounting principles generally accepted in the United States (US GAAP) relating to the preparation of financial statements for interim periods.

These financial statements should be read in conjunction with the Company's annual financial statements and accompanying notes as of December 31, 2001 included in the Company's Annual Report on Form 20F.

Comparative data in the annual and interim financial statements for 2001 have been restated – see Note 3D.

The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for a fair presentation.

Results for the three and six month periods ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002.

**Note 2 - SIGNIFICANT ACCOUNTING POLICIES**

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 described in Note 5.

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

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS**

- A. On May 15, 2002, Elron completed its merger with Elbit Ltd. (“Elbit”), in which Elron previously held 44%. As a result, each outstanding ordinary share of Elbit, other than shares held by Elron, was exchanged for 0.45 ordinary shares of Elron and, accordingly, Elron issued 5,617,601 ordinary shares. Elron also assumed options held by Elbit employees to purchase 240,525 ordinary shares of Elron with a fair value of \$997.

Elbit invests in high technology companies, which are primarily engaged in the fields of e-business (electronic business) and m-commerce (mobile commerce).

The purchase price of the Elbit acquisition was approximately \$73,887, which was calculated as follows:

Fair value of Elron ordinary shares issued	\$ 70,220
Fair value of options assumed <sup>(*)</sup>	\$ 975
Transaction and other costs	<u>\$ 2,692</u>
Total	<u><u>\$ 73,887</u></u>

<sup>(\*)</sup> Net of intrinsic value of \$23.

Ordinary shares were valued based on the average price of Elron ordinary shares during the period beginning on the day of the announcement of the exchange ratio (September 4, 2001) and ending five days thereafter. The fair value of options assumed was determined using the Black-Scholes pricing method.

The purchase price has been allocated to tangible and intangible assets acquired and liabilities assumed, based on the fair value of Elbit’s assets and liabilities, based on a preliminary analysis made by an independent valuation appraiser. The excess of the purchase price over the estimated fair values of the identifiable net assets acquired was recorded as goodwill, which is not deductible for tax purposes.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS (Cont.)**

A. (Cont.)

The allocation of the purchase price to assets purchased and liabilities assumed was as follows:

Current assets	\$ 12,325
Long-term investments	65,586
Other long-term assets	1,061
Property and equipment, net	6,285
Goodwill	18,599
Liabilities assumed	<u>(29,969)</u>
Net assets acquired	<u>\$ 73,887</u>

Net deferred tax assets relating to operating loss carryforwards have been fully offset by a valuation allowance.

The goodwill recorded reflects the anticipated synergies that will result from the combined entity, including anticipated reduction in operational and management costs, the creation of a better platform and a more simplified and efficient organizational structure and greater resources and scope of operations, which will benefit the Elron group companies.

The operating results of Elbit, as a wholly owned subsidiary, have been included in the Company's consolidated financial statements from the date of the merger (May 15, 2002). See Note 4 for pro forma information.

- B. On May 6, 2002, Elron announced the closing of the purchase of shares of DEP Technology Holdings Ltd. ("DEP") in which it previously held 33%. Pursuant to the share purchase agreement signed on November 19, 2001 with Discount Investment Corporation Ltd. ("DIC"), which then held approximately 42% of Elron's shares, Elron issued 2,261,843 ordinary shares to DIC in exchange for DIC's investment (67%) in DEP, including rights to loans in the amount of approximately \$3,529 provided by DIC to a subsidiary of DEP, RDC Rafael Development Corporation Ltd. ("RDC"), held 48% by DEP.

DEP invests in high technology companies, which are primarily engaged in the fields of communications, medical devices, semi conductors and software.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS (Cont.)**

B. (Cont.)

The share purchase is intended to further enhance Elron's position in the high technology markets, to enable Elron to manage existing DEP investments independently and to allow Elron to pursue additional investment opportunities.

The purchase price of the DEP acquisition was \$29,502, consisting of \$29,449 representing the fair market value of newly issued Elron ordinary shares, which has been calculated using the average price of Elron's shares during a period of a few days before and after the announcement date of the number of shares to be issued to DIC, and \$53 in transaction costs.

The purchase price has been allocated to tangible and intangible assets acquired and liabilities assumed, based on the fair value of DEP's assets and liabilities, based on a preliminary analysis made by an independent valuation appraiser.

The allocation of the purchase price was as follows:

Current assets	\$ 467
Long-term investments	38,233
Property and equipment, net	19
Other assets	2,339
Liabilities assumed	<u>(15,085)</u>
Total	\$ 25,973
Loans from DIC to a subsidiary of DEP	<u>3,529</u>
Net assets acquired	<u><u>\$ 29,502</u></u>

Net deferred tax assets relating to operating loss carryforwards have been fully offset by a valuation allowance.

The amount of \$38,233, allocated to long-term investments accounted for under the equity method, represents their fair value and consists of intangible net assets allocated to each equity investment and is net of any related deferred taxes. The aggregate amount allocated to identifiable intangible assets of the equity investments was \$16.5 million with a weighted average amortization period of approximately 11 years. An aggregate amount of \$6.5 million has been recorded as goodwill relating to the above equity investments. The goodwill is not deductible for tax purposes.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS (Cont.)**

B. (Cont.)

The operating results of DEP have been included in the Company's consolidated financial statements from the date of closing of the share purchase (May 6, 2002). See Note 4 for pro forma information.

C. In the second quarter of 2002, Elbit and DEP recorded a write down of certain investments. Elron's share in these write downs included in the statements of operations amounted to \$2.8 million. The balance of the write down was considered in the allocation of the purchase price in the transactions referred to in 3A and 3B above.

D. Elron has direct holdings in certain companies in which RDC also holds shares. As a result of the purchase of DEP, Elron's aggregate interest in these companies has increased and enables Elron to exercise significant influence in these companies. In accordance with U.S. Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock", Elron's direct holdings in these companies, which were accounted for by Elron at cost, are accounted for retroactively under the equity method of accounting ("step-by-step acquisition"). Implementing step-by-step acquisition resulted in a restatement of Elron's financial statements for all prior periods in which Elron's investments in these companies were recorded at cost or as available for sale securities.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS (Cont.)**

D. (Cont.)

Following are the effects of the restatement:

(1) Consolidated balance sheet

	<b>December 31, 2001</b>		
	<b>As reported</b>	<b>Effect of restatement</b>	<b>As restated</b>
Investments in affiliated companies	155,967	6,293	162,260
Other investments	27,484	(19,980)	7,504
Deferred tax assets (liabilities)	(3,254)	4,227	973
Capital surplus	162,109	3,571	165,680
Accumulated other comprehensive income <sup>(*)</sup>	49,745	(7,514)	42,231
Retained earnings	26,751	(5,516)	21,235
Total shareholders' equity	248,172	(9,459)	238,713

<sup>(\*)</sup>Restatement of unrealized gains on securities

(2) Consolidated statements of operations

	<b>For the three months ended June 30, 2001</b>		
	<b>As reported</b>	<b>Effect of restatement</b>	<b>As restated</b>
Net loss from equity investments	(4,680)	(671)	(5,351)
Net loss	(10,385)	(671)	(11,056)
Basic and diluted net loss per share	(0.49)	(0.03)	(0.52)



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS (Cont.)**

D. (Cont.)

(2) Consolidated statements of operations (Cont.)

	<b>For the six months ended June 30, 2001</b>		
	<b>As reported</b>	<b>Effect of restatement</b>	<b>As restated</b>
Net loss from equity investments	(6,872)	(1,291)	(8,163)
Net loss	(19,740)	(1,291)	(21,031)
Basic and diluted net loss per share	(0.93)	(0.06)	(0.99)

	<b>For the year ended December 31, 2001</b>		
	<b>As reported</b>	<b>Effect of restatement</b>	<b>As restated</b>
Net loss from equity investments	(24,558)	(2,684)	(27,242)
Other income (expenses), net	(5,105)	220	(4,885)
Net loss	(48,350)	(2,464)	(50,814)
Basic net loss per share	(2.28)	(0.12)	(2.40)
Diluted net loss per share	(2.29)	(0.12)	(2.41)

E. On June 25, 2002, Chip Express Corporation ("Chip Express"), in which Elron had approximately a 35% interest, issued, in a private placement, approximately 21,650,700 redeemable preferred shares in consideration for \$16,000. Elron purchased approximately 6,984,000 redeemable preferred shares in consideration for approximately \$5,000, of which approximately \$500 was paid by a conversion of convertible notes. As a result, Elron's interest in Chip Express decreased to approximately 34% with no gain or loss recognized.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 3 - MAJOR TRANSACTIONS (Cont.)**

- F. On April 30, 2002, Elron and RDC converted notes of Galil Medical Ltd. ("Galil"), in which Elron held 3.7% and in which RDC held 32.1%, in the amount of approximately \$3,160 to 2,671,385 preferred C shares. As a result, Elron's and RDC's interests in Galil increased to approximately 4.3% and 37.4%, respectively.

In May 2002, the shareholders of Galil signed an agreement to invest in Galil by way of convertible notes in an aggregate amount of up to \$5,000 with an option to invest an additional amount of \$2,000. The option is exercisable until September 2002 or a different date if agreed to by all the shareholders participating in this investment. Elron's and RDC's investment, as of balance sheet date, according to this agreement amounted to approximately \$2,200.

On June 27, 2002, Elron purchased 10.75% of the outstanding shares of Galil from Lumenis Ltd. in consideration for \$850 which has been allocated to identifiable intangible assets. Lumenis Ltd. also has the right to receive a future earn-out payment, conditioned upon the occurrence of certain events on or before May 27, 2004 in accordance with the terms of the share purchase agreement. As a result, Elron's interest in Galil increased to 15.09%.

As a result of these transactions, Elron, directly and through its subsidiary, RDC, has a controlling voting interest in Galil and, accordingly, Galil's assets and liabilities as of June 30, 2002 were consolidated with those of Elron.

- G. Subsequent to balance sheet date, Elron converted notes of Mediagate N.V. ("Mediagate"), in which Elron held 29%, in the amount of approximately \$3,588 to 32,828,510 preferred F shares. Elron also invested approximately \$2,500 in Mediagate through a rights offering. As a result of these transactions Elron's interest in Mediagate increased to 68% and accordingly the accounts of Mediagate will be consolidated with those of Elron in the third quarter of 2002.
- H. In November 2001, as part of its restructuring plan, Elron TeleSoft Inc. ("ETI"), a subsidiary of Elron, signed an agreement with Elbit Systems Ltd. ("ESL"), held approximately 21% by Elron, for the sale of the net assets and activities of ETI in the government field, in consideration for approximately \$5,700. The transaction was completed in 2002 and resulted in an immaterial loss.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 4 - SUPPLEMENTAL PRO FORMA INFORMATION (UNAUDITED)**

The pro forma information presents the results of operations of Elron after giving effect to the merger with Elbit and the share purchase of DEP as if they had been in effect at the beginning of each of the reported periods, and includes the effect of amortization of identifiable intangible assets and the deferred stock-based compensation from these dates.

The following pro forma information is based upon the historical financial statements of Elron (after restatement, as discussed in Note 3D), Elbit and DEP and does not incorporate, nor does it assume, any benefits from cost savings or synergies of the combined companies.

The pro forma data is presented for comparative purposes only and is not necessarily indicative of the operating results that would have occurred had the merger or the share purchase been consummated at the dates indicated, nor are they necessarily indicative of future operating results or financial condition.

PRO FORMA COMBINED RESULTS OF OPERATIONS

	<b>For the six months ended June 30</b>		<b>For the three months ended June 30</b>		<b>For the year ended December 31</b>
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>	<b>2001</b>
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Net revenues	12,250	19,941	6,190	10,338	33,859
Net loss from equity investments	(13,149)	(12,109)	(7,845)	(5,976)	(28,628)
Gain (loss) from disposal and changes in holdings in related companies, net	1,818	(167)	1,892	(23)	2,102
Other expenses, net	(407)	(6,142)	(234)	(2,485)	(19,493)
Finance income	<u>2,732</u>	<u>4,116</u>	<u>1,173</u>	<u>1,195</u>	<u>7,888</u>
Total income	3,244	5,639	1,176	3,049	(4,272)
Costs and expenses	<u>42,739</u>	<u>43,231</u>	<u>22,484</u>	<u>21,823</u>	<u>91,657</u>
Loss before tax benefit and minority interests	<u>(39,495)</u>	<u>(37,592)</u>	<u>(21,308)</u>	<u>(18,774)</u>	<u>(95,929)</u>
Loss from continuing operations	<u>(36,731)</u>	<u>(31,404)</u>	<u>(19,945)</u>	<u>(16,957)</u>	<u>(80,266)</u>
Net loss	<u>(36,731)</u>	<u>(30,453)</u>	<u>(19,945)</u>	<u>(16,967)</u>	<u>(79,315)</u>
Basic and diluted net loss from continuing operations per share	<u>(1.26)</u>	<u>(1.08)</u>	<u>(0.69)</u>	<u>(0.58)</u>	<u>(2.76)</u>
Basic and diluted net loss per share	<u>(1.26)</u>	<u>(1.05)</u>	<u>(0.69)</u>	<u>(0.58)</u>	<u>(2.73)</u>
Weighted average number of ordinary shares used in computation (thousands)	<u>29,104</u>	<u>29,068</u>	<u>29,114</u>	<u>29,068</u>	<u>29,070</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 4 - SUPPLEMENTAL PRO FORMA INFORMATION (Cont.)**

Pro forma results of operations for the six months and three months ended June 30, 2001 and for the year ended December 31, 2001, include amortization of goodwill in the amount of \$1,145, \$587, and \$2,307 respectively. Goodwill is no longer being amortized in accordance with SFAS 142, effective as of January 1, 2002.

**Note 5 - GOODWILL AND OTHER INTANGIBLE ASSETS**

On January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142) and accordingly goodwill is no longer being amortized as of January 1, 2002. In accordance with SFAS 142, the Company has also evaluated the useful lives of its other intangible assets and has concluded that no change in the period of amortization is necessary.

The annual estimated amortization expense relating to Elron's intangibles (including intangibles allocated to investments accounted for under the equity method) other than goodwill existing at June 30, 2002 for each of the five years in the period ending December 31, 2006 is approximately as follows:

	<u>Total amortization</u>	<u>(*)</u>
2002 -	\$ 5,200	\$ 3,100
2003 -	\$ 5,800	\$ 4,000
2004 -	\$ 4,600	\$ 2,600
2005 -	\$ 3,400	\$ 1,200
2006 -	\$ 2,800	\$ 1,600

(\*) Amortization of intangibles allocated to investments accounted for under the equity method

As of June 30, 2002, the Company has unamortized goodwill in the amount of approximately \$32,173 (includes an amount of \$6,562 allocated to investments accounted for under the equity method). In connection with SFAS 142's transitional goodwill impairment evaluation, the Company has estimated the fair value of each reporting unit and has determined that the carrying amount of each reporting unit does not exceed its fair value. Accordingly, the Company has concluded that as of January 1, 2002, there is no indication of impairment of goodwill.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars, except share and per share data  
(Unaudited)

**Note 5 - GOODWILL AND OTHER INTANGIBLE ASSETS (Cont.)**

The following transitional information is presented to reflect net loss and earnings per share for all prior periods adjusted to exclude amortization of goodwill:

	<b>For the six months ended June 30</b>		<b>For the three months ended June 30</b>		<b>For the year ended December 31</b>
	<b>2002</b>	<b>2001</b>	<b>2002</b>	<b>2001</b>	<b>2001</b>
	<b>(Unaudited)</b>		<b>(Unaudited)</b>		<b>(Audited)</b>
Reported net loss	(23,416)	(21,031)	(15,155)	(11,056)	(50,814)
Goodwill amortization	-	831	-	416	1,565
Adjusted net loss	<u>(23,416)</u>	<u>(20,200)</u>	<u>(15,155)</u>	<u>(10,640)</u>	<u>(49,249)</u>
Loss per share:					
Reported basic loss per share	(1.00)	(0.99)	(0.59)	(0.52)	(2.40)
Goodwill amortization	-	0.04	-	0.02	0.07
Adjusted basic loss per share	<u>(1.00)</u>	<u>(0.95)</u>	<u>(0.59)</u>	<u>(0.50)</u>	<u>(2.33)</u>
Reported diluted loss per share	(1.00)	(0.99)	(0.59)	(0.52)	(2.41)
Goodwill amortization	-	0.04	-	0.02	0.07
Adjusted diluted loss per share	<u>(1.00)</u>	<u>(0.95)</u>	<u>(0.59)</u>	<u>(0.50)</u>	<u>(2.34)</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

In thousands of U.S. Dollars  
(Unaudited)

**Note 6 - BUSINESS SEGMENTS**

The Company operates in three business segments: the Internet products segment, the Systems and Projects segment and a segment which includes the holdings in affiliated and other companies, engaged in various fields of advanced technology, and the corporate operations, which provide the strategic and operational support to the group companies. All of the assets and liabilities acquired in the Elbit merger, the DEP share purchase and the Galil acquisition are included in the holdings segment. Segment information is as follows:

	<u>Internet products</u>	<u>Systems and Projects</u>	<u>Holdings (including corporate headquarters)</u>	<u>Adjustments</u>	<u>Total</u>
<b>For the six months ended June 30, 2002</b>					
Total income	4,251	7,398	(11,320)	-	329
Net loss	(4,915)	(2,234)	(16,267)	-	(23,416)
Total assets	7,074	22,436	423,307	(11,777)	441,040
Goodwill	1,085	5,496	25,592	-	32,173
<b>For the three months ended June 30, 2002</b>					
Total income	2,380	3,363	(7,175)	-	(1,432)
Net loss	(2,229)	(1,593)	(11,333)	-	(15,155)
<b>For the six months ended June 30, 2001</b>					
Total income	4,741	15,111	(8,339)	-	11,513
Net loss	(5,157)	(7,286)	566	(9,154)	(21,031)
<b>For the three months ended June 30, 2001</b>					
Total income	2,510	7,739	(3,967)	-	6,282
Net loss	(2,154)	(3,936)	(4,966)	-	(11,056)
<b>For the year ended December 31, 2001</b>					
Total income	9,077	23,782	(23,733)	-	9,126
Net loss	(11,188)	(15,302)	(24,324)	-	(50,814)
Total assets	7,801	32,060	297,938	(11,489)	326,310
Goodwill	1,085	6,890	-	-	7,975

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**ANNEX TO THE CONSOLIDATED FINANCIAL STATEMENTS**

In thousands of U.S. Dollars  
(Unaudited)

**Details relating to the investments in the consolidated balance sheet as of June 30, 2002**

	<u>% Outstanding shares</u>	<u>Carrying value of the investment June 30, 2002 (*)</u>	<u>Market value of the publicly traded investments as of:</u>	
			<u>June 30, 2002</u>	<u>August 6, 2002</u>
<b><u>Consolidated Companies:</u></b>				
Elron Software Inc.	96%	962	-	-
Elron Telesoft Inc.	99%	3,002	-	-
Galil Medical Ltd.**	33%	5,465	-	-
Elbit Vflash Inc.	100%	477		
Israel Commerce Community Ltd. (ICC)	51%	262		
Textology Inc.	64%	-		
Dealigence Inc.	48%	-		
<b><u>Affiliated Companies (equity):</u></b>				
Elbit Systems Ltd. (Nasdaq: ESLT)	21%	82,857	135,717	126,374
Given Imaging Ltd. (Nasdaq: GIVN)**	20%	30,623	37,302	54,304
NetVision Ltd.	46%	1,180	-	-
MediaGate N.V.	68%	2,457	-	-
Wavion Inc.	45%	443	-	-
Kidum Elron IT (KIT) Ltd.	29%	1,689	-	-
Chip Express Corporation	34%	6,717	-	-
Pulsicom Israel Technologies Ltd.	17%	611	-	-
3DV Systems Ltd.**	24%	962	-	-
Witcom Ltd.**	20%	577	-	-
Cellenuim M.C.S. Ltd.	50%	4,486	-	-
CellAct Ltd.	45%	345	-	-
Semiconductors Engineering Laboratories Ltd. (SELA)**	24%	479	-	-
Ingeneo Ltd.	23%	400	-	-
<b><u>Available for sale:</u></b>				
Partner Communications Company Ltd. (Nasdaq: PTNR)	12%	92,977	92,977	102,496
Elbit Vision Systems Ltd. (Nasdaq: EVSN)	26%	688	688	530
Cisco Systems Inc. (Nasdaq: CSCO)	***	2,541	2,541	2,199
<b><u>Partnership:</u></b>				
Gemini Israel Fund	5%	321	-	-
InnoMed	12%	2,029	-	-
<b><u>Cost:</u></b>				
Oren Semiconductor Inc.	17%	6,624	-	-

(\*) Includes loans and convertible notes.

(\*\*) Includes the carrying value and the percentage holding of the investment in Elron's books and Elron's share in the carrying value and percentage holding of the investment in RDC's books.

(\*\*\*) 182,000 shares.