

ECI Telecom Ltd.

**Consolidated
Financial Statements
As at December 31, 2003**

Consolidated Financial Statements as at December 31, 2003

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Report of Independent Accountants To the Board of Directors and Shareholders of ECI Telecom Ltd.

We have audited the accompanying consolidated balance sheets of ECI Telecom Ltd. ("the Company") and its subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity and consolidated cash flows for each of the years in the three-year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of certain consolidated subsidiaries, whose assets constitute approximately 7.8% and 6.4% of total consolidated assets at December 31, 2003 and 2002 respectively and whose revenues constitute approximately 6.9%, 7.3% and 5.5% of consolidated revenues for the years ended December 31, 2003, 2002 and 2001, respectively. Those financial statements were audited by other auditors whose reports thereon have been furnished to us. Our opinion expressed herein, insofar as it relates to the amounts included for the above-mentioned subsidiaries, is based solely upon the reports of the other auditors. The Company's investment in affiliated companies at December 31, 2003 and 2002, was \$ 19,646 thousand and \$ 23,240 thousand, respectively, and its equity in losses of the said companies was \$ 4,334 thousand, \$ 3,055 thousand and \$ 983 thousand for the years ended December 31, 2003, 2002 and 2001, respectively. The financial statements were audited by other auditors whose reports were furnished to us, and our opinion, insofar as it relates to the amounts included for the said companies is based solely on the reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based upon our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company and its subsidiaries as of December 31, 2003 and 2002, and the results of their operations, comprehensive income (loss), changes in shareholders' equity and their cash flows for each of the years in the three-year period ended December 31, 2003, in conformity with generally accepted accounting principles in the United States of America.

As discussed in Note 1A(8), the Company restated its consolidated financial statements for the year ended December 31, 2002.

Somekh Chaikin
Certified Public Accountants (Israel)
A member of KPMG International
March 23, 2004



Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is a member of KPMG International, a Swiss cooperative.

Consolidated Balance Sheet as at December 31

		2003	2002
	Note	\$ in thousands	Restated (*) \$ in thousands
Assets			
Current assets			
Cash and cash equivalents	17A	145,375	356,649
Short-term investments	2,17B	44,945	6,840
Receivables:			
Trade	17C	166,739	207,315
Other	17D	17,097	24,194
Prepaid expenses		5,711	4,349
Work in progress		10,498	13,690
Inventories	3	122,993	149,747
Assets - discontinued operations	21	2,315	20,648
Total current assets		515,673	783,432
Long-term receivables and related deposits, net	4	106,645	132,173
Long-term deposits and marketable securities	2	65,803	-
Investments	5	28,916	36,202
Property, plant and equipment	6		
Cost		281,491	281,449
Less - accumulated depreciation		158,239	142,862
		123,252	138,587
Software development costs, net	7	16,289	20,082
Goodwill and other intangible assets, net	8	12,186	21,045
Other assets	15F	8,801	16,795
Total assets		877,565	1,148,316

Shlomo Dovrat
Chairman of the Board

Giora Bitan
Executive Vice President and
Chief Financial Officer

March 23, 2004

	2003	2002
Note	\$ in thousands	Restated (*) \$ in thousands
Liabilities and Shareholders' Equity		
Current liabilities		
Short-term loans and current maturities of long-term debts	9A, 17E 30,000	230,012
Trade payables	56,685	41,221
Other payables and accrued liabilities	17F 118,026	133,826
Liabilities - discontinued operations	21 735	12,148
Total current liabilities	205,446	417,207
Long-term liabilities		
Banks loans	9A 30,000	-
Other liabilities	9B 6,015	8,379
Liability for employee severance benefits, net	10 26,600	26,357
Total long-term liabilities	62,615	34,736
Total liabilities	268,061	451,943
Minority interests	39,999	56,756
Commitments and contingencies	11	
Shareholders' equity	12	
Ordinary shares NIS 0.12 par value per share, authorized 200,000,000 shares; Issued and outstanding 107,512,612 shares as of December 31, 2002 and 108,038,063 as of December 31, 2003	6,163	6,152
Capital surplus	662,903	658,425
Accumulated other comprehensive loss	(5,393)	(1,832)
Retained deficit	(94,168)	(23,128)
Total shareholders' equity	569,505	639,617
Total liabilities and shareholders' equity	877,565	1,148,316

(*) See Note 1A(8)

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

Consolidated Statements of Operations for the Year Ended December 31

		2003	2002	2001
		Restated (*)		
	Note	\$ in thousands, except per share amounts		
Revenues	17G	421,424	602,860	871,748
Cost of revenues	17H; 20	256,753	379,480	725,431
Gross profit		164,671	223,380	146,317
Research and development costs, net	17I	72,120	89,331	120,755
Selling and marketing expenses	17J	87,940	110,996	135,898
General and administrative expenses	17K	55,929	91,355	76,818
Amortization of acquisition-related intangible assets	19	1,773	1,760	10,187
Impairment of assets	20	6,686	3,725	96,526
Loss from exchange of assets	20	-	6,783	-
Liability for royalties payable to the Chief Scientist	11C3	-	-	8,394
Restructuring and spin off expenses	20	8,394	-	19,381
Purchase of in process research and development	19	-	-	916
Operating loss		(68,171)	(80,570)	(322,558)
Financial expenses	17L	(8,342)	(18,375)	(26,667)
Financial income	17L	7,791	24,342	31,784
Other expenses - net	17M	(5,386)	(11,087)	(32,192)
Loss from continuing operations before taxes on income		(74,108)	(85,690)	(349,663)
Taxes on income	15	(2,163)	(8,427)	290
Loss from continuing operations after taxes on income		(76,271)	(94,117)	(349,343)
Company's equity in results of investee companies, net		(4,334)	(3,055)	(983)
Minority interest in income (loss) of subsidiaries net of taxes		14,936	1,084	(1,820)
Loss from continuing operations		(65,669)	(96,088)	(352,146)
Cumulative effect of accounting change, net of taxes	1U	-	(550)	1,710
Discontinued operations:				
Loss on discontinued operations, net	21	(5,371)	(65,830)	(61,940)
Net loss		(71,040)	(162,468)	(412,376)
Loss per share	17O			
Basic and diluted loss per share for:				
Continuing operations		(0.61)	(0.91)	(3.79)
Cumulative effect of accounting change, net		-	(0.01)	0.02
Discontinued operations		(0.05)	(0.62)	(0.67)
Net loss		(0.66)	(1.54)	(4.44)

(*) See Note 1A(8)

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

Consolidated Statements of Comprehensive Income (Loss) for the Year Ended December 31

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>\$ in thousands</u>	<u>Restated (*)</u> <u>\$ in thousands</u>	<u>\$ in thousands</u>
Net loss	<u>(71,040)</u>	<u>(162,468)</u>	<u>(412,376)</u>
Other comprehensive income (loss):			
Cumulative effect of an accounting change, net	-	-	(2,631)
Realization of gain on available for sale securities	-	-	5,229
Unrealized gains (losses) from changes in the fair value of financial instruments	<u>(4,843)</u>	<u>(3,632)</u>	<u>4,431</u>
Unrealized holding gains (losses) on available for sale securities arising during the year, net	<u>1,282</u>	<u>-</u>	<u>(6,527)</u>
Total other comprehensive income (loss)	<u>(3,561)</u>	<u>(3,632)</u>	<u>502</u>
Comprehensive loss	<u>(74,601)</u>	<u>(166,100)</u>	<u>(411,874)</u>

(*) See Note 1A(8)

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

Statement of Changes in Shareholders' Equity

	Number of shares ⁽¹⁾	Share capital	Capital surplus	Accumulated other comprehensive income (loss)	Retained earnings (Note 15A1)	Treasury stock	Total shareholders' equity
	\$ in thousands, except share amounts						
Balance at January 1, 2001	92,358,907	5,873	681,806	1,298	585,943	(117,490)	1,157,430
Changes during 2001 -							
Net loss for the year ended December 31, 2001	-	-	-	-	(412,376)	-	(412,376)
Cumulative effect of an accounting change, net (Note 1U(2))	-	-	-	(2,631)	-	-	(2,631)
Realization of gain on available for sale securities, net	-	-	-	5,229	-	-	5,229
Net unrealized loss on available for sale securities	-	-	-	(6,527)	-	-	(6,527)
Amortization of deferred compensation expenses	-	-	3,208	-	-	-	3,208
Net unrealized gain on financial instruments	-	-	-	4,431	-	-	4,431
Sale of Treasury stock	1,214,642	-	(28,400)	-	-	34,492	6,092
Balance at December 31, 2001	<u>93,573,549</u>	<u>5,873</u>	<u>656,614</u>	<u>1,800</u>	<u>173,567</u>	<u>(82,998)</u>	<u>754,856</u>

⁽¹⁾ Issued and outstanding.

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

Statement of Changes in Shareholders' Equity (cont'd)

	Number of shares ⁽¹⁾	Share capital	Capital surplus	Accumulated other comprehensive income (loss)	Retained earnings (deficit) (Note 15A1) Restated(*)	Treasury stock	Total shareholders' equity
	\$ in thousands, except share amounts						
Balance at January 1, 2002	93,573,549	5,873	656,614	1,800	173,567	(82,998)	754,856
Changes during 2002 -							
Net loss for the year ended December 31, 2002	-	-	-	-	(162,468)	-	(162,468)
Share issuance, net	13,160,000	263	-	-	(34,227)	82,998	49,034
Share issuance to employees and others	779,063	16	1,960	-	-	-	1,976
Amortization of deferred compensation expenses	-	-	(149)	-	-	-	(149)
Net unrealized loss on financial instruments	-	-	-	(3,632)	-	-	(3,632)
Balance at December 31, 2002	107,512,612	6,152	658,425	(1,832)	(23,128)	-	639,617
Changes during 2003 -							
Net loss for the year ended December 31, 2003	-	-	-	-	(71,040)	-	(71,040)
Share issuance to employees	424,633	8	647	-	-	-	655
Employees stock options exercised and paid, net	100,818	3	263	-	-	-	266
Amortization of deferred compensation expenses	-	-	3,568	-	-	-	3,568
Net unrealized gain on available for sale securities	-	-	-	1,282	-	-	1,282
Net unrealized loss on financial instruments	-	-	-	(4,843)	-	-	(4,843)
Balance at December 31, 2003	108,038,063	6,163	662,903	(5,393)	(94,168)	-	569,505

⁽¹⁾ Issued and outstanding

(*) See Note 1A(8)

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

Consolidated Statement of Cash Flows for the Year Ended December 31

	2003	2002	2001
	\$ in thousands	Restated (*) \$ in thousands	\$ in thousands
Cash flows from operating activities			
Net loss	(71,040)	(162,468)	(412,376)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:			
Depreciation and amortization	41,622	56,451	71,281
Cumulative effect of accounting change, net	-	550	(1,703)
Amortization of deferred compensation	3,568	81	5,339
Loss on sale of property and equipment	1,362	1,736	1,778
Impairment of assets	6,686	3,725	133,506
Loss from exchange of assets	-	6,783	-
Liability for royalties payable to the Chief Scientist	-	-	8,394
Capital losses, net	4,862	8,738	23,352
Other - net (mainly long-term deferred taxes)	7,066	6,039	(3,780)
In-process research and development costs	-	-	916
Company's equity in results of investee companies	4,334	3,055	983
Minority interest in net results of subsidiaries	(16,956)	6,045	2,621
Increase (decrease) in marketable securities	(111)	852	4,780
Decrease in trade receivables (including non-current maturities of bank deposits and trade receivables)	69,069	112,056	62,445
Decrease in other receivables	9,531	30,170	11,336
Decrease (increase) in prepaid expenses	(1,410)	4,501	(3,456)
Decrease (increase) in work in progress	3,192	19,540	(11,542)
Decrease in inventories	24,149	113,056	95,349
Increase (decrease) in trade payables	14,413	(35,217)	(92,800)
Decrease in other payables and accrued liabilities	(23,500)	(38,461)	(10,529)
Decrease in other long-term liabilities	(2,364)	(3,194)	(275)
Increase (decrease) in liability for employee severance benefits	537	(2,081)	(79)
Cumulative effect of an accounting change on discontinued operations	-	36,646	-
Impairment of long-lived assets relating to the discontinued operation	-	22,678	-
Net cash provided by (used in) operating activities	75,010	191,281	(114,460)
Cash flows from investing activities			
Decrease (increase) in investments in deposits, net	(22,563)	(450)	6,122
Software development costs capitalized	(11,364)	(12,935)	(19,407)
Investment in property, plant and equipment	(11,347)	(11,759)	(31,743)
Proceeds from sale of property, plant and equipment	878	746	2,158
Purchase of technology	(869)	-	(1,580)
Acquisition of investee companies	(203)	(2,584)	(1,266)
Long-term loan granted	-	(6,227)	(19,776)
Investment in marketable securities	(80,317)	-	-
Proceeds from sale of available for sale securities	-	-	4,632
Proceeds from sale of shares of an investee company	-	-	4,419
Long-term loans granted to investee companies	-	-	(184)
Acquisition of newly consolidated subsidiary (A)	-	513	288
Repayment from related party	-	-	2,275
Sale of subsidiaries and operations (B)	9,100	(10,003)	14,053
Proceeds from realization of shares at consolidated subsidiary	-	20,302	-
Net cash used in investing activities	(116,685)	(22,397)	(40,009)

(*) See Note 1A(8)

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

Consolidated Statements of Cash Flows for the Year Ended December 31 (cont'd)

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>\$ in thousands</u>	<u>Restated (*)</u>	<u>\$ in thousands</u>
	<u>\$ in thousands</u>	<u>\$ in thousands</u>	<u>\$ in thousands</u>
Cash flows from financing activities			
Proceeds from long-term debt	-	-	250,000
Repayment of long-term debt	(100,000)	(90,000)	-
Decrease in short-term credit, net	(70,012)	(18)	(162,487)
Share issue expenses	-	(646)	-
Dividend paid to the minority	-	-	(481)
Proceeds from share issuance	921	51,656	6,092
Net cash provided by (used in) financing activities	(169,091)	(39,008)	93,124
Effect of change in exchange rate on cash	(508)	581	1,094
Net increase (decrease) in cash and cash equivalents	(211,274)	130,457	(60,251)
Cash and cash equivalents at beginning of year	356,649	226,192	286,443
Cash and cash equivalents at end of year	145,375	356,649	226,192
Supplemental disclosures:			
Income taxes paid, net of tax refunds	7,158	(124)	5,268
Interest paid	2,479	10,008	17,648
A. Acquisition of newly consolidated subsidiaries (Note 19)			
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>\$ in thousands</u>	<u>\$ in thousands</u>	<u>\$ in thousands</u>
Net current assets (other than cash)	-	(1,795)	2,174
Investment in investee companies	-	2,482	-
Property, plant, equipment and other assets, net	-	(171)	(707)
Goodwill	-	(3)	(16,348)
In process research and development	-	-	(916)
Long-term liabilities	-	-	1,500
Minority interest	-	-	9,841
Capital gain on issue of shares to the minority in consideration for acquisition thereof	-	-	4,744
	-	513	288

(*) See Note 1A(8)

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

Consolidated Statement of Cash Flows for the Year Ended December 31 (cont'd)**B. Sale of subsidiaries and operations**

A breakdown of the book value of the assets and liabilities of subsidiaries and operations that were sold is as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>\$ in thousands</u>	<u>Restated (*)</u> <u>\$ in thousands</u>	<u>\$ in thousands</u>
Net current assets (other than cash)	(600)	9,393	8,468
Property, plant and equipment and other assets, net	843	6,949	6,364
Inventories	8,857	3,263	17,948
Investment in investee company	-	(22,825)	(133)
Minority interest	-	-	(298)
Loss on sale	-	(6,783)	(18,296)
	<u>9,100</u>	<u>(10,003)</u>	<u>14,053</u>

For 2003 and 2002, see also Notes 21 and 5A, respectively.

C. Non-cash activities

Sale of fixed assets in return for shares in investee company	<u>1,053</u>	<u>-</u>	<u>1,017</u>
Exchange of shares in investee companies	<u>-</u>	<u>-</u>	<u>449</u>

(*) See Note 1A(8)

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

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies

Significant accounting policies, applied on a consistent basis (except as disclosed in Note 1U1 below) are as follows:

A. General

- (1) ECI Telecom Ltd. (hereinafter "ECI" or "Company") is an Israeli corporation which develops, manufactures and markets telecommunications equipment for carriers and other providers of telecommunication services. ECI's products and platforms are designed to increase the capacity and efficiency of new and existing local and international communications networks. They are designed to help telecommunications service providers maximize the value of their networks and reduce operating expenses while providing voice, data, video, multimedia and other revenue generating services to their customers. ECI specializes in metro optical networks, broadband access, bandwidth management and carrier-class VoIP solutions.

ECI manufactures and markets its products itself and through its subsidiaries and affiliates in Israel and abroad.

- (2) On November 7, 2000, the Board of Directors adopted a plan to split ECI into five distinct companies, as follows: Inovia Telecoms Ltd. ("Inovia"), ECI Telecom - NGTS Ltd. ("NGTS"), Enavis Networks Ltd. ("Enavis"), Lightscape Networks Ltd. ("Lightscape"), and InnoWave ECI Wireless Systems Ltd. ("InnoWave") (already operating as a separate company), with the parent company to serve as a holding company and sub-contractor of the split-up companies.

The Company established the four new subsidiaries, which absorbed the employees of the various divisions and were to receive operating assets from the Company (for segment reporting see Note 17G). The Company received a tax ruling that the transfer of activities to the new companies would be tax free, retroactive to the beginning of 2001.

The plan of demerger contemplated that the parent company would continue to manufacture for the split-up companies, to distribute certain of their products abroad through certain subsidiaries and to hold shares in ECTel Ltd. and the various start-up companies. It would also provide the split-up companies with management and other services.

In November 2000, the Board of Directors approved the merger of ECI Telecom (1990) Export Ltd., a wholly-owned subsidiary of the Company, with and into the Company. This subsidiary held the manufacturing plant that serviced Inovia. The merger was approved by the Israeli Tax Authorities and by the Court in 2001.

The transfer of assets to the subsidiaries was never carried out. In November 2002, the Board of Directors decided to reverse the split-up plan and not to transfer the assets and liabilities to the subsidiaries.

In December 2002, the Company notified the Israeli Tax Authorities of the retroactive cancellation of the split-up plan.

During 2002, the Company's Board of Directors decided to focus the Company's activities on its two core businesses, which are organized in two divisions: Broadband Access Division (formerly - Inovia) and Optical Network Division (formerly - Lightscape and Enavis).

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**A. General (cont'd)**

- (3) In December 2002, the Company transferred part of the NGTS activities to a new company subsequently called Veraz Networks Inc., which was set up with third parties and in which the Company holds approximately 43 % of the share capital (36 % on a fully diluted basis), see Note 5A.
In addition, in April 2003, the Company sold the activities of InnoWave, see Note 21. Accordingly, the results of discontinued operations for all periods reported were reclassified to one line in the statement of operations following the results from continuing operations.
- (4) During 2003, ECTel's Board of Directors decided on a plan to sell the operation of the Governmental Segment of ECTel. Therefore, the results of the said segment for all periods were reclassified to one line in the statement of operations following the result from continuing operations, see Note 21.
- (5) The financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States.
- (6) The currency of the primary economic environment in which the operations of the Company and its subsidiaries are conducted is the U.S. dollar ("dollar").

Most of the Company's sales are made outside of Israel, mainly in dollars and other non-dollar currencies (see Note 17G as to geographical distribution). Most purchases of materials and components, as well as most selling and other expenses incurred outside Israel, are in dollars. In view of the foregoing, the dollar has been determined to be the Company's functional currency.

Transactions and balances denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured into dollars in accordance with the principles set forth in Statement No. 52 of the Financial Accounting Standards Board (FASB) of the United States.

All exchange gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statement of operations when they arise. Such foreign exchange gains and losses are included in the same statement of operations items as those in which the related transactions are included.

- (7) 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 revenues and expenses during the reporting period. These are management's best estimates based on experience and historical data, however, actual results could differ from these estimates.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 1 - Significant Accounting Policies (cont'd)****A. General (cont'd)**

- (8) In December 2002, the Company closed a transaction pursuant to which it transferred the VOIP and other activities, including certain related net assets with a book value of \$ 19.6 million, of the business NGTS, plus \$10 million in cash, to NexVerse Networks, in exchange for approximately 43% (fully diluted 36%) of the shares of NexVerse. The name of the Company resulting from this transaction was changed to Veraz Networks and ECI's investment in Veraz is being accounted for by the equity method and was initially recorded at the amount of \$ 29.6 million.

During 2003 a third party valuation commissioned by Veraz was finalized, which evaluated among other things, the fair value of the shares transferred to ECI as at December 31, 2002. The valuation indicated that the fair market value as at December 31, 2002 of the Veraz shares held by ECI to be \$ 22.8 million. Due to the fact that the value of the shares received by ECI was less than the value of the assets transferred, ECI reduced its investment in Veraz by \$ 6.8 million, resulting in an additional charge to earnings in 2002.

The following represents the effects of the restatement on the Consolidated Balance Sheet as of December 31, 2002 and the Consolidated Statement of Operations for the year ended December 31, 2002.

Consolidated Balance Sheet (\$ in thousands)

	<u>As reported</u>	<u>As restated</u>
Investments	42,985	36,202
Total assets	1,155,099	1,148,316
Retained deficit	(16,345)	(23,128)
Total shareholders' equity	646,400	639,617

Consolidated Statements of Operations (\$ in thousands, except per share amounts)

	<u>As reported*</u>	<u>As restated</u>
Loss from exchange of assets	-	(6,783)
Loss from continuing operations	(89,305)	(96,088)
Net loss	(155,685)	(162,468)
Basis and diluted loss per share from continuing operations	(0.85)	(0.91)
Basic and diluted net loss per share	(1.48)	(1.54)

* After reclassification of discontinued operation and other - see Note 1P and Note 21.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**B. Principles of consolidation**

The consolidated financial statements include those of the Company and all of its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

C. Cash and cash equivalents

The Company considers all highly liquid investments with a maturity of three months or less at date of purchase, to be cash equivalents (except for held to maturity debt investments).

D. Investments

1. Investee companies

Investments in investee companies, in which the Company has significant influence (affiliated companies) are stated using the equity method, that is, at cost plus the Company's share of the post-acquisition gains or losses.

Investment in entities in which the Company does not have significant influence (hereinafter - "other companies"), are stated as follows:

- Marketable securities - as stated in 2 hereinafter.
- Non-marketable securities - at cost, less any decline in value which is not of a temporary nature.

2. Marketable securities

The Company classifies its debt securities in one of three categories: Trading, available for sale or held to maturity and its equity securities as trading or available for sale. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity debt securities are those securities in which the Company has the ability and intent to hold the security until maturity. All debt securities not included in trading or held to maturity are classified as available for sale.

Trading, and available-for-sale securities are recorded at fair value. Held-to-maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**D. Investments (cont'd)**

A decline in the market value of any available-for-sale or held-to-maturity security below cost, that is deemed to be other than temporary, results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

E. Inventories

Inventories are stated at the lower of cost or market. Cost is determined as follows:

Raw materials (including components) - on the moving average basis.

Work in process and finished products:

Raw materials and components - on the moving average basis.

Labor and overhead components - on the basis of actual manufacturing costs.

F. Property, plant and equipment

1. Assets are stated at cost.
2. Depreciation is computed using the straight-line method, over the estimated useful economic life of the assets as estimated by the Company.

Annual rates of depreciation are as follows:

Buildings	2.5%
Machinery and equipment	10% - 33% (mainly 10%)
Motor vehicles	15%
Office furniture and equipment	7% - 10%

Leasehold improvements are amortized by the straight-line method over the lower of the lease term or the estimated useful economic life.

3. Major renewals and improvements are capitalized, while repairs and maintenance are expensed as incurred.
4. Upon the sale or retirement of equipment and leasehold improvements, the cost and related accumulated depreciation and amortization are eliminated from the respective accounts and the resulting gain or loss is reflected in the consolidated statements of operations.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**G. Accrued warranty costs**

Accrued warranty costs are calculated in respect of products sold and work performed (for periods subsequent to delivery of the products or performance of the work) based on management's estimation and in accordance with the Company's prior experience (see also Note 17F).

H. Allowance for doubtful debts

The financial statements include an allowance which Management believes adequately reflects the loss inherent in receivables for which collection is in doubt. In determining the adequacy of the allowance Management based its estimate on information at hand about specific debtors, including their financial situation, the volume of their operations, aging of the balance and evaluation of the security received from them or their guarantors.

I. Software development costs

The Company capitalizes certain software development costs in accordance with SFAS No. 86 "*Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed*". Capitalization of software development costs begins upon the determination of technological feasibility as defined in the Statement and continues up to the time the software is available for general release to customers, at which time capitalized software costs are amortized to research and development costs on a straight-line basis over the expected life of the related product, generally two to three years.

Software development costs include costs which relate principally to projects which have recently been released or are not yet available for release to customers. Management believes that future revenues related to these projects will be sufficient to realize the amounts capitalized at December 31, 2003, and as such these amounts will be recovered over the lives of the related projects. It is possible, however, that those estimates of future revenues could be adversely impacted if these projects are not finally completed and released in the future or if market acceptance of related technology is not as anticipated by Management. As a result, the recovery of these capitalized software development costs through future revenues could be reduced materially. In such event, the related capitalized software development costs will be written-off.

J. Business combinations

The Company has adopted SFAS No. 141 "*Business Combinations*", issued in July 2001 which requires that the purchase method be used for all business combinations initiated after June 30, 2001. Separate recognition of intangible assets is required if they meet one of two criteria - the contractual-legal right criterion or the separability criterion. In addition to the disclosure requirements of APB Opinion No. 16, this Statement requires disclosure of the primary reason for the business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**K. Goodwill and other intangible assets**

The Company has adopted SFAS No. 142 "*Goodwill and Other Intangible Assets*", issued in July 2001. According to SFAS No. 142, goodwill and intangible assets that have indefinite useful lives will not be subject to amortization, but rather will be tested at least annually for impairment. Intangible assets that have finite useful lives will continue to be amortized over their useful lives, but without the constraint of an arbitrary ceiling (as was set before by APB Opinion No. 17, "Intangible Assets"). See also Note 1U1.

L. Acquisition of Company's stock

Acquisition of Company's stock is presented as Treasury Stock in the statement of changes in shareholders' equity, according to the cost method.

M. Revenue recognition

1. System revenues are recognized when the product has been delivered and when title to the system and risk of loss have been substantially transferred to the customer, provided that collection is reasonably assured. When the sale arrangement includes customer acceptance provisions with respect to network interoperability, revenue is not recognized before the Company has demonstrated that the criteria specified in the acceptance provisions have been satisfied.

When a sale involves multiple elements, such as sales of products that include installation and integration services, the entire fee from the arrangement is evaluated under EITF 00-21, "Revenue Arrangements with Multiple Deliverables". Accordingly, in an arrangement with multiple deliverables, the arrangement consideration is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met if all of the following conditions are met: (1) the delivered items have value to the customer on a standalone basis, (2) there is objective and reliable evidence of the fair value of the undelivered items, (3) if the arrangement includes a general right of return, delivery or performance of the undelivered items is probable and substantially in the control of the Company.

2. Revenues from sales involving long-term credit arrangements at less than accepted interest rates are recorded at the present value of the related future cash flows. The difference between the amounts receivable and their present value is to be recognized as interest income over the period of the debt.
3. Software license revenue is generally recognized at the time the software is delivered to the customer, if collection is probable and the Company has no significant obligations remaining under the sales or licensing agreement and no significant customer acceptance requirements exist subsequent to software delivery.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**M. Revenue recognition (cont'd)**

4. Service revenues from product maintenance contracts and separately priced extended warranty contracts are generally recognized ratably over the contract period, while revenue from software services generally is recognized as the services are performed or, if no pattern of performance is evident, ratably over the period during which they are performed.
5. Long-term contracts are those requiring design, development, engineering and modification and are of a significantly longer duration than contracts for system sales. Revenue from long-term contracts is recognized using the percentage of completion method, which is in accordance with Statement of Position (SOP 81-1). The percentage of completion is determined as a ratio of accumulated costs incurred (including materials, labor and overhead) to total estimated costs of the contract. In the event that management anticipates a loss on a particular contract, such anticipated loss is provided for in full in the period when the loss is first anticipated.

N. Research and development

Research and development costs, net of any grants, are charged to the statements of operations as incurred. Royalties paid and accrued in respect of the said grants are classified to cost of goods sold.

O. Purchased in-process research and development costs (IPR&D)

Purchased in-process research and development represents the value assigned in a purchase business combination to research and development projects of the acquired business that were commenced, but not yet completed at the date of acquisition, for which technological feasibility has not been determined and which have no alternative future use in research and development activities or otherwise. In accordance with Statement of Financial Accounting Standards No. 2, "*Accounting for Research and Development Costs*", as interpreted by FASB Interpretation No. 4 amounts assigned to purchased in-process research and development meeting the above criteria must be charged to expense at the date of consummation of the purchase business combination.

P. Reclassification

Certain amounts in prior years' financial statements have been reclassified to conform to the current year's presentation. See also Note 21.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**R. Derivative financial instruments**

On January 1, 2001, the Company adopted SFAS No. 133, *Accounting for Derivative Instruments and Certain Hedging Activities* and SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activity, an Amendment of SFAS 133*. SFAS Nos. 133 and 138 require that all derivative instruments be recorded on the balance sheet at their respective fair values.

The Company has significant international sales transactions in foreign currencies and has a policy of hedging forecasted and actual foreign currency risk with forward foreign exchange contracts and foreign exchange options. The Company's forward foreign exchange contracts are primarily denominated in Euro, Pounds Sterling and ILS and are for periods consistent with the terms of the underlying transactions, generally one year or less. Derivative instruments are employed to eliminate or minimize certain foreign currency exposures that can be confidently identified and quantified.

On the date a derivative contract is entered into, the Company designates the derivative as either a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge), a foreign-currency fair-value or cash-flow hedge (foreign currency hedge). For all hedging relationships the Company formally documents the hedging relationship and its risk-management objective and strategy for undertaking the hedge, the hedging instrument, the item, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed, and a description of the method of measuring ineffectiveness. This process includes linking all derivatives that are designated as fair-value, cash-flow, or foreign-currency hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, the Company discontinues hedge accounting prospectively.

Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a fair-value hedge, along with the loss or gain on the hedged asset or liability or unrecognized firm commitment of the hedged item that is attributable to the hedged risk, are recorded in operations. Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a cash-flow hedge are recorded in other comprehensive income (loss) to the extent that the derivative is effective as a hedge, until operations are affected by the variability in cash flows of the designated hedged item. Changes in the fair value of derivatives that are highly effective as hedges and that are designated and qualify as foreign-currency hedges are recorded in either operations or other comprehensive income (loss), depending on whether the hedge transaction is a fair-value hedge or a cash-flow hedge. The ineffective portion of the change in fair value of a derivative instrument that qualifies as either a fair-value hedge or a cash-flow hedge is reported in operations. Changes in the fair value of derivative trading instruments are reported in current period operations.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)

Q. Income taxes

1. The Company accounts for income taxes under Statement of Financial Accounting Standards (SFAS) No. 109 "*Accounting for Income Taxes*".

Under SFAS 109 deferred tax assets or liabilities are recognized in respect of temporary differences between the tax bases of assets and liabilities and their financial reporting amounts as well as in respect of tax losses and other deductions which may be deductible for tax purposes in future years, based on tax rates applicable to the periods in which such deferred taxes will be realized. Deferred tax assets for future tax benefits from realization are included when their realization is more likely than not. Valuation allowances are established when necessary to reduce deferred tax assets to the amount considered more likely than not to be realized. Deferred tax assets and liabilities are classified as current or long-term items in accordance with the nature of the assets or liabilities to which they relate, when there is no underlying assets or liabilities the deferred tax assets and liability are classified in accordance with the period of expected reversal..

Deferred taxes were not recorded in respect of the following matters -

- Certain undistributed earnings of foreign consolidated subsidiaries which are taxable upon distribution by way of dividend, as no such dividend distribution intention exists (for domestic consolidated subsidiaries, see 2 hereunder).
 - Differences between the rate of change in the Israeli Consumer Price Index (which serves as a basis for measurement for tax purposes) and the rate of change in the NIS/US dollar exchange rate, this in accordance with paragraph 9 (f) of SFAS 109.
2. In accordance with paragraph 33 of SFAS 109, deferred taxes have not been provided for the Parent Company's temporary difference relating to operations in both its domestic subsidiaries and domestic "approved enterprises" as the tax laws provide methods whereby the reported amounts of these investments can be recovered tax-free and the parent company expects that it will ultimately utilize these methods.
 - Earnings distributed by domestic subsidiaries relating to "approved enterprises" can be transferred to the Parent Company by way of a tax-free merger.
 - Earnings distributed related to the Parent Company's "approved enterprises" are not taxable to the Parent Company in a liquidation as such taxes would be due from the shareholders.
 - Earnings distributed by domestic subsidiaries which are not attributable to an "approved enterprise" are not taxable.

Income tax expense represents the tax payable for the period and the change during the period in deferred tax assets and liabilities.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**R. Derivative financial instruments (cont'd)**

The Company discontinues hedge accounting prospectively when it is determined that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative expires or is sold, terminated, or exercised, the derivative is dedesignated as a hedging instrument, because it is unlikely that a forecasted transaction will occur, a hedged firm commitment no longer meets the definition of a firm commitment, or management determines that designation of the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued because it is determined that the derivative no longer qualifies as an effective fair-value hedge, the Company continues to carry the derivative on the balance sheet at its fair value and no longer adjusts the hedged asset or liability for changes in fair value. The adjustment of the carrying amount of the hedged asset or liability is accounted for in the same manner as other components of the carrying amount of that asset or liability. When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, the Company continues to carry the derivative on the balance sheet at its fair value, removes any asset or liability that was recorded pursuant to recognition of the firm commitment from the balance sheet, and recognizes any gain or loss in operations. When hedge accounting is discontinued because it is probable that a forecasted transaction will not occur, the Company continues to carry the derivative on the balance sheet at its fair value with subsequent changes in fair value included in operations, and gains and losses that were accumulated in other comprehensive income are recognized immediately in operations. In all other situations in which hedge accounting is discontinued, the Company continues to carry the derivative at its fair value on the balance sheet and recognizes any subsequent changes in its fair value in operations. See also Note 1U2.

S. Comprehensive income

The Company adopted SFAS No. 130, "*Reporting Comprehensive Income*" which establishes standards for reporting and presentation of comprehensive income and its components in a full set of financial statements. Comprehensive income consists of net income (loss) and net unrealized gains (losses) on securities and on the change in the fair value of financial instruments and is presented in the statement of shareholders' equity and comprehensive income (loss).

T. Stock option plan and employee purchase plan

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, "*Accounting for Stock Issued to Employees*", and related interpretations, including FASB Interpretation No. 44, "*Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB Opinion No. 25*" issued in March 2000, to account for its fixed plan stock options. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

SFAS No. 123, "*Accounting for Stock-Based Compensation*", established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic value-based method of accounting described above, and has adopted the disclosure requirements of SFAS No. 123.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 1 - Significant Accounting Policies (cont'd)
T. Stock option plan and employee purchase plan (cont'd)

Had compensation expenses for stock options granted under the Company's stock option plan been determined based on the fair value at the grant dates consistent with the method of SFAS No. 123, the Company's net loss and net loss per share would have been as follows:

	For the year ended December 31		
	2003	2002	2001
	Restated (*)		
	\$ in thousands, except per share amounts		
Net loss, as reported	(71,040)	(162,468)	(412,376)
Add: Stock-based employee compensation expenses included in reported net income, net of related tax effects	3,568	286	3,592
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(23,450)	(59,930)	(72,511)
Pro Forma net loss	<u>(90,922)</u>	<u>(222,112)</u>	<u>(481,295)</u>
Net loss per share (basic and diluted) per: (\$)			
- as reported	(0.66)	(1.54)	(4.44)
- pro forma	(0.84)	(2.10)	(5.18)

(*) See Note 1A(8)

U. Accounting changes

- Effective January 1, 2002, the Company applies the provisions of SFAS 142 *"Goodwill and Other Intangible Assets"*.

In connection with the transitional impairment evaluation, Statement No. 142 required the Company to perform an assessment of whether there was an indication that goodwill was impaired as of January 1, 2002. To accomplish this, the Company must (1) identified its reporting units, (2) determined the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units, and (3) determined the fair value of each reporting unit. If the carrying value of any reporting unit exceeds its fair value, detailed fair values for each of the assigned and unassigned assets (excluding goodwill) and liabilities are determined to calculate the amount of goodwill impairment, if any. The difference between the fair value of the reporting unit and the fair value of the assigned and unassigned assets (excluding goodwill) and liabilities related to the reporting unit represents as the 'fair value' of the goodwill. If the fair value of the goodwill is lower than its carrying value, the Statement required that the difference be written off.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 1 - Significant Accounting Policies (cont'd)
U. Accounting changes (cont'd)

In 2002, the Company performed the transitional impairment evaluation as provided in the said standard. Accordingly, a loss in the amount of \$ 37,196 thousand from a decline in value of goodwill (including an amount of \$ 36,646 thousand, which is attributed mainly to InnoWave - see also Note 21) was included as a cumulative effect of a change in accounting policy.

Had amortization of goodwill and intangible assets been accounted for in accordance with the method of SFAS 142, the Company net loss from continuing operations, net loss and Basic and Diluted loss per share would have been as follows:

	For the year ended December 31		
	2003	2002	2001
	Restated (*)		
	\$ in thousands, except per share amounts		
Reported loss from continuing operations	(65,699)	(96,088)	(352,146)
Add back: Goodwill amortization	-	-	5,181
Adjusted loss from continuing operations	<u>(65,699)</u>	<u>(96,088)</u>	<u>(346,965)</u>
Reported net loss	(71,040)	(162,468)	(412,376)
Add back: Goodwill amortization	-	-	9,264
Adjusted net loss	<u>(71,040)</u>	<u>(162,468)</u>	<u>(403,112)</u>

(*) See Note 1A(8)

1. Effective January 1, 2002, the Company applies the provisions of SFAS 142 "Goodwill and Other Intangible Assets" (cont'd)

	For the year ended December 31		
	2003	2002	2001
	Restated (*)		
	\$ in thousands, except per share amounts		
Basic and diluted loss per share from:			
Continuing operations as reported	(0.61)	(0.91)	(3.79)
Add back: goodwill amortization	-	-	0.08
Adjusted continuing operations	<u>(0.61)</u>	<u>(0.91)</u>	<u>(3.71)</u>
Net loss as reported	(0.66)	(1.54)	(4.44)
Add back: Goodwill amortization	-	-	0.08
Adjusted net loss	<u>(0.66)</u>	<u>(1.54)</u>	<u>(4.36)</u>

(*) See Note 1A(8)

2. Commencing January 1, 2001, the Company applied the provisions of SFAS 133 in connection with "Accounting for Derivative Financial Instruments and Hedging Activities" (see 1R, above). Adoption of SFAS 133 was made by means of:

- Cumulative effect as at the beginning of the year in the amount of \$ 1,710 thousand or \$ 0.02 per share.
- Comprehensive loss in the amount of \$ 2,631 thousand.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 1 - Significant Accounting Policies (cont'd)**V. Impairment or disposal of long-lived assets**

The Company adopted SFAS No. 144, *"Accounting for the Impairment or Disposal of Long-Lived Assets"* (SFAS No. 144) as of January 1, 2002. This Statement requires that long-lived assets be reviewed for impairment 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 future cash flows expected to be generated by the asset or used in its disposal. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. See also Notes 20 and 21.

W. Sale of financial assets

The Company adopted SFAS 140 – *"Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"*. The Statement requires that a transfer of financial assets in which control is surrendered, is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. See Note 17P.

X. Net income (loss) per ordinary share

Basic loss per ordinary share is computed by the dividing net loss for each reporting period by the weighted average number of ordinary shares outstanding during the period. Diluted loss per common share is computed by dividing net loss for each reporting period by the weighted average number of common shares outstanding during the period plus the effects of potentially dilutive common shares.

Y. Commitments and contingencies

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 2 - Investment Securities and Deposits**

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Short-term:		
Short-term deposits (see Note 17B.)	4,404	6,520
Marketable securities:		
Trading	9,359	-
Available for sale securities*	1,282	320
Held to maturity	29,900	-
	44,945	6,840
Long-term:		
Long-term deposits	15,679	-
Marketable security - held to maturity	50,124	-
	65,803	-

* At December 31, 2003, the Company had net unrealized gains on Available for Sale Securities of \$ 1,282 thousand.

The amortized cost, gross unrealized holding gains, gross unrealized holding losses and fair value of held-to-maturity securities by major security type and class of security at December 31, 2003, were as follows:

	Amortized Cost	Gross Unrealized Holding Gains	Fair Value
	\$ in thousands	\$ in thousands	\$ in thousands
Held-to maturity			
U.S. Government agencies	25,550	50	25,600
Corporate debt securities	53,667	368	54,035
Other	807	32	839
	80,024	450	80,474

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 2 - Investment Securities and Deposits (cont'd)**

Maturities of debt securities classified as held-to-maturity were as follows at December 31, 2003:

	Amortized Cost	Fair value
	\$ in thousands	\$ in thousands
Held to maturity:		
First year	29,900	29,911
Due after one year through five years	48,291	48,699
Due after five years through ten years	1,833	1,864
	<u>80,024</u>	<u>80,474</u>

Note 3 - Inventories

Consist of the following:

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Raw materials and components	48,773	61,232
Work in process	22,528	35,366
Finished products	51,692	53,149
	<u>122,993</u>	<u>149,747</u>

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 4 - Long-Term Receivables and Related Deposits, Net of Current Maturities
A. Consist of the following:

	Weighted average interest rate as of December 31 2003 %	December 31 2003 \$ in thousands	December 31 2002 \$ in thousands
Long-term trade receivables and related pledged deposits (1)	6.3%	178,903	203,164
Less deferred interest income (**)		7,583	7,670
Total (2)		171,320	195,494
Less - provision for doubtful debts (***)		40,600	34,000
Less - current maturities		24,075	29,321
		106,645	132,173

The trade receivables and deposits are denominated in U.S. dollars.

(*) The deferred interest income represents the difference between the original amount of the receivables and their net present value computed, at the transaction date, by the relevant interest rate.

(**) See Notes 17C and 4C.

(1) Long-term trade receivables and related pledged deposits (a)(b) (hereinafter - receivables) consist mainly of receivables resulting from sales of the Company's products, providing from one to ten years credit commencing on the date of signing of the sales contract or the finance agreement related thereto or other date as mentioned in the contract. Such receivables are interest bearing and are payable in quarterly or semi-annual payments. The principal is paid generally after the grant of a grace period. These receivables are partially secured by trade risk insurance policies.

(a) Long-term receivables and related pledged deposits are disclosed together because the economic substance of the two assets is very similar (see (b) below).

(b) The deposits are pledged to a commercial bank and are mainly released simultaneously with, and in amounts equal to, payments on account of the loan extended by the commercial bank to a foreign commercial bank (hereinafter "the customer bank"). The commercial bank in Israel serves the customer bank as a source of financing for the purpose of the sale transaction with the Company.

(2) As at December 31, 2003 and 2002 - includes customer in Brazil, amounting to \$ 85 million and \$ 90 million, respectively (see 4C below) and certain other customers whose indebtedness does not exceed \$ 5 million per customer as at December 31, 2003 and, \$ 7 million as at December 31, 2002.

(3) In the opinion of the Company's management, due to the nature of the customers and their activities, their financial performance, updated financial and business data, previous business relations and existing trade insurance as stated above, as well as provision for doubtful debts, the Company has limited risk exposure in relation to the long-term receivables as well as the long-term pledged deposits.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 4 - Long-Term Receivables and Related Deposits, Net of Current Maturities (cont'd)

B. Aggregate maturities are as follows:

	December 31 2003
	<u>\$ in thousands</u>
First year (current maturities)	24,075
Second year	57,897
Third year	60,329
Fourth year	35,282
Fifth year	1,320
	<u>178,903</u>

- C. 1.** In 2000, the Company, and its former subsidiary (InnoWave), signed an agreement for supply of equipment and vendor financing with a major customer of the subsidiary in the amount of \$168 million, to be utilized based on certain supply milestones. At December 31, 2003, the amount owed by the client was \$133 million (not taking into account the provisions for doubtful debt - see below).

Repayment was to start three years after the draw down date and be paid in semi-annual installments over a period of four years (end of maturity after seven years). The interest rate was based on performance measurements specified in the agreement (starting from Libor plus 6.5% in the first years to Libor plus 4.5% in the last years).

In accordance with the agreement, the Company and two other international equipment suppliers received pledges on the communications operating license in the client's territories, as well as further pledges such as shareholders' guarantees, contracts pledge and revenues pledge.

- 2.** During 2002, after the customer defaulted on his payments, the Company included a provision for a doubtful debt, in the amount of \$34 million with respect to this debt. In light of significant macro-economic and political changes in the territory in which the customer conducts its activities and based on a valuation of the collaterals which the customer provided for the benefit of the Company, which were valued by an independent external appraiser, the Company's Management and its Board of Directors believe that collection of the debt in its original amount is doubtful and, in their estimation, the provision included constitutes, as at the date of the financial statements, that portion of the debt the collection of which is doubtful.
- 3.** During the reporting period, the Company added another provision for a doubtful debt in the amount of \$6.6 million with respect to the abovementioned customer. The provision reflects the expected outcome of advanced discussions with the customer which include revised and extended repayment terms.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 5 - Investments

Consist of the following:

	December 31 2003	December 31 2002
		Restated(*)
	\$ in thousands	\$ in thousands
Affiliated companies (A)	19,646	23,240
Convertible notes (B)	5,600	9,000
Other	3,670	3,962
	<u>28,916</u>	<u>36,202</u>

A. Investments in affiliated companies are comprised of:

	December 31 2003	December 31 2002
		Restated(*)
	\$ in thousands	\$ in thousands
Cost of shares	28,223	28,133
Accumulated income (losses)	(8,577)	(4,893)
	<u>19,646</u>	<u>23,240</u>

(*) See Note 1A(8).

In December 2002, the Company closed a transaction pursuant to which it transferred the VOIP and other activities, including certain related net assets with a book value of \$ 19.6 million of the business NGTS, plus \$10 million in cash, to NexVerse Networks, in exchange for approximately 43% (fully diluted 36%) of the shares of NexVerse valued at \$ 22.8 million.

The name of the Company resulting from this transaction was changed to Veraz Networks and ECI's investment in Veraz has been accounted for by the equity method. According to the agreement, Veraz became an exclusive distributor of ECI's DCME products which are produced by the Company and sold to Veraz in accordance with the terms set in the agreement. In addition, the Company manufactures and sells to Veraz certain of its VOIP products.

As a result of the transaction, the Company recorded in 2002 a loss in the amount of \$ 10.8 million. This loss included the amount of \$ 6.8 million related to loss from exchange of assets, \$ 2.2 million from impairment of assets and \$ 1.8 million (which was included in the cost of revenues) of inventory which, according to Veraz's business plan, were unlikely to be used. See Note 20B.

B. Convertible notes

The Company has invested in convertible notes of a customer's parent company (see Note 4C), in an amount of \$27 million. The original maturity date of the convertible notes was November 30, 2003 bearing interest at a rate of 5% per annum to be paid on the maturity date. The debt was not repaid in November 2003, and as at the date of signing the financial statements, the Company and the customer are in the process of negotiating the rescheduling of the said debt. Conversion of the notes will not give the Company significant influence in the said company. The notes which will not be converted into share capital until the maturity date or upon an IPO, will be repaid.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 5 - Investments (cont'd)**

During 2002, due to significant concern regarding the financial ability of the abovementioned company to repay the notes (see also Note 4C), the Company included, as part of the "other expenses" category, a provision in the amount of \$18 million, for decline in value of the above-mentioned investment.

During the reporting period, an associated \$3.4 million charge recorded in "other expenses" for decline in the value of the abovementioned investment, reflects the expected outcome of advanced discussion with the debtor regarding revised and extended repayment terms of the said debt.

Note 6 - Property, Plant and Equipment

Property, plant and equipment consists of the following:

	Freehold land and buildings	Machinery and equipment	Motor vehicles	Office furniture and Equipment	Leasehold improvements	Total
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
Cost						
Balance at beginning of year	56,013	186,398	11,084	11,618	16,336	281,449
Additions	13	12,290	221	190	689	13,403
Disposals *	669	6,126	3,203	1,564	1,799	13,361
Balance at end of year	<u>55,357</u>	<u>192,562</u>	<u>8,102</u>	<u>10,244</u>	<u>15,226</u>	<u>281,491</u>
Accumulated depreciation and amortization						
Balance at Beginning of year	6,613	111,259	6,232	7,970	10,788	142,862
Additions	1,040	19,103	1,436	708	1,543	23,830
Disposals *	-	3,020	2,386	1,081	1,966	8,453
Balance at end of year	<u>7,653</u>	<u>127,342</u>	<u>5,282</u>	<u>7,597</u>	<u>10,365</u>	<u>158,239</u>
Undepreciated balance at December 31, 2003	<u><u>47,704</u></u>	<u><u>65,220</u></u>	<u><u>2,820</u></u>	<u><u>2,647</u></u>	<u><u>4,861</u></u>	<u><u>123,252</u></u>
Undepreciated balance at December 31, 2002	<u>49,400</u>	<u>75,139</u>	<u>4,852</u>	<u>3,648</u>	<u>5,548</u>	<u>138,587</u>

* Including assets disposed as a result of discontinuance of the Governmental Segment of ECTel (see Note 21). Regarding pledge, see Note 14.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 7 - Software Development Costs, Net**

Capitalization and amortization of software development costs during the years ended December 31, 2003, and 2002 is comprised as follows:

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Balance at beginning of year	20,082	27,086
Capitalization of software development costs during the year	11,364	12,935
Amortization and write-offs during the year	(15,157)	(19,939)
	16,289	20,082

Note 8 - Goodwill and Other Intangible Assets, Net

Consist of the following:

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Goodwill, net	10,329	16,348
Intangible assets related to acquisitions (Note 19), net	1,857	4,697
Total goodwill and intangibles (1)	12,186	21,045
(1) Original amount	157,142	156,863
Amortization and write down due to decline in value	(144,956)	(135,818)
	12,186	21,045

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 9 - Long-Term Liabilities
A. Loans

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Long-term loans **	60,000	160,000
Less - current maturities	30,000	160,000
	30,000	-

** The loans carry an annual interest rate of Libor plus 2% (the LIBOR interest rate at December 31, 2003 is 1.2%), and are repayable quarterly.

During the current period, the Company made an early repayment of a long-term loan from banks in the amount of \$ 78 million. In addition, according to the loan agreement, the Company repaid an amount of approximately \$ 22 million.

Commencing from October 2002 till the first quarter of 2003, the Company did not comply with some of the covenants as set forth in the loans agreements (see Note 14), therefore in 2002, long-term loans in the amount of \$ 106,667 thousand were reclassified as current liabilities. Current maturities in the amount of \$ 53,333 thousand of the loans were already included as part of current liabilities.

B. Other liabilities

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Provision for claim (*)	6,000	6,000
Other liabilities	15	2,379
	6,015	8,379

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 10 - Liability for Employee Severance Benefits, Net
A. Employees of the Company and of its consolidated subsidiaries in Israel (Israeli companies)

Under Israeli law and labor agreements, the Israeli companies are required to make severance and pension payments to their retired or dismissed employees and to employees leaving employment in certain other circumstances.

1. The liability in respect of most of its non-senior employees is discharged by participating in a defined contribution pension plan and making regular deposits with a pension fund. The liability deposited with the pension fund is based on salary components as prescribed in the existing labor agreement. The custody and management of the amounts so deposited are independent of the companies and accordingly such amounts funded (included in expenses on an accrual basis) and related liabilities are not reflected in the balance sheet.
2. In respect of the liability to other employees, individual insurance policies are purchased and deposits are made with recognized severance pay funds.

The liability for severance pay is calculated on the basis of the latest salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited including accumulated income thereon as well as by the unfunded provision.

3. As to the union employees of Tadiran Telecommunication Ltd. (TTL) (formerly Tadiran Communications Ltd. - see Note 19A) who are covered by the labor agreements which were in force in TTL, the Company's liability for severance pay is in accordance with such labor agreements.

If the Company terminates the employment of these employees up to 2011, they are entitled to additional benefits. After that time, the employees will no longer be eligible for such benefits.

4. The expenses in respect of severance and pension pay (not include expenses in restructuring) for the years ended December 31, 2003, 2002 and 2001 are \$ 5,593, \$ 8,869 thousand and \$8,361 thousand respectively.
5. Company's liability for termination of the employer-employee relationship is composed as follows:

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
Provision for severance pay	52,943	53,574
Amounts funded including accumulated income	26,343	27,217
	26,600	26,357

Withdrawals from the funds may be made only for the purpose of disbursement of severance pay.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 10 - Liability for Employee Severance Benefits, Net (cont'd)**B. Employees of U.S. consolidated subsidiaries (U.S. companies)**

The subsidiaries sponsor a section 401(K) defined contribution plan or 401(A) plan which permits its employees to invest up to certain amounts of their compensation (subject to limitation by Internal Revenue Service Regulations) on a pretax basis in certain self-directed investment programs. The subsidiaries may, at the discretion of the Board of Directors, make contributions to the plan. Company contributions with respect to this plan were \$ 499 thousand, \$ 588 thousand and \$ 197 thousand in 2003, 2002 and 2001, respectively.

C. Employees in the rest of the world

The provision for severance pay includes amounts related to employees in countries other than Israel and the U.S. and are calculated in accordance with the rules of the country, if any, in which they operate.

Note 11 - Commitments and Contingencies**A. Claims and potential claims**

1. Following the cut in workforce (see Note 20), in accordance with the reorganization plan of the Company, claims and demands for higher amounts of severance pay were submitted by certain former employees who were employed under personal contracts. Management of the Company believes, based on the opinion of its legal advisors, that these demands will be rejected and therefore no provision was recorded in respect thereto in the financial statements.
2. The Company and its subsidiaries conduct negotiations from time to time with international technology companies ("technology companies") regarding allegations that they are using certain patents owned by the technology companies in its products. Although the Company cannot assess each negotiation for its merit, it estimates that any settlement, if needed, will not have a material adverse effect on the Company's financial position or results of operations.
3. In October 1997, an investigation was commenced by the Israeli Comptroller of Restrictive Trade Practices (hereinafter - "comptroller") regarding alleged price fixing and non-competitive practices among TTL, Tadiran and Telrad Telecommunications and Electronics Industries Ltd., a subsidiary of Koor (Koor is a significant shareholder of the Company and Tadiran). Pursuant to the Restrictive Trade Practices Law - 1988, a fine may be levied against an entity or person violating the law. In addition, violators may be liable for damages that are proven as a result of their violation.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 11 - Commitments and Contingencies (cont'd)****A. Claims and potential claims (cont'd)**

The Department of the Restrictive Trade Practice authority investigators recommended filing criminal charges against certain of the entities or persons investigated in connection with such suspicions. The legal department of the Authority is reviewing the investigation material and the recommendation of the investigators. This review has taken years and at this time the outcome cannot be predicted.

Tadiran has agreed to indemnify the Company for damages above \$6 million. The Company cannot estimate the results of the investigation prior to the decision of the comptroller.

4. The Company is in dispute with a subcontractor regarding certain financial terms of a supply agreement as described in Note 11H4. The dispute was referred to an arbitrator in April 2003 and the subcontractor submitted a claim in the amount of \$ 24.5 million and an additional ILS 24.0 million.

The Company rejected the allegations made against it and already filed its defense statement. The Company also filed a claim against the subcontractor in the amount of at least \$ 42.0 million and an additional ILS 35.4 million.

In the opinion of Management, the arbitrator's decision will not have any negative material effect on the Company's financial position and/or the results of its operations.

5. Several claims have been submitted against the Company and against consolidated subsidiaries, resulting from ordinary business operations inter alia, for using patents owned by others. Management of the companies, based mainly on opinions of their legal advisors, believe that the effect, if any, of the results of such claims on the financial position of the Company and the results of its operations will be immaterial and therefore the provisions which are included in the financial statements in respect thereof are appropriate and sufficient.

B. Lease commitments

The Company and its consolidated subsidiaries have entered into several operating lease agreements in Israel and abroad. The agreements expire on various dates from 2004 to 2021 (some of which have renewal options) and are in local currencies or linked to the dollar or to the Israeli Consumer Price Index.

Future minimum annual rent payments to which the Company and its subsidiaries are committed under the above leases, at rates in effect at December 31, 2003, are as follows:

<u>Year ending December 31</u>	<u>\$ in thousands</u>
2004	13,880
2005	8,387
2006	5,360
2007	3,562
2008 and thereafter	6,862

As to rent expense under the Company's leases, see Note 17N.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 11 - Commitments and Contingencies (cont'd)**C. Royalty commitments**

1. The Company is committed to pay royalties to the Government of Israel on proceeds from sale of products in the Research and Development of which the government participated by way of grants. The royalties are computed mainly at the rates of 3.5% of the aggregated proceeds from sale of such products, up to the amount not exceeding 100% of such grants. As at December 31, 2003 the maximum possible future commitment of the Company is approximately \$ 137 million.
2. The Company is committed to pay royalties to certain parties whose products, patents or technology are incorporated in certain products of the Company. Such royalties are based on sales of systems or a family of products incorporating such products, patents or technology and are paid based either on a fixed rate, a price per unit sold or as a rate of the system or the family of products sale price.
3. During 2001, one of the Company's divisions reached agreements with the Office of the Chief Scientist (OCS) in Israel, according to which the latter will be paid without dependency on the existence of future sales, an agreed-upon sum, which will constitute full and final settlement of any liability and debt which the division may have to the Chief Scientist. As a result of the above, an expense in the amount of \$8,394 thousand was included in the financial statements in respect of the results of the agreement.

D. Financial instruments**(1) Derivative financial instruments**

The Company has significant international sales transactions in foreign currencies and has a policy of hedging forecasted and actual foreign currency risk with forward foreign exchange contracts and purchased and writing options. The Company's forward foreign exchange contracts and purchased options are primarily denominated in Euro, Pounds Sterling and ILS and are for periods consistent with the terms of the underlying transactions, generally one year or less. Derivative instruments are employed to eliminate or minimize certain foreign currency exposures that can be identified and quantified. The Company was exposed to but realized no losses from non-performance by counter parties on these derivatives.

The Company uses foreign currency forward contracts designated as fair value hedges to protect against the foreign currency exchange rate risks related to the remeasurement of firm sales commitments and recognized assets such as accounts receivable. Changes in the fair value of these derivatives are recognized in operations as offsets to the changes in the fair value of the related assets or liabilities.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 11 - Commitments and Contingencies (cont'd)**D. Financial instruments (cont'd)****(1) Derivative financial instruments (cont'd)**

The Company uses a combination of forwards and purchased and writing options designated as cash flow hedges to protect against the foreign currency exchange rate risks inherent in its forecasted revenue denominated in currencies other than the U.S. dollar. The Company's cash flows hedges mature generally within less than a year. For derivative instruments that are designated and qualify as cash flow hedges, the effective portions of the gain or loss on the derivative instruments are initially recorded in accumulated other comprehensive income (loss) as a separate component of shareholders' equity and subsequently reclassified into operations in the period during which the hedged transactions is recognized operations. The ineffective portion of the gain or loss is reported in financial income or expenses immediately. The effective portion of cash flow and foreign currency hedges is reported in the same financial statement line item as the changes in value of the hedged item. For foreign currency option and forward contracts designated as hedges, hedge effectiveness is measured by comparing the cumulative change in the hedge contract with the cumulative change in the hedged item, both of which are based on forward rates.

The Company uses variable-rate debt to finance its operations. The debt obligations expose the Company to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of a portion of its interest payments. To meet this objective, management enters into interest rate swap agreements to manage fluctuations in cash flows resulting from interest rate risk. These swaps change the variable-rate cash flow exposure on the debt obligations to fixed cash flows. Under the terms of the interest rate swaps, the Company receives variable interest rate payments and makes fixed interest rate payments thereby creating the equivalent of fixed-rate debt.

Changes in the fair value of interest rate swaps designated as hedging instruments that effectively offset the variability of cash flows associated with variable-rate, long-term debt obligations are reported in AOCI. These amounts subsequently are reclassified into interest expense as a yield adjustment of the hedged interest payments in the same period in which the related interest affects earnings.

Other derivatives not designated as hedging instruments under SFAS No. 133 consist primarily of purchase and writing options used to hedge foreign currency cash flows. For derivative instruments not designated as hedging instruments under SFAS No. 133, changes in the fair values are recognized in operations in the period of change.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 11 - Commitments and Contingencies (cont'd)**D. Financial instruments (cont'd)**

(1) Derivative financial instruments (cont'd)

Fair value hedging transactions

As at December 31, 2003, one of the Company's subsidiaries and the Company had entered into currency forward contracts, as a hedge against sales contracts receivable and firm commitments, as follows:

The Company's subsidiary

- a. Obligation to sell Euro 1.3 million for a total amount of US\$ 1.6 million.
- b. Obligation to sell Pounds sterling 2.2 million for a total amount of US\$ 3.6 million.

The Company

- c. Obligation to sell Australian dollar 1.5 million for a total amount of US\$ 1.1 million.
- d. Obligation to sell CNY (Chinese Yuan) 42.3 million for a total amount of US\$ 5.2 million.

Since the effect of the fluctuations in foreign currency exchange rates is set off against the effect on the hedged sales agreements, the subsidiary does not have any exposure to exchange rate differentials in this connection.

Anticipated cash flow hedging transactions

As at December 31, 2003, the Company had entered into forward currency transactions and also purchased and writing options as hedges for currency exchange rates for various periods of time. These transactions constitute a future cash flow hedge for sales agreements and for the anticipated backlog of orders.

As at December 31, 2003, the Company had entered into 106 hedge transactions and strategies in respect of sales and anticipated sales amounting to 117.6 million Euro, 6.6 million Pounds sterling and \$ 2.0 million in other currencies.

The hedge transactions strategies are shown in the balance sheet at fair value. The fair value of future transactions is based on future exchange rates, as quoted at the balance sheet date.

The Company had net realized foreign currency exchange losses of \$ 6.9 million and \$1.5 million in 2003 and 2002, respectively.

Comprehensive income (loss) at December 31, 2003 includes an unrealized loss of \$ 4.8 million relating to the above hedge transactions. As of December 31, 2003, the net unrealized loss on financial instruments is \$ 6.7 million. This amount is expected to appear in the statement of income for the year ended December 31, 2004.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 11 - Commitments and Contingencies (cont'd)**D. Financial instruments (cont'd)**

(1) Derivative financial instruments (cont'd)

Wages payments

As at December 31, 2003, the Company had entered into 16 hedge transactions and strategies in respect of wages payments amounting to ILS 73.1 million.

Interest rate cash flow risk

Interest expense for the year ended December 31, 2003, includes net losses in the amount of US\$ 502 thousand, representing unfavorable cash flow hedge transactions arising from the difference between the interest rate fixed in the interest rate swap and the rate on the hedged debt obligation with respect to the portion applicable to the current year.

Non-hedging transactions

The financing expenses include a loss of \$ 2.0 million for the year ended December 31, 2003. This amount reflects the change in the exercise rate of the foreign currency between the future exercise rate and the rate prevailing at the balance sheet date deriving from the time value factor, which is not considered as being for hedging purposes.

(2) Concentration of credit risks

Financial instruments which seem to expose the Company to risks of credit concentration, include cash, deposits, currency hedging transactions, trade and other receivables.

The cash and deposits as well as the hedging transactions are deposited and/or executed through a number of established financial institutions. These financial institutions are located in Israel, the USA and Europe. The policy of the Company is to avoid the risk of making deposits with one financial institution. The Company frequently evaluates the amounts and volume of the transactions executed with each one of the said financial institutions. The exposure in respect of credit to customers is limited due to the large number of customers and their geographical spread as well as the provision for doubtful debts in the financial statements.

As to the long-term deposits and customer debts see Note 4. Management of the Company believes that the credit risk is limited since the customers are large suppliers of communications services operating in countries in which this sector is anticipated to grow.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 11 - Commitments and Contingencies (cont'd)**D. Financial instruments (cont'd)**

(3) Fair value in the financial statements

Management estimates that the fair value of the financial instruments is not materially different from the amounts included in the financial statements. In its determination of fair value, management used certain estimates, as described below, which do not necessarily indicate amounts which are recoverable in current market trading.

- Cash and cash equivalents, short-term investments, trade receivables, other receivables, trade payables, other payables and advances from customers:

The book value is the same as the fair value due to the short realization period and/or repayment date of these instruments.

- Long-term receivables and liabilities:

The book value is not materially different from the fair value since the Company's interest rates on its long-term liabilities or receivables are not materially different from those indicated in respect of the assets and liabilities as at the balance sheet date.

E. Capital expenditure commitments

The Company and its consolidated subsidiaries in Israel are incurring capital expenditures pursuant to "Approved Enterprise" programs. At December 31, 2003, the Companies are committed to invest approximately \$ 643 thousand pursuant to these programs. Completion of such investment programs will provide tax benefits in the future (see Note 15A2).

F. Purchase commitments

At December 31, 2003, the Company has commitments, in the aggregate amount of \$ 68,910 thousand, covering, primarily, the purchase of materials as well as, to a lesser extent, for the acquisition of equipment (December 31, 2002 - \$ 120,019 thousand).

G. Guarantees

1. At December 31, 2003, the Company has granted guarantees to third parties in the sum of \$ 7,773 thousand mainly as guarantees for tenders which the Company has attained or in which it participates. The Company will be required to perform under the guarantees if it does not fulfill the tender's terms. The expiry dates of the guarantees are till 2004.
2. The Company also maintains certain third-party guarantees (primarily with banks) mainly to support its performance obligations under customer contracts and other contracts that can be demanded in case of material breach of contracts. As at December 31, 2003, these guarantees approximated \$ 30,427 thousand. The expiry dates of guarantees vary and the last of them expires in 2009.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 11 - Commitments and Contingencies (cont'd)**H. Commitments**

1. In November 2001, the Company sold the operations of its information technology unit ("IT"). The Company signed a five-year outsourcing contract with EDS Israel. Under the agreement, EDS Israel assumed all the IT operations and is required to supply maintenance, support and development services during the term of the agreement, in consideration for a sum of between \$15 and \$ 18 million, per year. In 2003 a new agreement replacing the previous agreement was signed. The agreement is for five years, beginning from 2003 and until the end of 2007. The Company has the possibility of being released from the agreement under certain circumstances. In the agreement, the Company undertook to pay EDS the amount of \$ 11.8 million in 2003 and an amount of between \$7.8 million and \$ 8.8 million in 2004-2007. In addition to these amounts, the Company pays additional amounts to EDS in respect of various projects that are not included in the agreement. For the year ended December 31, 2003 and 2002, the cost of such services to the Company was \$ 14 million and \$ 15.2 million, respectively.

2. The Company has an obligation to indemnify the purchasers of certain activities and/or the purchasers of subsidiaries at rates which are stipulated in the sales agreement, should the purchasers be forced to discharge former employees of TTL during a period up to 2011 (see Note 10A(3)) and, therefore, to pay increased severance benefits.

In the opinion of Company management, the provisions for future indemnification, as stated, which are included in the financial statements, are proper and adequate.

3. If the Company dismisses any of the remaining unionized employees of TTL by 2011, it is committed to pay them increased severance benefits or early retirement pensions, depending on age and seniority (see Note 10A(3)). As at December 31, 2003, the maximum amount payable as a result of this commitment is \$ 15.9 million. Management does not expect to dismiss the said employees and therefore no provision in respect thereof has been included in the financial statements.
4. In December 1999, an agreement was signed with SCI Systems Ltd. ("SCI") for the sale of a plant (known as Shemer) which manufactures electronic components. SCI is one of the largest manufacturers of electronic components in the world. As part of the agreement, SCI will, for several years to come, be the subcontractor for part of the manufacturing activities of the Company, on a cost plus basis.

The Company is in dispute with SCI as to the interpretation of certain financial aspects of the agreement, such as volume commitments, discount terms for large orders, the minimum size of orders, timing etc. - See Note 11A4.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 11 - Commitments and Contingencies (cont'd)****H. Commitments (cont'd)**

5. Commitments to indemnify directors and officers

In August 2001, the audit committee and the Board of Directors of ECI resolved to grant ECI's directors and officers at the level ;of vice president and above, who may serve from time to time, indemnification to the fullest extent permitted by law and approved the form of indemnification letter to be provided to each such director and officer. The Company has undertaken to indemnify its directors and officers for financial obligations and reasonable litigation costs imposed on them in connection with their duties. The undertaking is limited to categories of events set forth in the indemnification letter and to an amount of \$ 15 million per director and officer, per case.

The prospective indemnification and form of indemnification letter were approved by the shareholders of ECI.

In July 2002, the audit committee and the Board of Directors of ECI resolved, subject to shareholders approval, to raise the amount of the aforesaid undertaking to a limit of \$ 30 million per director per case, but not more than a commitment of \$ 225 million in the aggregate for all persons to be indemnified. The aforesaid changes were approved by ECI's shareholders.

I. Consolidated company stock options

As at December 31, 2003, ECTel Ltd., a subsidiary traded on a US stock exchange, has options, which were granted to its employees and which are convertible into ordinary shares. If all the options are exercised into shares, the rate of holding of the Company may decrease from 58.3% to 47.7%, without the Company incurring a capital deficiency.

Note 12 - Shareholders' Equity**A. Authorized, issued and outstanding shares**

	<u>Authorized</u>	
	<u>December 31 2003</u>	<u>December 31 2002</u>
	<u>Number of shares</u>	
ILS 0.12 par value per share	<u>200,000,000</u>	<u>200,000,000</u>

1. The Company's shares (ILS 0.12 par value each) are traded in the United States on the over the counter market and are listed on the Nasdaq Stock Market.
2. For details of the issued share capital and treasury stock, see Statement of Changes in Shareholders' Equity.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 12 - Shareholders' Equity (cont'd)**A. Authorized, issued and outstanding shares (cont'd)**

3. On December 6, 2001, a private placement agreement was signed with a group of investors in respect of 12.5% of the issued share capital of the Company. The closing of this agreement took place on February 12, 2002. The investors paid an amount of \$ 50 million to the Company in consideration for the shares they received. Part of the shares allotted to the above mentioned investors were the balance of the Company's shares held as Treasury stock.
4. Pursuant to the service agreement with one of the Company's director, the Company issued to him in 2003 and 2002, 5,650 ordinary shares and 3,940 ordinary shares, respectively.

B. Dividends

Dividends may be paid by the Company only out of retained earnings. There are no restrictions on the transfer of funds to foreign shareholders for the payment of dividends. See Note 15A(2).

C. Share incentive and stock option plans**1. ECI Plan**

- a. The Company's current stock option plans are the ECI Telecom Ltd. Key Employee Share Incentive Plan 1991 and the ECI Telecom Ltd. Employee Share Incentive Plan 2002 (together the "ECI Plans"), which were adopted by the shareholders at the Annual General Meetings held respectively on August 29, 1991 and November 19, 2002. The ECI Plans will expire on December 31, 2012.

The ECI Plans provide that options may be granted to any employee, director, consultant or contractor of the Company pursuant to (a) one or more sub-plans designed to benefit from the provisions of Section 102 of the Israeli Income Tax Ordinance (New Version) 1961 and (b) any other share incentive plan approved by the Board of Directors of the Company.

Under the terms of the ECI Plans, as of December 31, 2003, the Company is authorized to grant options for a total of 29,760,700 (increased from 26,760,700 following shareholders' approval on July 30, 2003) shares, subject to anti-dilution adjustment. The option awards are personal and non-assignable and terminate automatically upon termination of employment (except for approved retirement or termination caused by death or disability or as otherwise approved by the Board of Directors or its Remuneration Committee).

On February 11, 2003 the Company granted to its employees and managers 879,228 share options at an exercise price of \$1.75 per share. The options vest as follows: 12.5% after six months and 6.25% on the last day of each following quarter over a period of 14 quarters.

In February 2003 the Company granted 300,000 share options to a company of which one of its directors shares control at an exercise price of \$ 2.21 per share. Half of the options vested immediately and the balance will vest in February 2004.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 12 - Shareholders' Equity (cont'd)**C. Share incentive and stock option plans (cont'd)****1. ECI Plan (cont'd)**

In February 2003, the Company granted an aggregate 130,000 share options to two directors at an exercise price of \$ 1.99 per share. 30,000 of these options will be fully vested in August 2004, and one third of the remaining 100,000 options will be vested, respectively, in January 2004, January 2005 and January 2006.

On April 10, 2003, the Company granted to its employees and managers 746,831 share options at an exercise price of 1.78 per share, which constituted the market price of the share on the date the options were granted. The options will be vested as follows: 12.5% after half a year and 6.25% during 14 consecutive quarters thereafter. In addition, the Company granted to its employees and managers 3,095,600 share options at an exercise price of \$0 per share. The share option will be vested as follows: 68.75% after one year and 6.25% during five consecutive quarters thereafter.

During the first quarter of 2003, the Company agreed to grant employees of certain segments the right to exchange their option warrants, convertible into shares in certain subsidiaries, for others, convertible into shares of the Company according to a certain ratio, on a date at least six months after conversion date. Accordingly, on September 10, 2003, the Company granted to its employees and managers 5,109,982 share options at an exercise price of \$ 3.24 per share. In most instances, these options were exercisable as to 50% from the date they were granted and as to additional 6.25% on the last day of each of the next eight consecutive quarters, beginning on September 30, 2003.

In addition, the Company granted certain persons who had agreed to the exchange but left the employ of the Company since the conversion date 132,413 share options at an exercise price of \$ 3.24 per share. The options vested immediately and are exercisable for one year thereafter.

None of the above share options (other than those granted at an exercise of \$0 per share) were granted at exercise prices below of the market price on the date of the grant.

During the reporting period, 100,818 options were exercised.

b. TTL Plan

As a result of the Merger with TTL in 1999, the Company has options outstanding which were originally granted before the Merger under plans established by TTL (TTL plans) and subsequently converted into the Company's options at the same ratio as that for the share of TTL.

c. U.S. Plan

At the Annual General Meeting held on August 29, 1991, the shareholders also approved a Key Employee Incentive Stock Option Plan for the Company's wholly-owned U.S. subsidiary, ECI Telecom Inc. (the "ECI U.S. Plan"), which has now expired, except as to outstanding option awards. Under the ECI U.S. Plan, any officer, management or other key employee of ECI Telecom Inc. could participate in the ECI U.S. Plan.

As at December 31, 2003, there are no outstanding options.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 12 - Shareholders' Equity (cont'd)
C. Share incentive and stock option plans (cont'd)
1. ECI Plan (cont'd)

Stock options under the ECI Plans are as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>Number of shares</u>	<u>Number of shares</u>	<u>Number of shares</u>
Total number authorized at beginning of year	26,760,700	14,760,700	14,760,700
Increase in number authorized during year	3,000,000	12,000,000	-
Options unexercised at beginning of year	(12,349,747)	(12,087,850)	(11,943,633)
Exercised till beginning of year	(2,028,982)	(2,028,982)	(2,028,982)
Granted during year	(10,523,271)	(780,000)	(905,000)
Cancelled during year	3,704,655	518,103	760,783
	<u>8,563,355</u>	<u>12,381,971</u>	<u>643,868</u>
Authorized for future grant at end of year			
Exercised during the year *	<u>100,818</u>	<u>-</u>	<u>-</u>
* Average price of options exercised during year (in US\$)	<u>2.62</u>	<u>-</u>	<u>-</u>
Options unexercised at end of year	<u>19,067,545</u>	<u>12,349,747</u>	<u>12,087,850</u>
Options may be exercised as follows (1):			
First year or thereafter	16,540,199	11,997,247	9,078,874
Second year or thereafter	1,911,858	147,500	2,748,976
Third year or thereafter	615,488	205,000	260,000
	<u>19,067,545</u>	<u>12,349,747</u>	<u>12,087,850</u>

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 12 - Shareholders' Equity (cont'd)
C. Share incentive and stock option plans (cont'd)
1. ECI Plan (cont'd)
b. Stock options under the ECI Plans (cont'd)

- (1) To be paid in ILS based on the rate of exchange of the dollar on the date of payment as follows:

Dollars per Share	<u>2003</u>	<u>2002</u>	<u>2001</u>
	Number of shares	Number of shares	Number of shares
Zero	2,942,728	-	-
1.31 - 3.17	2,587,619	650,000	-
3.24	5,124,326	-	-
3.25 - 7.61	598,334	798,600	918,600
14 - 21	1,134,842	1,443,016	1,443,016
23.85 - 26.38	183,500	269,000	269,000
26.66	3,985,054	5,630,531	5,778,034
27.51 - 29.53	1,792,292	2,705,950	2,826,550
30 - 40	718,850	852,650	852,650
	<u>19,067,545</u>	<u>12,349,747</u>	<u>12,087,850</u>

2. Fair value method

- a. In October 1995 the Financial Accounting Standards Board (FASB) issued SFAS 123 "*Accounting for Stock-based Compensation*" which establishes financial accounting and reporting standards for stock-based compensation plans. The statement defines a fair value based method of accounting for an employee stock option.

As required by SFAS 123, the Company has determined the weighted average fair value of stock-based arrangements grants during 2003 to be \$ 1.7. The fair values of stock based compensation awards granted were estimated using the "Black - Scholes" option pricing model with the following assumptions.

<u>Year of grant</u>	<u>Option Term</u>	<u>Expected volatility</u>	<u>Risk free interest rate</u>
2003	5	70	1.00%
2002	5	105	1.50%
2001	5	90	2.00%

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 12 - Shareholders' Equity (cont'd)
C. Share incentive and stock option plans (cont'd)
2. Fair value method (cont'd)

- b. Had the compensation expenses for stock options granted under the Company's stock option plans been determined based on fair value at the grant dates consistent with the method of SFAS 123, the Company's net loss and net loss per share would have been as follows:

	For the year ended December 31		
	2003	2002	2001
	Restated (*)		
	\$ in thousands, except per share amounts		
Net loss, as reported	(71,040)	(162,468)	(412,376)
Add: Stock-based employee compensation expenses included in reported net income, net of related tax effects	3,568	286	3,592
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(23,450)	(59,930)	(72,511)
Pro Forma net loss	<u>(90,922)</u>	<u>(222,112)</u>	<u>(481,295)</u>
Net loss per share (basic and diluted) per: (\$)			
- as reported	(0.66)	(1.54)	(4.44)
- pro forma	(0.84)	(2.10)	(5.18)

(*) See note 1A(8)

3. Employee Stock Purchase Plans ("ESPP")

In July 2000, the ECI Telecom Ltd. 2000 Employee Stock Purchase Plans were approved. Under the ESPP plan all employees were permitted to purchase shares at a price equal to 85% of the lower of the fair market value at the beginning or end of each offering period.

Under the ESPP, the Company sold to its employees during 2003, 2002 and 2001, 418,983, 775,123 and 1,214,642 ordinary shares of the Company (which, in 2001 were previously treasury stock), respectively. The ESPP plan is no longer in effect.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 13 - Balances in Currencies Other Than the Dollar

	December 31, 2003				December 31, 2002			
	Israeli currency	Foreign currency			Israeli currency	Foreign currency		
		Euro	Pounds Sterling	Others		Euro	Pounds Sterling	Others
				\$ in thousands				
Assets								
Trade receivables	12,115	49,473	4,799	3,834	11,876	40,734	5,438	4,741
Other current assets	25,760	3,993	2,143	1,809	14,435	4,332	578	10,557
Long-term deposits and marketable securities	18,282	-	-	-	-	-	-	-
	<u>56,157</u>	<u>53,466</u>	<u>6,942</u>	<u>5,643</u>	<u>26,311</u>	<u>45,066</u>	<u>6,016</u>	<u>15,298</u>
Liabilities								
Trade payables	32,443	4,034	263	2,466	19,299	4,693	278	521
Other current liabilities	31,790	6,446	2,989	4,549	41,426	4,797	3,985	1,394
Long-term liabilities (including current maturities)	25,966	-	-	65	26,170	3,127	493	39
	<u>90,199</u>	<u>10,480</u>	<u>3,252</u>	<u>7,080</u>	<u>86,895</u>	<u>12,617</u>	<u>4,756</u>	<u>1,954</u>

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 14 - Charges (Assets Pledged)

The existing and future liabilities of the Company towards Israeli banks are collateralized by certain pledges on assets (real estate in Israel), on certain rights (shares in companies held by the Company) and by an unlimited "negative pledge" on the Company's assets. As a condition to the continued granting of credit by the banks, and in accordance with the "negative pledge", the Company was obligated to maintain certain financial ratios, such as an equity ratio, capital to assets ratio, current ratio and a certain ratio of operating income. According to a facility agreement with the lending banks, the Company was to have maintained these ratios since the third quarter of 2001. Commencing from October 1, 2002 until the first quarter of 2003, the Company was not in compliance with some of the financial ratios and, therefore, the loans starting from the third quarter of 2002 until the first quarter of 2003 were classified as current loans.

During the reporting period, the Company signed a letter agreement which amended the aforementioned facility agreement. Under the letter agreement, the Company repaid an amount of approximately \$ 78 million in respect of the long-term loan and fully paid of \$45 million of the short-term loan. In addition, the Company is to maintain certain financial ratios, inter alia, tangible equity to total liabilities, current ratio and, starting 2004, certain ratios of operating income. Accordingly, the loan starting from the second quarter of 2003 is classified as long-term.

See Note 4A for pledges on deposits.

See Note 17B for restricted deposits.

Note 15 - Taxes on Income**A. Tax programs under various Israeli tax laws:****1. Israel tax reform**

During 2003, tax reform legislation was enacted, which significantly changed the taxation basis of corporate and individual taxpayers from a territorial basis to a worldwide basis. From such date an Israel resident taxpayer will be taxed on income produced and derived both in and out of Israel.

The main provisions of the tax reform that may affect the Company are as follows:

a) Transfer pricing of international transactions with related parties.

The Income Tax Ordinance was amended to include provisions concerning transfer pricing between related parties, where one of the parties is situated abroad. Detailed provisions are to be included in Income Tax Regulations that have yet to be issued. The Company considers that the transfer pricing policy adopted with foreign affiliates is economically fair, however, an adjustment may be required following the issue of the said Regulations. In the opinion of the Company, the regulation will not have a material effect.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 15 - Taxes on Income (cont'd)

A. Tax programs under various Israeli tax laws: (cont'd)

b) Employee stock incentive plans

The tax reform codified past practice and determined three alternative tracks for taxing employee stock option plans. Where a trustee arrangement is in place, the employer can either claim an expense for tax purposes while the employee will be fully taxed up to the maximum marginal tax rate of 50% (49% in 2004) or the Company can waive the tax expense and the employee will pay a reduced tax rate of 25% after ending of a "trustee period" (2-3 years from the date of grant). Where there is no trustee arrangement, the employee is fully taxable and no expense is allowed to the Company. There are detailed provisions for implementing these tracks. The company chose to waive the tax expense and the employees will pay a reduced tax rate of 25%.

c) Controlled foreign company (CFC)

The amendment to the law introduced Controlled Foreign Company (CFC) provisions, which, in certain circumstances, will lead to the Israeli company being charged to tax on passive income of foreign affiliates as if it had received a dividend from such companies.

d) Capital gain tax is reduced to 25% from 36%, (except with respect to capital gains from marketable securities which consist to be 36%), with transitional provisions for assets acquired prior to January 1, 2003.

e) The seven year limit for carrying forward of capital losses has been removed with respect to capital losses arising from 1996 and thereafter.

2. Tax benefits under the Law for the Encouragement of Capital Investments, 1959.

Pursuant to the above Law the Company and its Israeli subsidiaries are entitled to tax benefits relating to investments in "Approved Enterprises" in accordance with letters of approval received.

A major part of the production facilities of the Company and its Israeli subsidiaries has been granted the status of an "Approved Enterprise" under the above Law. According to the Law, a Company is entitled to an investment grant (up to 24% of investment cost) and also to a tax benefit, which grants the Company a reduced tax rate of 25% for a specific period (Alternative A). The Company's "Approved Enterprise" is subject to zero tax rates under the "Alternative Benefit Method" and reduced tax rates (25% subject to examination of the level of foreign ownership), for specified periods (alternative B). All of the approved enterprises, which currently entitle the Company to benefits, are under alternative B.

The period of benefits in respect of most of the Company's production facilities will terminate in the years 2004-2011. Some of the Company's current investments are made under new approvals.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 15 - Taxes on Income (cont'd)

A. Tax programs under various Israeli tax laws: (cont'd)

In the event of distribution of cash dividends from income taxed at zero rate, a reduced tax rate in respect of the amount distributed would have to be paid. As of December 31, 2003, the Company has an accumulated loss and therefore it cannot distribute a cash dividend. Effectively such dividend distribution would be reduced by the amount of the tax. Benefits are attributed to an "Approved Enterprise" based on the growth in turnover upon implementation of each plan.

In 1999 the tax authority published instructions that allowed R&D companies under some conditions to reduce the base turnover by 10% for each year beginning 1996 till year 2001. Those instructions are reducing the effective tax rate by the reduction in turnover subject to the full tax rate.

3. Measurement of results for tax purposes under the Income Tax Law (Inflationary Adjustments), 1985.

Under this law, operating results for tax purposes are measured in real terms, in accordance with the changes in the Israeli CPI, or in the exchange rate of the dollar - for a "Foreign Investors' Company", as defined by the Law for the Encouragement of Capital Investments, 1959. The Company and its Israeli subsidiaries elected to measure their operating results on the basis of the changes in the Israeli CPI. As a result the Company and its subsidiaries are entitled to deduct from their taxable income an "equity preservation deduction" (which partially compensates for the decrease in the value of shareholders' equity resulting from the annual rise in the Israel CPI).

4. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969.

The Company is an "Industrial Company" as defined by this Law, and as such is entitled, among other benefits, to claim accelerated depreciation of machinery and equipment as prescribed by regulations issued under the inflationary adjustments tax law.

5. The rate of company tax on income received in Israel from sources other than an Approved Enterprise is mainly 36%.
6. In 2002 the Company came to an arrangement with the income tax authorities concerning tax returns filed by TTL through 1998. Among other terms of the arrangement, the Company undertook to pay a further \$ 1.2 million in taxes if it does not produce certain confirmations from government agencies in future periods as defined in the arrangement. In the opinion of Management, the provisions included in the balance sheet are adequate and sufficient.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 15 - Taxes on Income (cont'd)
B. Non-Israeli subsidiaries

Non Israeli subsidiaries are taxed based upon tax laws in their countries of residence.

C. Taxes on income from continuing operations

Taxes on income included in the consolidated statements of operations are comprised as follows:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Current taxes relating to-			
The Company and its Israeli subsidiaries	1,559	3,092	2,383
Foreign subsidiaries	(6,704)	211	1,995
	<u>(5,145)</u>	<u>3,303</u>	<u>4,378</u>
Deferred taxes relating to -			
The Company and its Israeli subsidiaries	424	4,850	(4,780)
Foreign subsidiaries	6,884	274	112
	<u>7,308</u>	<u>5,124</u>	<u>(4,668)</u>
	<u><u>2,163</u></u>	<u><u>8,427</u></u>	<u><u>(290)</u></u>

(*) In 2002 - Including tax benefits of \$ 1,136 thousand with respect to previous years.

D. Loss from continuing operations before taxes on income

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	Restated(*) \$ in thousands	\$ in thousands
The Company and its Israeli subsidiaries	(67,179)	(87,490)	(353,520)
Foreign subsidiaries	(6,929)	1,800	3,857
	<u>(74,108)</u>	<u>(85,690)</u>	<u>(349,663)</u>

(*) See Note 1A(8)

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 15 - Taxes on Income (cont'd)
E. Reconciliation of the statutory tax expense (benefit) to actual tax expense

A reconciliation of the statutory tax expense, assuming all income is taxed at the statutory rate (see A4 above) applicable to the income of companies in Israel, and the actual tax expense is as follows:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	Restated(*) \$ in thousands	\$ in thousands
Loss from continuing operations as reported in the consolidated statements of operations	(74,108)	(85,690)	(349,663)
Theoretical income tax benefit on the above amount (36%)	(26,678)	(30,848)	(125,879)
Foreign tax rate differential	(1,559)	2,382	1,251
Current losses - for which no deferred tax benefit has been recorded	17,329	5,535	20,818
Tax benefits with respect to previous years	-	(1,136)	-
Effect of lower tax rates arising from "Approved Enterprise Status"	6,517	14,801	51,559
Increase in taxes resulting from non-deductible expenses (mainly amortization of goodwill)	9,079	17,496	46,821
Other**	(2,525)	197	5,140
Taxes on income for the reported year	2,163	8,427	(290)

(*) See Note 1A(8)

(**) Resulting from the difference between the changes in the Israeli CPI, which forms the basis for computation of taxable income of the Company and its Israeli subsidiaries - (see A2 above) and the exchange rate of Israeli currency relative to the dollar.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 15 - Taxes on Income (cont'd)

F. Components of deferred income tax

- (1) As at December 31, 2003 and December 31, 2002, deferred income tax consists of future tax assets (liabilities) attributable to the following:

	December 31 2003	December 31 2002
	<u>\$ in thousands</u>	<u>\$ in thousands</u>
Deferred tax assets:		
Tax credit carryforwards	3,840	2,856
Capital loss carryforward	48,022	46,386
Operating loss carryforward ^(a)	60,584	52,413
Vacation pay accruals and severance pay fund	4,352	6,761
Property, plant and equipment	4,771	3,258
Other	2,698	4,529
	<u>124,267</u>	<u>116,203</u>
Gross total deferred tax assets		
Valuation allowance for deferred tax assets ^(a)	(111,645)	(94,316)
Net deferred tax assets ^(a)	<u>12,622</u>	<u>21,887</u>
Deferred tax liabilities:		
Software development costs	(1,629)	(3,058)
Depreciation	(149)	(677)
	<u>(1,778)</u>	<u>(3,735)</u>
Net deferred tax liabilities		
Deferred income tax, net ^(b)	<u>10,844</u>	<u>18,152</u>

^{a)} In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences, net of the existing valuation allowances at December 31, 2003. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced. Based on this assessment, as of December 31, 2003, the Company determined that it is more likely than not that \$ 10.8 million of such assets will be realized, therefore resulting in a valuation allowance of \$ 111.6 million.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 15 - Taxes on Income (cont'd)**F. Components of deferred income tax (cont'd)**

Based on the fiscal 2002 assessment, the Company had determined that it was more likely than not that \$ 18 million of such assets were to be realized, therefore resulting in a valuation allowance of \$ 94 million. Based on the fiscal 2001 assessment, the Company had determined that it was more likely than not that \$ 23 million of such assets were to be realized, therefore resulting in a valuation allowance of \$ 70 million. If changes occur in the assumptions underlying the Company's tax planning strategies or in the scheduling of the reversal of the Company's deferred tax liabilities, the valuation allowance may need to be adjusted in the future.

The Company has not recognized a deferred tax liability of approximately \$ 1,074 thousand for the undistributed earnings of its foreign operations that arose in 2003 and prior years because the Company currently does not expect those unremitted earnings to reverse and become taxable to the Company in the foreseeable future. A deferred tax liability will be recognized when the Company is no longer able to demonstrate that it plans to permanently reinvest undistributed earnings. As of December 31, 2003, the undistributed earnings of these subsidiaries were approximately \$ 4,296 thousand (December 31, 2002 - \$ 5,488 thousand).

(b) Long-term deferred taxes in the amount of \$ 8,801 thousands are included in the other assets item of the balance sheet and short-term deferred taxes in the amount of \$ 2,043 thousands are included in other receivables.

(2) As at December 31, 2003, the Company and its subsidiaries had, for tax purposes, operating loss carryforwards, capital loss carryforwards, general business and alternative tax net operating loss carryforwards (NOL) of \$ 393.4 million, \$ 139.4 million, \$ 1.4 million and \$ 67 million, respectively.

The company had no minimum tax credit carryover. A portion of the federal and alternative minimum tax net operating loss carryforwards will begin to expire over the period of 2019 through 2023. A portion of the capital loss and the general business carryforwards with expiration dates from 2003 to 2021.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 15 - Taxes on Income (cont'd)**G. Tax assessment**

Final tax assessments have been received by some of the Israeli companies through the 1992 tax year.

H. Company spin-off

Towards the end of 2000, the Company applied to the Israeli tax authorities for a tax ruling that, under Israeli tax law, its shareholders would not be liable to taxation as a result of the spin-off plan described in Note 1A.(2) above. The main points of the ruling are as follows:

- a. The new investors in the spun-off companies shall not constitute more than 50%;
- b. Assets and liabilities shall be distributed between these companies as per special financial statements to be submitted to the tax authorities, based mainly on book values;
- c. Losses for tax purposes shall be distributed between these companies pro rata to their equity;
- d. Benefits accruing under the Law for the Encouragement of Capital Investments shall be computed on a consolidated basis until the second stage of the plan is implemented and/or until another method is decided upon;
- e. The Company can file consolidated tax returns for itself and its new subsidiaries, committing to pay tax on the consolidated results of operations;
- f. Certain earnings and losses shall be taxable as stated in the letter of approval, and
- g. If the second stage comes into effect and one or more of these companies is split off will reach \$ 15 million.

As mentioned in Note 1A(2), the Company notified the tax authorities of the retroactive cancellation of the split-up plan. In the opinion of Management, which is based on the advice of its professional consultants, the application will be accepted by the tax authorities.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 16 - Related Party Transactions**

Related parties are comprised of principal shareholders (10% and up of the Company's share capital) and their subsidiaries and affiliates as well as affiliates of the Company.

Transactions with related parties are mainly as follows:

- a. sales of certain of the Company's products and expenses related to such sales;
- b. financing expenses owing to the issue of capital notes convertible into shares and working capital balances;

A. Balances due to or from related parties:

	<u>December 31</u> <u>2003</u> <u>\$ in thousands</u>	<u>December 31</u> <u>2002</u> <u>\$ in thousands</u>
Assets:		
Trade receivables	3,530	8,738
Other receivables	317	35
Liabilities:		
Trade payables	3,635	-
Other payables	10,064	1,016

B. Income from, and expenses to, related parties:

	<u>Year ended December 31</u>		
	<u>2003</u> <u>\$ in thousands</u>	<u>2002</u> <u>\$ in thousands</u>	<u>2001</u> <u>\$ in thousands</u>
Sales	28,473	4,945	3,787
Cost of revenues	8,751	2,264	3,659
Selling and marketing expenses	2,779	2,043	182
General and administrative expenses	1,498	5,338	93
Financial expenses	15	108	-
Financial income	46	-	-

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information
Balance sheet:
A. Cash and cash equivalents

Including deposits of \$ 127,649 thousand at December 31, 2003 (December 31, 2002 - \$ 334,308 thousand).

B. Short-term investments

Including restricted balances of \$ 1,035 thousand at December 31, 2003 (December 31, 2002 - \$ 1,035 thousand).

C. Trade receivables

Net of provision for doubtful accounts of \$ 42,904 thousand at December 31, 2003 (December 31, 2002 - \$ 34,764 thousand).

The activity in the allowance for doubtful accounts for impaired notes receivable for the years ended December 31, 2003 and 2002 follows:

	<u>2003</u>	<u>2002</u>
	<u>\$ in thousands</u>	<u>\$ in thousands</u>
Allowance for doubtful accounts at beginning of year	34,764	28,974
Additions charged to bad debt expense	10,378	9,652
Write-down charged against the allowance	(1,200)	(2,769)
Recoveries of amounts previously charged off	(1,038)	(1,093)
Allowance for doubtful accounts at end of year	<u>42,904</u>	<u>34,764</u>

As to sales of certain trade receivables, see Note 17P.

D. Other receivables

	<u>December 31</u>	<u>December 31</u>
	<u>2003</u>	<u>2002</u>
	<u>\$ in thousands</u>	<u>\$ in thousands</u>
Employees	1,252	1,608
Chief Scientist	2,033	3,054
Deferred income tax	2,043	1,357
Tax authorities	289	-
Accrued income	976	706
Advances to suppliers	816	2,552
Related parties	317	35
Others	9,371	14,882
	<u>17,097</u>	<u>24,194</u>

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)
E. Short-term loans and current maturities of long-term debts

Consist of the following:

	<u>December 31</u> <u>2003</u> <u>\$ in thousands</u>	<u>December 31</u> <u>2002</u> <u>\$ in thousands</u>
Short term loans	-	70,012
Current maturities of long term debts *	<u>30,000</u>	<u>160,000</u>
	<u><u>30,000</u></u>	<u><u>230,012</u></u>

F. Other payables and accrued liabilities

Consist of the following:

	<u>December 31</u> <u>2003</u> <u>\$ in thousands</u>	<u>December 31</u> <u>2002</u> <u>\$ in thousands</u>
Employees and social benefits	31,092	32,654
Chief Scientist	1,149	15,454
Tax authorities	5,235	9,107
Commissions payable	17,932	22,979
Advances from customers	8,888	4,179
Warranty accrual (*)	7,308	9,546
Accrued expenses	31,832	29,850
Other payables and accrued liabilities	<u>14,590</u>	<u>10,057</u>
	<u><u>118,026</u></u>	<u><u>133,826</u></u>
(*) Balance at the beginning of the year	9,546	12,485
Warranty expenses	(5,104)	(6,052)
Change in accrual	<u>2,866</u>	<u>3,113</u>
Balance at the end of the year	<u><u>7,308</u></u>	<u><u>9,546</u></u>

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)**G. Disclosures about segments and related information****1. Segment Activities Disclosure:**

Segment information is presented in accordance with SFAS 131, "*Disclosures about Segments of an Enterprise and Related Information*." This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and internal financial reports to management. The Company's internal financial reporting systems present various data for management to run the business, including statement of operations (P&L).

In 2003, following the sale of NGTS and the merger of Enavis and Lightscape, there was a change in the segments of the Company. Accordingly, in prior years the results of Enavis and NGTS were classified under Optical Networks and Others, respectively.

Hereunder the Company's segments:

Broadband Access Division (formerly - Inovia)

The access systems division focuses on the development and production of access products for communications systems, including broadband solutions which make it possible to transfer multi-media content, as well as narrowband solutions. These products are designed to increase the transmission capacity of cable systems, as well as SDSL and ADSL systems designed for wideband home internet applications on copper wires (telephony).

Optical Network Division (formerly - Lightscape and Enavis)

The division is a supplier of intelligent optical networking solutions for the metro and regional optical markets. It provides fully managed and scalable optical networks allowing "just on time" seamless coupling of network growth to the changing service needs of the operator, while delivering a variety of services including data, voice and video by means of optic DWDM, SDH/Sonet or Gigabit, Ethernet or other data transmission interfaces.

The products are based on advanced synchronic digital hierarchy and optical technologies. Its lead product is the XDM, an optical dubbing system based on a new technique of band flattening which makes extensive use of state-of-the-art technology. The XDM enables the user to choose the initial platform for simple, low-speed, applications and, at a later stage, to expand them as required, simply, efficiently and at low cost

In addition, the division develops, markets and supplies modular solutions for broadband management on cross connect platforms, enabling operators to provide services in a variety of protocols and technologies, thus profiting from the width of the band laid in the optical infrastructure.

It provides network management systems and manufactures advanced digital cross – connect systems combining voice with data, multiplexers and other products.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)**G. Disclosures about segments and related information (cont'd)****1. Segment Activities Disclosure: (cont'd)**ECtel (ECTL)

ECtel is a developer and provider of Quality of Service (QoS) and performance monitoring, fraud prevention and billing mediation solutions for telecom service providers worldwide.

See also Note 21

Other

The Other segment contains mainly the Company's manufacturing and service units; head office and management services; general and project management services to outside customers and others; sales and marketing activities for certain products of the above divisions outside Israel, through the Company's subsidiaries; and other investments which are not identified with any of the operational segments.

The Company's manufacturing and service units serve as a manufacturing and service sub-contractors and carries out activities primarily for the above divisions and for Veraz. The sales to the divisions do not generate profits. The cost of manufacturing is included in the cost of sales of each of the divisions, as applicable. The above divisions are charged on a specific basis, so that their costs reflect the production costs of the manufacturing and service units with respect to the goods and services developed and sold by each respective division.

Included in the Other segment until December 2002, were the activities of the Company's NGTS (Next Generation Telephony System) division, whose principal operations were transferred to Veraz. (See Note 5A.) This division developed and manufactured solutions for the transmission of telephony over internet protocol (IP) networks at carrier grade levels of quality, reliability and density. It specialized in supplying media gateways connecting IP networks to traditional communication networks and offered combined solutions for the transmittal of telephony over IP networks, including telephony carriers, software switching, management and service systems, combined with value added and third party services.

Among the other former operations included in the Other segment were the activities of the ECI Business Systems unit (until its sale in November 2001), which specialized in end equipment and switching systems for businesses in Israel and abroad.

See also Note 21 on the discontinued operations of InnoWave.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)

G. Disclosures about segments and related information (cont'd)

2. Operational segments statement operation disclosure:

The following financial information is the information that management uses for analyzing the results. The figures are presented in consolidated method as presented to management.

	Year ended December 31, 2003				
	Optical Network	Broadband Access	ECtel	Other	Consolidated
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
Revenues	177,706	182,290	28,857	32,571	421,424
Operating expenses**	207,659	165,863	58,804	42,189	474,515
Impairment of assets	-	-	6,019	667	6,686
Restructuring expenses	7,243	478	-	673	8,394
Operating profit (loss)	(37,196)	15,949	(35,966)	(10,958)	(68,171)
	Year ended December 31, 2002				
	Restated*				
	Optical Network	Broadband Access	ECtel	Other	Consolidated
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
Revenues	233,218	241,807	52,426	75,409	602,860
Operating expenses**	262,754	237,154	54,106	118,908	672,922
Impairment of assets	-	-	-	3,725	3,725
Loss from exchange of assets	-	-	-	6,783	6,783
Operating profit (loss)	(29,536)	4,653	(1,680)	(54,007)	(80,570)

* See Note 1A(8)

** Including cost of sale, research and development costs, selling and marketing expenses, general and administrative expenses and amortization of related intangible assets.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)
G. Disclosures about segments and related information (cont'd)
2. Operational segments statement operation disclosure:

	Year ended December 31, 2001				
	Optical Network	Broadband Access	ECtel	Other	Consolidated
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
Revenues	311,756	332,338	60,951	166,703	871,748
Operating expenses*	378,505	438,608	51,776	200,200	1,069,089
Impairment of assets	44,766	39,806	-	11,954	96,526
Liability for royalties payable to the Chief Scientist	-	8,394	-	-	8,394
Restructuring and spin-off expenses	7,909	4,365	-	7,107	19,381
Purchase of in- process research and development	-	-	916	-	916
Operating profit (loss)	(119,424)	(158,835)	8,259	(52,558)	(322,558)

* Including cost of sale, research and development costs, selling and marketing expenses, general and administrative expenses and amortization of related intangible assets.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 17 - Supplementary Financial Statement Information (cont'd)
G. Disclosures about segments and related information (cont'd)

3. The following financial information identifies the assets to segments:

	Year ended December 31, 2003				
	Optical Network	Broadband Access	ECtel	Other	Consolidated
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
Assets*	189,235	108,288	59,229	201,850	558,602
Depreciation and amortization**	18,332	11,208	7,897	10,009	47,469
Capital investments	11,322	4,130	2,503	7,681	25,636

	Year ended December 31, 2002				
	Optical Network	Broadband Access	ECtel	Other	Consolidated
	\$ thousands	\$ thousands	\$ thousands	\$ thousands	\$ thousands
Assets *	254,464	126,990	104,170	213,810	699,434
Depreciation and amortization**	24,104	10,988	1,873	23,211	60,176
Capital investments	13,871	4,718	1,961	4,318	24,868

* The assets include: trade receivables (short and long-term), inventories, property, plant and equipment, goodwill and other intangibles.

** Including impairment of assets.

4. Sales to significant customers

The following table summarizes the percentage of sales to significant customers group (when they exceed 10 percent of total revenue for the year):

	Year ended December		
	2003	2002	2001
Customer 1	18%	21%	(*)
Customer 2	10%	10%	23%

(*) Less than 10 percent of total revenue.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)

G. Disclosures about segments and related information (cont'd)

5. Information on sales by geographic distribution

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
North America	23,522	41,299	95,448
Europe	246,666	355,064	424,155
Africa, Asia Pacific and Australia	68,334	134,537	193,180
Israel	62,914	32,519	107,416
Others	19,988	39,441	51,549
	421,424	602,860	871,748

H. Cost of revenues

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Materials and components consumed	148,401	220,391	534,711
Salaries, wages and employee benefits	41,318	51,192	82,103
Depreciation and amortization	12,756	15,267	17,911
Other manufacturing and other service costs	44,264	53,205	33,815
Cost of revenues	246,739	340,055	668,540
Decrease (increase) in inventories of work in process and finished products	10,983	21,707	(56,795)
	257,722	361,762	611,745
Provision for inventory write off (see also Note 20)	-	7,446	99,163
Royalties to the government (see Note 11(C)(1))	* (969)	10,272	14,523
	256,753	379,480	725,431

(*) In 2003, the Company reached an arrangement with the Chief Scientist according to which it would be credited with the amounts of the excess royalties that were paid in respect of the sale of certain products in prior years. Such credits amount to \$ 6.3 million.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)

I. Research and Development costs, net

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Expenses incurred	87,478	112,063	150,861
Less - grant participations (see Note 11C)	15,358	22,732	30,106
	72,120	89,331	120,755

J. Selling and marketing expenses

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Salaries and employee benefits	40,709	47,863	61,173
Agents' commissions	13,955	20,199	22,133
Advertising and exhibitions	2,411	2,268	2,272
Foreign travel	5,855	7,460	7,083
Other	25,010	33,206	43,237
	87,940	110,996	135,898

K. General and administrative expenses

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Salaries and employee benefits	18,967	24,106	34,217
Rent and maintenance of premises	2,059	3,350	2,367
Bad and doubtful debt expenses	(**)22,356	(*)50,144	20,576
Other	12,547	13,755	19,658
	55,929	91,355	76,818

(*) See also Note 4C(2)

(**) See also Note 4C(3)

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)

L. Financing income, net

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Financing expenses:			
Interest on loans from banks	2,449	10,036	17,975
Interest and bank charges	1,389	3,198	5,158
Exchange rate differences (see Note 1A(6))	4,504	4,480	3,534
Loss on revaluation of marketable securities	-	661	-
	8,342	18,375	26,667
Financing income:			
Interest mainly on bank deposits and receivables	6,397	20,603	24,534
Exchange rate differences (see Note 1A(6))	624	3,739	4,030
Gain on sale and revaluation of marketable Securities	770	-	3,220
	7,791	24,342	31,784

M. Other income (expenses), net

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Gain from sale of shares and issuance of new shares in a consolidated subsidiary ⁽¹⁾	-	11,397	5,144
Loss from sale of an affiliated company	-	-	(7,299)
Loss from sale of property and equipment, net	(167)	(881)	(1,521)
Loss from realization of investment and allowance for impairment of investments ⁽²⁾	(1,587)	(3,139)	(13,000)
Decline in value of convertible notes (see Note 5B)	(3,400)	(18,000)	-
Other expenses, net	(232)	(464)	(241)
Capital loss from sale of business operations ⁽³⁾	-	-	(17,708)
Capital gain from disposal of consolidated companies	-	-	2,433
Total other expenses, net	(5,386)	(11,087)	(32,192)

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)
M. Other income (expenses), net (cont'd)

- (1) During 2002, the Company sold 8.5% of the share capital of ECtel. As a result, the Company recognized a pre-tax gain of \$ 11.4 million. Following the sale and conversion of options, the Company's holding in ECtel decreased to 59%.
- (2) Arising from a permanent impairment in the value of an investments. The write down is based, among other factors, on stock exchange prices, the operations of the investee and a series of other relevant considerations.
- (3) During the fourth quarter of 2001, the Company completed the transaction for the sale of a division, which does not consist a segment, to a group of investors in consideration for \$ 12,500 thousand. Under the agreement, all assets and liabilities of the Division were transferred, including liabilities related to employee severance agreements amounting to \$ 27.5 million, serving as a cover for employee severance payments until the year 2012. (See also Note 17G).

N. Supplementary Statement of Operations information

	Year ended December 31		
	2003	2002	2001
	\$ in thousands	\$ in thousands	\$ in thousands
Expenses:			
Maintenance and repairs	9,963	7,459	9,476
Depreciation of property, plant and equipment	23,830	32,009	29,022
Taxes (other than income taxes)	2,171	2,453	2,911
Rent	11,507	21,200	20,244
Advertising costs	1,980	2,558	3,463
Royalties	162	11,412	15,231
Amortization of capitalized software	15,157	19,939	20,901

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 17 - Supplementary Financial Statement Information (cont'd)
O. Loss per share ("LPS")

Following are the details of the basic and diluted LPS:

	2003			2002			2001		
	Net loss	Number of shares	Loss per share amount	Net loss	Number of shares	Loss per share amount	Net loss	Number of shares	Gain per share amount
	<u>\$ in thousands</u>	<u>in thousands</u>	<u>\$</u>	<u>Restated(*)</u> <u>\$ in thousands</u>	<u>in thousands</u>	<u>Restated(*)</u> <u>\$</u>	<u>\$ in thousands</u>	<u>in thousands</u>	<u>\$</u>
Loss for continuing operation	<u>(65,699)</u>	<u>107,831</u>	<u>(0.61)</u>	<u>(96,088)</u>	<u>105,512</u>	<u>(0.91)</u>	<u>(352,146)</u>	<u>92,896</u>	<u>(3.79)</u>
Cumulative effect of accounting change, net of taxes	<u>-</u>	<u>-</u>	<u>-</u>	<u>(550)</u>	<u>105,512</u>	<u>(0.01)</u>	<u>1,710</u>	<u>92,896</u>	<u>0.02</u>
Discontinued operations	<u>(5,371)</u>	<u>107,831</u>	<u>(0.05)</u>	<u>(65,830)</u>	<u>105,512</u>	<u>(0.62)</u>	<u>(61,940)</u>	<u>92,896</u>	<u>(0.67)</u>
Net loss per share	<u>(71,040)</u>	<u>107,831</u>	<u>(0.66)</u>	<u>(162,468)</u>	<u>105,512</u>	<u>(1.54)</u>	<u>(412,376)</u>	<u>92,896</u>	<u>(4.44)</u>

(*) see Note 1A(8)

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 17 - Supplementary Financial Statement Information (cont'd)**P. Factoring of financial assets**

The Company entered into accounts receivable factoring agreements with a number of financial institutions ("banks"). Under the terms of the agreements, the Company has the option to factor receivables, with the banks on a non-recourse basis, provided that the banks approve the receivables in advance. In some cases, the Company continues to be obligated in the event of commercial disputes, (such as product defects) which are not covered under the credit insurance policy, unrelated to the credit worthiness of the customer. The Company accounts for the factoring of its financial assets in accordance with the provisions of SFAS No. 140.

The agreements call for factoring fees on invoices or promissory notes factored with the banks, as follows: USD and EUR transactions – in most cases, Libor for the relevant period on the basis of the semi-annual discount to yield plus a margin of 1.8% per annum on average. In the past, there were no cases in which the Company had to reimburse the banks for accounts receivables following business disputes. The Company does not expect any reimbursements to take place in the foreseeable future.

As at December 31, 2003, trade receivables amounting to \$ 16,671 thousand (December 31, 2002 - \$ 45,634 thousand) were factored.

Note 18 - Relevant Recently Enacted Accounting Standards**A. FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity**

On May 15, 2003, the FASB issued FASB Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This Statement established standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatory redeemable financial instruments of nonpublic entities. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. For nonpublic entities, mandatory redeemable financial instruments are subject to the provisions of this Statement for the first fiscal period beginning after December 15, 2003. FASB staff position 150-3 defers the effective date of FASB 150 for certain mandatory controlling interests. The Company believes that the adoption of FASB 150 will not have an impact on its consolidated financial statements.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 18 - Relevant Recently Enacted Accounting Standards (cont'd)
B. FASB Interpretation No. 46 (revised December 2003) Consolidation of Variable Interest Entities

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was issued in January 2003.

The Company will be required to apply FIN 46R to variable interests in VIEs no later than March 31, 2004. For any VIEs that must be consolidated under FIN 46R the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. The Company believes that the adoption of FIN 46R will not have an impact on its consolidated financial statements.

Note 19 - Acquisitions
A. Tadiran Telecommunications Ltd. (hereinafter "TTL")

Effective the first quarter of 1999, ECI completed the merger with TTL (hereinafter "merger").

The cost of the purchase totaled \$403.8 million, which included cost excesses in the amount of \$229.9 million, as follows:

	<u>\$ in thousands</u>
R&D in process(*)	87,327
Goodwill and intangible assets	<u>142,583</u>
	<u>229,910</u>

* See Note 19E below.

In the merger agreement, the Company undertook to indemnify the seller in respect of losses and damages incurred by the latter in respect of future taxes imposed on the Company or certain of its subsidiaries and for which a provision was not fully provided in respect thereof in the financial statements of the Company.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 19 - Acquisitions (cont'd)**B. Wave Pacer DSL Division**

In April 2000, ECI and its subsidiary purchased WavePacer, Pulse Communications Inc.'s Digital Subscriber Line (DSL) business unit located in Herdon, Virginia, for an initial cash consideration of \$62.7 million.

The excess of the purchase price over the fair value of the net tangible assets amounted to \$59 million, of which \$20.5 million related to in-process research and development, which has been written off to the statement of income (as to the valuation of IPR&D - See Note 19E.).

In 2001, management of the Company decided that the value of goodwill had been impaired and accordingly a provision was recorded for the said decline in value of the goodwill - See Note 20A(2).

C. WinNet Metropolitan Communication System Inc. (WinNet).

In June 2000, a wholly owned subsidiary purchased for a total consideration of \$40.5 million, all the rights in WinNet Metropolitan Communications Systems Inc., an emerging broadband wireless communications company, located in the Silicon Valley in California. In addition, the Company paid approximately an additional \$ 7 million, since certain milestones stipulated in the purchase agreement were achieved during 2000.

The excess of the purchase price over the fair value of the net tangible assets amounted to \$ 47.6 million, of which \$ 8.3 million related to in-process research development, which has been written off to the statement of income. (As to the valuation of IPR&D - See Note 19(E) below).

In 2001 Management of the Company decided that the value of goodwill had been impaired and accordingly a provision was recorded for the said decline in value of the goodwill.

D. Acquisition of Telrad Hawk Net-I Ltd. ("NetEye")

On October 1, 2001, ECTel, a consolidated company, acquired, from a related party, complete ownership of NetEye, including shareholders' loans. NetEye is engaged in the research, development and marketing of real time fraud management in Internet and next generation telecommunications networks. In consideration of the purchase, ECTel issued shares and options totalling \$ 16,500 thousand. The transaction was accounted for by the purchase method according to SFAS No. 141. Goodwill, in the amount of \$ 16,348 thousand and other intangible assets arising from acquisition of shares of NetEye are subject to amortization in accordance with SFAS No. 142. According to the requirements of SFAS No. 142, goodwill and other intangible assets with indefinite useful lives are no longer amortized, but instead tested for impairment at least annually.

In 2003, Management of ECTel decided that the value of goodwill had been impaired and accordingly a provision was recorded for the said decline in value of the goodwill - see Note 20B(1).

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 19 - Acquisitions (cont'd)****E. In process research and development (IPR&D)**

In process research and development was calculated in accordance with an external valuation which is based on the principles stated in SFAS 2 and its related clarifications, regarding research and development components that have not yet developed into proof of technological feasibility and for which there is no future alternative use. The calculation of the research and development stage of each R&D project included:

- Analysis of the completion and development stage of each R&D project.
- Estimate of the costs required to complete the project and bring it to maturity.
- The anticipated contribution from sale of the products being developed by the R&D project

Note 20 - Restructuring, Impairment of Assets and Loss from Exchange of Assets**A. For the year ended December 31, 2003****1. Restructuring expenses**

As part of the Company's Board of Directors' decision to focus on its two core activities, the Company recorded \$ 8.4 million in reorganization expenses associated largely with the integration of Lightscape Optical Networks and Enavis Networks into the Optical Networks Division, mainly termination benefits and rent contract expenses as follows:

	<u>Year ended December 31 2003</u> \$ thousands
Severance expenses	6,120
Rent contract expenses	2,274
	<u>8,394</u>

A reconciliation of the beginning and ending restructuring liability balances is as follows:

	<u>Severance pay</u> \$ thousands	<u>Rent contract</u> \$ thousands	<u>Total</u> \$ thousands
At the beginning of the year	-	3,944	3,944
Restructuring expenses	6,120	2,274	8,394
Paid	(2,428)	(768)	(3,196)
Classified to pension liability	(2,985)	-	(2,985)
At the end of the year	<u>707</u>	<u>5,450</u>	<u>6,157</u>

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 20 - Restructuring, Impairment of Assets and Loss from Exchange of Assets (cont'd)**A. For the year ended December 31, 2003 (cont'd)****2. Impairment of assets**

During the reporting period, the Company recorded \$6.7 million impairment charge associated mainly with ECTel, a consolidated company, arising from the write-down of goodwill from its Net-Eye acquisition in October 2001 (see Note 19D).

In June 2003, due to significant reduction in ECTel's revenues, it was determined that goodwill has been impaired. ECTel obtained an independent appraisal to assess whether goodwill carried on the books needed to be written down. The independent appraisal used the Discounted Cash Flow ("DCF") approach to measure the fair value of the goodwill. Under the DCF approach, the fair value of the goodwill is dependent on the present value of future economic benefits to be derived from the reporting unit to which the goodwill was attributed. Future net cash flows available for distribution are discounted at a discount rate of 17.7%, which management believes reflects the risk of the Company.

ECTel wrote down the impaired goodwill by \$ 6.0 million to its present fair value of \$ 10.3 million.

B. For the year ended December 31, 2002**1. Impairment of assets**

During 2002, the Company made a provision of \$ 3.7 million for a decline in value of assets relating to land and building including in property, plant and equipment and also, wrote off \$ 7.4 million of inventory relating to discontinued production and marketing of certain products.

See Note 21 regarding impairment of goodwill and other intangible assets.

2. Loss from exchange of assets

In December 2002, the Company closed a transaction pursuant to which it transferred the VOIP and other activities, including certain related net assets with book value of \$ 19.6 million, of the business NGTS, plus \$10 million in cash, to NexVerse Networks, in exchange for approximately 43% (fully diluted 36%) of the shares of NexVerse. The name of the Company resulting from this transaction was changed to Veraz Networks.

During 2003 a third party valuation commissioned by Veraz was finalized, which evaluated among other things, the fair value of the shares transferred to ECI as at December 31, 2002. The valuation indicated that the fair market value as at December 31, 2002 of the Veraz shares held by ECI to be \$ 22.8 million. Due to the fact that the value of the shares received by ECI was less than the value of the assets transferred, ECI recorded a loss from exchange of assets of \$ 6.8 million.

Notes to the Consolidated Financial Statements as at December 31, 2003

Note 20 - Restructuring, Impairment of Assets and Loss from Exchange of Assets (cont'd)**C. For the year ended December 31, 2001**

During 2001 the Company's management had to adjust its forecast for 2001 revenues significantly, due to the sharp and unexpected decline in demand for telecommunication equipment, including the Company's products. Management therefore decided to make far-reaching cutbacks, including, among other steps, the dismissal of 1,400 employees (in addition to the 400 whose employment was terminated at the end of December 2000), representing 30% of its total work force.

It was also decided to abandon manufacturing and marketing of certain product lines as well as marketing activities in certain geographic areas.

Following this, the Company included losses in its financial statements regarding Inventory write-offs, impairment of long lived assets (mainly goodwill) and other expenses relating to restructuring (mainly severance pay), as detailed below:

1. Inventory write-off

Following the adjusted budget and abandonment of products as described above, the Company wrote off \$ 99.2 million of inventories which, in its estimation, reflects the write-off of inventory to its fair market value.

2. Impairment of long-lived assets

- (a) During the second quarter of 2000, the Company acquired an activity ("Wavepacer") in the United States, which is engaged in developing products for access solutions, in the amount of \$ 62.7 million (see Note 19B).

During 2001, material changes took place worldwide in the telecommunications market, which had far-reaching implications for the Company. Management therefore decided to halt the development activities of Wavepacer and to dismiss most of its employees.

Accordingly, the financial statements for 2001 include a loss totalling \$ 35 million representing the decline in value of goodwill and other intangible assets owing to the acquisition of the above business. This figure reflects, in management's opinion, the value of assets which are not recoverable. In determining the amount of the write down, the Company followed the guidance of FAS 121 using a discounted cash flow model.

- (b) Following material changes in the operations of Enavis and their effect on the results of operations which are reflected by, inter alia, a decline of about 50% in the volume of sales as compared to sales in the past, and in light of the examination made by management of the Company of the updated business model, budgets and forecast of cash flows for the future operations of Enavis, a \$ 44 million loss was recorded in the financial statements owing to a decline in the value of the goodwill of Enavis. The figure was determined according to the guidelines of SFAS 121.
- (c) The financial statements include losses from the decline in value of additional intangible assets and other fixed assets in the amount of \$ 17.6 million.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 20 - Restructuring, Impairment of Assets and Loss from Exchange of Assets (cont'd)****3. Restructuring and spin off expenses**

As part of the sharp and unexpected decline in demand for telecommunication equipment, including the Company's products, the managers of the Company as well as of the various subsidiaries made decisions with respect to business and operating plans. It was decided to stop manufacturing and developing certain products including the related costs the Company will have to pay, to dismiss employees and other expenses related to the reorganization, as follows:

	Year ended December 31 2001
	\$ thousands
Severance expenses	9,675
Rent contract expenses *	5,995
Consultation (legal, tax and other)	1,475
Other (mainly because of cancellation of contracts)	2,236
	<u>19,381</u>

* From which no economic benefit is expected, due to shut down of operations.

Note 21 - Discontinuance of Operations

- A.** During the third quarter of 2002, the Company's Board of Directors decided on a plan to sell the operations of the InnoWave segment, which specializes in development of solutions for broadband wireless access to communications networks.

In April 2003, the Company signed an agreement with Alvarion to sell the InnoWave operation. The total value of the transaction was approximately \$ 20 million, consisting of a cash consideration paid by Alvarion and the cash balances withdrawn by ECI at closing. In addition, Alvarion granted warrants to purchase 200,000 Alvarion shares over a period of five years at an exercise price of \$ 3 per share (of which, warrants to purchase 50,000 were to be transferred to certain key InnoWave employees being transferred to Alvarion).

- B.** During the reporting period, ECTel's Board of Directors decided on a plan to sell the operations of the Government segment of ECTel, which provides telecommunication monitoring needs to government agencies.

The Company found a purchaser for the Government segment and intends to sign a definite agreement with him shortly after the date of these financial statements. (See Note 22).

The assets and liabilities which relate to the discontinued operations are presented in separate categories in the current assets and current liabilities sections, respectively. A loss from discontinued operations is presented in the statements of operations after the loss from continuing operations.

Notes to the Consolidated Financial Statements as at December 31, 2003**Note 21 - Discontinuance of Operations (cont'd)****C. Assets and liabilities of the discontinued segment and discontinued operation**

	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
<u>Assets relating to discontinued segment and discontinued operation*</u>		
Trade and other receivables	-	8,883
Inventory	332	8,798
Long-term receivables	-	2,234
Property, plant and equipment	1,394	733
Other assets	589	
	2,315	20,648
	December 31 2003	December 31 2002
	\$ in thousands	\$ in thousands
<u>Liabilities relating to discontinued segment and discontinued operation*</u>		
Trade payables	-	2,699
Other payables	541	9,449
Liability for employee severance benefits, net	194	-
	735	12,148

* The assets and liabilities as of December 31, 2003 relate to the discontinued Governmental segment.

The assets and liabilities as of December 31, 2002, relate to the discontinued Innowave segment.

Notes to the Consolidated Financial Statements as at December 31, 2003
Note 21 - Discontinuance of Operations (cont'd)
D. Results of operations of the discontinued segment and discontinued operation

	Year ended December 31		
	2003	2002	2001
	<u>\$ in thousands</u>	<u>\$ in thousands</u>	<u>\$ in thousands</u>
Segment and operation revenues	15,840	89,988	142,881
Segment and operation expenses ⁽¹⁾	21,211	119,172	204,821
Cumulative effect of an accounting change, net (Note 1U1)	-	36,646	-
Results of segment and operation activities	<u>(5,371)</u>	<u>(65,830)</u>	<u>(61,940)</u>

⁽¹⁾ Including impairment of long-lived assets for the years ended December 31, 2002 and 2001, in the amount of \$ 22,678* thousand and \$ 26,980 thousand, respectively, (see note 19C).

* As a result of the decline in the first quarter of 2002 in the demand for products of InnoWave, Management updated its forecast of anticipated sales. In accordance with the provisions of SFAS 144 (see Note 1V), a loss was recorded from the decline in value of intangible assets in InnoWave in the amount of \$ 15,835 thousand. Also as a result of the expected disposal proceeds, the Company wrote down property, plant and equipment in the amount of \$ 6,843 thousand

Note 22 - Subsequent Event

- A.** On February 9, 2004 - ECTel, a subsidiary of the Company, signed a definitive agreement to sell its Government Surveillance business to Verint Systems Inc. for approximately \$35 million in cash. According to the terms of the transaction, the Company will transfer to Verint various assets and liabilities relating to its Government Surveillance business. It is expected that the impact of the transaction will be recorded in the Company's first quarter financial statements. The transaction is subject to customary closing conditions, including regulatory approvals.
- B.** On March 9 2004, the Board of Directors of ECI decided, in principle, that ECI will distribute 7.6 million of its shares in ECTel Ltd. to ECI's shareholders. ECI currently holds approximately 10.5 million, or 58%, of ECTel's shares. After distribution of the shares, ECI will hold approximately 16% of ECTel's outstanding shares. The distribution of the shares is subject to approval by the Tel Aviv District Court, the consent of ECI's banks and a ruling from the tax authorities. The Board intends to declare the distribution and fix the record date when these approvals are obtained.

ELRON ELECTRONIC INDUSTRIES LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2003

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REPORT OF INDEPENDENT AUDITORS

To the Shareholders of
ELRON ELECTRONIC INDUSTRIES LTD.

We have audited the accompanying consolidated balance sheet of Elron Electronic Industries Ltd. (the "Company") and its subsidiaries as of December 31, 2003, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the year then ended. 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 audit.

We did not audit the financial statements of certain affiliates, the investment in which, at equity, amounted to \$ 46.8 million as of December 31, 2003, and the Company's equity in their losses amounted to \$ 9.7 million for the year then ended. 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 audit in accordance with auditing standards generally accepted in the 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit 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, 2003 and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2(s) to the consolidated financial statements, on January 1, 2003, the Company adopted SFAS 123, "Accounting for Stock - Based Compensation" with respect to all employee awards granted, modified or settled after January 1, 2003.

Tel-Aviv, Israel
March 10, 2004

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

REPORT OF INDEPENDENT AUDITORS

To the Shareholders of
ELRON ELECTRONIC INDUSTRIES LTD.

We have audited the accompanying consolidated balance sheet of Elron Electronic Industries Ltd. (the "Company") and its subsidiaries, as of December 31, 2002 (as restated – see Note 7(d)7), and the related restated consolidated statements of operations, changes in shareholders' equity and cash flows for each of the two years in the period ended December 31, 2002. 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 subsidiaries, whose assets constitute 4.5% of consolidated total assets as of December 31, 2002, and whose net losses constitute approximately 4.8% of consolidated net loss for the year ended December 31, 2002. Also, we did not audit the financial statements of certain affiliates, the investment in which, at equity, amounted to \$13.0 million as of December 31, 2002, and the Company's equity in their losses amounted to \$4.6 million and \$8.1 million for the years ended December 31, 2002 and 2001, 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 auditing standards generally accepted in the 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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, 2002 and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in United States. As discussed in note 2(l) to the consolidated financial statements, on January 1, 2002, the Company adopted SFAS 142, "Goodwill and Other Intangible Assets".

Luboshitz Kasierer
An affiliate member of Ernst & Young International

Tel Aviv, Israel
March 12, 2003, except as
to Note 7(d)7 which is
dated March 10, 2004

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	Note	December 31,	
		2003	2002
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents	4	\$ 83,906	\$ 67,901
Short-term investments	5	37,158	3,180
Trade receivables, net **	6	5,016	9,238
Other receivables and prepaid expenses **		2,516	4,528
Inventories and contracts-in-progress		<u>1,471</u>	<u>2,197</u>
Total current assets		<u>130,067</u>	<u>87,044</u>
LONG-TERM ASSETS			
Investments in affiliated companies	7	156,819	*132,204
Investments in other companies and long-term receivables **	8	128,799	* 89,134
Debentures and bank deposits	10	700	28,928
Deferred taxes	16	1,871	2,990
Severance pay deposits		<u>2,144</u>	<u>2,262</u>
Total long-term assets		<u>290,333</u>	<u>255,518</u>
PROPERTY AND EQUIPMENT, NET	11	<u>8,317</u>	<u>11,576</u>
INTANGIBLE ASSETS	12		
Goodwill		12,019	21,538
Other intangible assets		<u>9,968</u>	<u>18,577</u>
		<u>21,987</u>	<u>40,115</u>
Total assets		<u>\$ 450,704</u>	<u>\$ 394,253</u>

* Restated - see Note 7(d)(7).

** Include receivables from related parties in the aggregate amount of \$3,684 and \$2,462 as of December 31, 2003 and 2002, respectively.

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	<u>Note</u>	<u>December 31,</u>	
		<u>2003</u>	<u>2002</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT LIABILITIES			
Short-term loans from banks and others	13	\$ 11,986	\$ 15,362
Current maturities of long-term loans from banks and others	15	44,021	17,637
Trade payables		3,408	5,738
Other payables and accrued expenses	14	<u>13,620</u>	<u>16,516</u>
Total current liabilities		<u>73,035</u>	<u>55,253</u>
LONG-TERM LIABILITIES			
Long-term loans from banks and others	15	17,221	49,389
Accrued severance pay and retirement obligations		2,850	2,921
Deferred taxes	16	40,684	23,650
Other		<u>103</u>	<u>414</u>
Total long-term liabilities		<u>60,858</u>	<u>76,374</u>
MINORITY INTEREST		<u>20,681</u>	<u>3,185</u>
SHAREHOLDERS' EQUITY:	18		
Ordinary shares of NIS 0.003 par value; Authorized: 35,000,000 shares as of December 31, 2003 and 2002; Issued and outstanding: 29,206,845 and 29,180,970 shares as of December 31, 2003 and 2002, respectively;		9,572	9,572
Additional paid-in capital		267,113	267,482
Accumulated other comprehensive income		51,792	7,529
Accumulated deficit		<u>(32,347)</u>	<u>* (25,142)</u>
Total shareholders' equity		<u>296,130</u>	<u>259,441</u>
Total liabilities and shareholders' equity		<u>\$ 450,704</u>	<u>\$ 394,253</u>

*Restated - See Note 7 (d)(7)

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

March 10, 2004	Ami Erel	Avraham Asheri	Doron Birger
Date of approval of the financial statements	Chairman of the Board of Directors	Director	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	Year ended December 31		
		2003	* 2002	* 2001
INCOME				
Net revenues**		\$ 16,547	\$ 15,179	\$ 23,782
Equity in losses of affiliated companies	20	(8,698)	*(24,189)	*(28,787)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	21	25,754	6,888	3,179
Other income (expenses), net	22	14,665	(743)	(4,888)
		48,268	(2,865)	(6,714)
COSTS AND EXPENSES				
Cost of revenues		10,198	10,716	21,059
Research and development costs, net		3,787	3,418	3,801
Marketing and selling expenses, net		7,763	6,412	2,496
General and administrative expenses		13,923	9,658	9,390
Restructuring costs	24	-	1,747	1,192
Amortization of intangible assets		1,073	1,044	2,448
Financial expenses (income), net	23	753	81	(1,708)
		37,497	33,076	38,678
Income (loss) before tax benefit (taxes on income)		10,771	*(35,941)	*(45,392)
Tax benefit (taxes on income)	16	(6,834)	2,862	2,985
Income (loss) from continuing operations after taxes on income		3,937	*(33,079)	*(42,407)
Minority interest in losses (income) of subsidiaries		(10,907)	2,823	438
Loss from continuing operations		(6,970)	*(30,256)	*(41,969)
Loss from discontinued operations	25	(235)	(11,323)	(10,390)
Net loss		\$ (7,205)	\$ *(41,579)	\$ *(52,359)
Loss per share				
Basic:	19			
Loss from continuing operations		\$ (0.24)	\$ *(1.15)	\$ *(1.98)
Loss from discontinued operations		\$ (0.01)	\$ (0.43)	\$ *(0.49)
Net loss		\$ (0.25)	\$ *(1.58)	\$ *(2.47)
Diluted :				
Loss from continuing operations		\$ (0.24)	\$ *(1.15)	\$ *(1.99)
Loss from discontinued operations		\$ (0.01)	\$ *(0.43)	\$ *(0.49)
Net loss		\$ (0.25)	\$ *(1.58)	\$ *(2.48)
Weighted average number of shares used in computing basic and diluted net loss per share (thousands)		29,194	26,272	21,191

* Restated - See Note 7(d)(7).

** Include revenues in the amount of \$4,156, \$2,487 and \$3,284, for the years ended December 31, 2003, 2002 and 2001, respectively, from related parties.

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

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

STATEMENT OF SHAREHOLDERS' EQUITY

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

	Number of shares	Share capital	Additional paid-in capital	Accumulated other comprehensive income	Retained earnings (Accumulated deficit)	Total comprehensive income (loss)	Total shareholders' equity
Balance as of January 1, 2001(*)	21,188,664	\$ 9,567	\$ 158,898	\$ 36,459	\$ 68,796		\$ 273,720
Exercise of options	25,000	-	306	-	-		306
Changes in additional paid-in capital in affiliated companies	-	-	2,899	-	-		2,899
Change in holdings in affiliated company	-	-	3,583	-	-		3,583
Amortization of deferred stock compensation	-	-	(6)	-	-		(6)
Other comprehensive income (loss), net of tax:							
Unrealized gains on available for sale securities	-	-	-	6,850	-	\$ 6,850	6,850
Reclassification adjustment for gain realized included in net loss	-	-	-	(1,056)	-	(1,056)	(1,056)
Foreign currency translation adjustment	-	-	-	(22)	-	(22)	(22)
Net loss	-	-	-	-	(52,359)	(52,359)	(52,359)
Balance as of December 31, 2001(*)	21,213,664	\$ 9,567	\$ 165,680	\$ 42,231	\$ *16,437		\$ 233,915
Total comprehensive loss						<u>\$ (46,587)</u>	
Exercise of options	87,862	-	605	-	-		605
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
Changes in additional paid-in capital in affiliated companies	-	-	336	-	-		336
Amortization of deferred stock compensation	-	-	222	-	-		222
Other comprehensive loss, net of tax:							
Unrealized losses on available for sale securities	-	-	-	(33,035)	-	\$ (33,035)	(33,035)
Reclassification adjustment for gain realized and other than temporary impairment included in net loss	-	-	-	(1,070)	-	(1,070)	(1,070)
Minimum pension liability in an affiliated Company	-	-	-	(597)	-	(597)	(597)
Net loss	-	-	-	-	(41,579)	(41,579)	(41,579)
Balance as of December 31, 2002 (*)	29,180,970	\$ 9,572	\$ 267,482	\$ 7,529	\$ (25,142)		\$ 259,441
Total comprehensive loss						<u>\$ (76,281)</u>	
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)
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>	

*Restated - See Note 7(d)(7).

The accompanying notes are an integral part of the 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,		
	2003	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES			
Net loss	\$ (7,205)	\$ *(41,579)	\$ *(52,359)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Equity in losses of affiliated companies	8,698	*24,189	*28,787
Dividend from affiliated companies	2,971	2,670	13,805
Minority interest in income (losses) of subsidiaries	10,907	(2,823)	(438)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	(25,754)	(6,888)	(3,179)
Gain from sale of investments in available for sale securities	(17,924)	(706)	(999)
Gain from disposal of businesses included in discontinued operations	(4,137)	(1,991)	-
Depreciation and amortization	3,573	4,372	6,362
Decline in value of other investments	3,716	1,866	1,222
Equity in losses of partnerships	547	303	25
Amortization (appreciation) of deferred stock compensation and call options	2,564	(104)	29
Deferred taxes, net	6,229	(3,398)	(2,796)
Changes in operating assets and liabilities			
Decrease in trade receivables	3,491	2,515	2,328
Decrease (increase) in other receivables and prepaid expenses	1,888	3,439	(1,305)
Decrease (increase) in trading securities, net	(4)	231	16,652
Decrease (increase) in inventories and contracts-in-progress	589	698	(1,310)
Increase (decrease) in trade payables	(2,009)	(1,385)	1,435
Decrease in other payables and accrued expenses	(5,275)	(11,314)	(7,710)
Other	652	695	568
Net cash provided by (used in) operating activities	<u>(16,483)</u>	<u>(29,210)</u>	<u>1,117</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in affiliated companies	(13,384)	*(19,951)	*(17,931)
Proceeds from sale of Elbit Systems shares	-	5,862	6,655
Proceeds from sale of Given Imaging shares	13,878	6,918	-
Cash and cash equivalents resulting from the merger with Elbit (Schedule A)	-	14,883	-
Cash and cash equivalents resulting from the share purchase of DEP (Schedule B)	-	284	-
Cash and cash equivalents resulting from newly consolidated subsidiaries (Schedule C)	-	2,978	-
Cash and cash equivalents resulting from sale of businesses and subsidiaries (Schedule D)	(6,148)	(1,984)	-
Investment in other companies	(299)	*(3,700)	*(1,900)
Proceeds from sale of investments in other companies	-	405	1,115
Repayment of long term receivables	772	-	-
Proceeds from sale of available for sale securities	46,143	890	1,332
Investments in held to maturity debentures and deposits	(10,877)	(11,381)	(12,213)
Proceeds from maturities of deposits and held to maturity debentures	8,975	4,482	39,357
Purchase of property and equipment	(547)	(969)	(1,132)
Proceeds from sale of property and equipment	329	515	311
Proceeds from sale of certain activities	-	6,589	3,430
Net cash provided by investing activities	<u>38,842</u>	<u>5,821</u>	<u>19,024</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from options exercised	177	605	306
Proceeds from exercise of options in a subsidiary	-	2	71
Receipt of long-term loans from banks	4,032	9,152	9,540
Repayment of loans from shareholder	-	(1,378)	-
Repayment of long-term loans	(6,200)	(706)	(630)
Decrease in short-term bank loan, net	(4,076)	(8,954)	401
Repayment of loans from minority shareholders of a subsidiary	(4,246)	-	-
Receipt of short-term loans from minority shareholders of a subsidiary	904	-	-
Proceeds from issuance of convertible notes to minority shareholders of a subsidiary	3,055	2,165	-
Net cash provided by (used in) financing activities	<u>(6,354)</u>	<u>886</u>	<u>9,688</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	16,005	(22,503)	29,829
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE YEAR	67,901	90,404	60,575
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	<u>\$ 83,906</u>	<u>\$ 67,901</u>	<u>\$ 90,404</u>

*Restated – see Note 7(d)(7).

The accompanying notes are an integral part of the 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,		
	2003	2002	2001
Supplemental cash flow information:			
Cash paid during the year for:			
Income taxes	\$ 96	\$ 521	\$ 6,025
Interest	\$ 1,466	\$ 1,916	\$ 4,202
Non-cash transactions:			
Exchange of marketable securities	\$ -	\$ -	\$ 2,140

SCHEDULE A:

	Year ended December 31,
	2002
Cash and cash equivalents resulting from the merger with Elbit	
Assets acquired and liabilities assumed on the merger date:	
Working capital, net (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	(18,275)
Long-term liabilities	40,123
Investment at equity prior to merger	42,739
Minority interests	82
Issuance of shares	71,194
Cash and cash equivalents acquired	\$ 14,883

SCHEDULE B:

	Year ended December 31,
	2002
Cash and cash equivalents resulting from the share purchase of DEP	
Assets acquired and liabilities assumed at the share purchase date:	
Working capital, net (except cash and cash equivalents)	\$ 19,115
Property and equipment	(28)
Investments in affiliated companies	(40,493)
Other investments	(3,315)
Other long-term 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

The accompanying notes are an integral part of the 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, 2002
SCHEDULE C:	
Cash and cash equivalents resulting from newly consolidated subsidiaries	
Assets acquired and liabilities assumed at the purchase date:	
Working capital, net (except cash and cash equivalents)	\$ 3,230
Property and equipment	(2,007)
Intangible assets	(12,024)
Deferred taxes	3,260
Accrued severance pay, net	179
Investment at equity prior to acquisition	8,231
Minority interests	2,109
Cash and cash equivalents acquired	\$ 2,978

	Year ended December 31,	
	2003	2002
SCHEDULE D:		
Cash and cash equivalents resulting from disposal of businesses		
Assets and liabilities at date of sale:		
Working capital, net (except cash and cash equivalents)	\$ (708)	\$ (677)
Property and equipment	1,274	266
Other assets	6,532	200
Deferred tax liability	(907)	-
Accrued severance pay, net	-	(33)
Gain resulting from sale of businesses	22,833	1,991
Securities received:		
Marketable securities	(5,400)	(1,600)
Other investments	(1,000)	(2,131)
Investment in affiliated Company	(30,272)	-
Liability incurred	1,500	-
Cash and cash equivalents received (paid)	\$ (6,148)	\$ (1,984)

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

Elron Electronic Industries Ltd. ("Elron" or "the Company"), an Israeli corporation, is a multi-national high technology operational holding company. Elron's global business is conducted through subsidiaries and affiliates, primarily in the fields of defense electronics, medical devices, communication, software, semiconductors and advanced materials.

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 No. 52").

Accordingly, items have been translated as follows:

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

Nonmonetary items – at historical exchange rates.

Revenue and expense items – at the exchange rates in effect as of the date of recognition of those items (excluding depreciation and other items deriving from non-monetary items).

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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 No. 52. All balance sheet accounts have been translated using the exchange rates 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. Inter-company balances and transactions have been eliminated upon consolidation.

As of the balance sheet date the significant subsidiaries whose balances and results are consolidated are: Elbit Ltd. ("Elbit"), DEP Technology Holdings Ltd. ("DEP"), RDC Rafael Development Corporation Ltd. ("RDC"), Elron Telesoft Inc. ("ETI"), Elron SW Inc. ("ESW")(Formerly: Elron Software ("ESI")), Galil Medical Ltd. ("Galil") and Mediagate N.V. ("Mediagate").

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 the 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 an original maturity of three months or less.

f. Long-term debentures and deposits

Bank deposits and debentures which are classified as held-to-maturity with maturities of more than one year and short-term bank deposits held as a security for long-term loans are included in long-term debentures and bank deposits. Debentures are classified as held-to-maturity when the Company has the intent and ability to hold these securities to maturity. The debentures and deposits are measured at amortized cost plus accrued interest. Accrued interest is recorded as finance 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

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

g. Marketable securities (Cont.)

Some marketable securities are classified as trading securities and are stated at the quoted market prices at each balance sheet date. Gains and losses (realized and unrealized) relating to trading securities as well as interest on such securities are included as other income (expenses).

Certain marketable securities covered by SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities", ("SFAS No. 115") were 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 decline in value judged to be other than temporary, are included in the consolidated statement of operations. When computing realized gain or loss, cost is determined on an average basis.

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 or technological obsolescence.

Cost is determined as follows:

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

Contracts-in-progress - represent amounts related to long-term contracts as determined by the percentage of completion method of accounting.

Finished Products - raw materials as mentioned above and other direct and indirect manufacturing costs on an average basis or "first in, first out" method.

i. Investments in companies

Investments in which the Company has significant influence but less than a controlling voting interest are accounted for using the equity method. Significant influence is presumed to exist when the Company owns between 20%-50% of the investee. 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 to apply the equity method when its investment (including advances and loans) is reduced to zero and it has no guaranteed obligations of the affiliate or is not otherwise committed to provide further financial support to the affiliate.

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 equity method losses based on the ownership level of the particular affiliate security or loan held by the Company to which the equity method losses are being applied.

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.)

The excess of the purchase price over the fair value of net tangible assets acquired is attributed to goodwill, technology and other identifiable intangible assets. Goodwill is no longer amortized effective January 1, 2002 - See Note 1 below. Technology and other identifiable intangible assets are amortized over a period of approximately 5-12 years, commencing from the acquisition date.

Gains arising from issuance of shares by affiliated companies to third parties are recorded as "Gains from disposal of businesses and affiliated companies and changes in holdings in affiliated companies net" 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 SAB 51 "Accounting for Sales of Stock by a Subsidiary".

When an investment in an investee, 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 are accounted for under the equity method.

Investments in other non-marketable companies in which the Company does not have the ability to exercise significant influence over operating and financial policies 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, credit defaults 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	15-20
Leasehold improvements	over the term of the lease

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

k. Impairment and disposal of long-lived assets

The Company's 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", 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.

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 assets are amortized over their estimated useful life.

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

Effective January 1, 2002, the Company adopted the full provisions of SFAS No. 142 "Goodwill and Other Intangible Assets ("SFAS No. 142"). Under SFAS No. 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 No. 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. The Company performed its first phase impairment analysis during the fourth quarter of 2003 and 2002 and found no instances of impairment of its recorded goodwill. 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.

Fair value is determined using discounted cash flows and market capitalization. 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 for each of the reportable units. The Company expects to perform the impairment tests during the fourth fiscal quarter of each year.

m. Revenue recognition

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

Software sales are accounted for in accordance with Statement of Position (SOP) 97-2, "Software Revenue Recognition," as amended.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

m. Revenue recognition (Cont.)

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, vendor specific objective evidence exists to allocate total fees to elements of an arrangement (in the case of license fees) and persuasive evidence of an arrangement exists.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement.

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 and from projects, related to software development, 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 long-term 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.

When a right of return exists, an estimate of the allowance for returns is provided in accordance with SFAS No. 48, "Revenue Recognition When Right of Return Exists". Reserves for estimated returns and allowances are provided at the time revenue is recognized. Such reserves are recorded based upon historical rates of returns and allowances and other factors.

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

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 for funding approved research and development projects, and royalty-bearing grants from the Government of Israel for the encouragement of marketing activity 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 and sales and marketing expenses, respectively.

Research and development and marketing grants received by certain of the company's subsidiaries in 2003 amounted to \$487 and \$0, respectively, (2002 - \$850 and \$105, respectively).

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 their estimated realizable value.

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 all periods presented all shares relating to the outstanding stock options have been 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, was 1,799, 5,007 and 11,694 for the years ended December 31, 2003, 2002 and 2001, respectively.

s. Stock based compensation

For stock options granted prior to 2003, the Company has elected to follow Accounting Principles Board Opinion No. 25, ("APB 25") "Accounting for Stock Issued to Employees" 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 at the grant date of the award or other measurement date over the exercise price. 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.)

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 under 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. Compensation cost is recorded over the vesting period on a straight line basis.

The expense related to stock-based employee compensation included in the determination of net loss for 2003, 2002 and 2001 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 No.123. If the Company and its subsidiaries had elected to adopt the fair value recognition provisions of SFAS No.123 as of its original effective date, pro forma net loss and pro forma basic and diluted net loss per share would be as follows:

	Year ended December 31,		
	2003	2002	2001
Net loss, as reported	\$ (7,205)	\$ *(41,579)	\$ *(52,359)
Add: Stock-based employee compensation expense included in reported net loss	973	933	29
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards	<u>1,377</u>	<u>2,876</u>	<u>974</u>
Pro forma net loss	<u>\$ (7,609)</u>	<u>\$ (43,522)</u>	<u>\$ (53,304)</u>
Loss per share:			
Basic - as reported	\$ (0.25)	\$ *(1.58)	\$ *(2.47)
Basic - pro forma	(0.26)	*(1.66)	*(2.51)
Diluted - as reported	(0.25)	*(1.58)	*(2.48)
Diluted - pro forma	(0.26)	*(1.66)	*(2.52)

* Restated - See Note 7(d)(7)

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 fair value for these options was estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions for 2003, 2002 and 2001:

	2003	2002	2001
Risk-free Interest Rate	1%	1.5%	3%
Expected Dividend Yield	0%	0%	0%
Expected Volatility	53%	39%	55%
Expected Lives	2.7	2.1	2.7

The Company provides the disclosures required by SFAS No. 123 and SFAS No. 148 in Note 18.

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 (loss)

Comprehensive income (loss) 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, foreign currency translation adjustments and minimum pension liabilities and unrealized losses on derivative instruments in an affiliated company (See Note 27).

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 employees, is fully provided 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 surrendered value of these policies, and includes immaterial profits.

Severance pay expenses for the years ended December 31, 2003, 2002 and 2001 amounted to \$731, \$611 and \$277, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

v. Discontinued operations

Under SFAS No. 144, when a component of an entity, as defined in SFAS No. 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 only when the operations and cash flows of the component sold 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 and long 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, 2003 and 2002, unless otherwise 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 and the inability to estimate the fair value of each investment without incurring excessive costs. The carrying amounts of these companies were \$48,992 and \$24,729 at December 31, 2003 and 2002, respectively, and they represent the original cost, net of impairment, and in the case of affiliates also the Company's equity, in the earnings or 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, long-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 debentures of U.S. corporations with high credit quality and with limited amount of credit exposure to any each 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 Israel and in the U.S. 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 are no significant off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

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

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation 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 (VIEs) 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 are unable to make significant decisions about its activities, or (3) has a group of equity owners that do not have the obligations to absorb losses or the right to receive returns generated by its operations.

FIN 46 requires a VIE to be consolidated if a party with an ownership, contractual or other financial interest in the VIE (a variable interest holder) is obligated to 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 party absorbs 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.

The Company has investments in and loans to various companies that are engaged primarily in the fields of high technology. Some of these companies are in their early stages of development and will require substantial third party investments until they can finance their activities without additional support from other parties. These companies are currently primarily funded with financing from venture capital funds, other holding companies and private investors. The investments in these companies are consolidated or accounted for by the equity method by the Company.

The Company will apply the provisions of FIN 46 as of March 31, 2004. The Company is currently evaluating the effects of FIN 46 in respect of its investments. It is possible that some of its unconsolidated investees may be considered a VIE in accordance with FIN 46. Accordingly, if it is determined that the Company is the primary beneficiary of a VIE, the Company will be required to consolidate the financial statements of such a VIE with its own financial statements as of March 31, 2004.

As of December 31, 2003, the Company's maximum exposure to loss does not exceed its investment in any of these companies.

z. Reclassifications

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

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

a. Elbit

On May 15, 2002, Elron completed its merger with Elbit, a high technology operational holding company, in which it 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 of Elbit held by Elbit's employees to purchase 240,525 ordinary shares of Elron with a fair value of \$ 997.

The purchase price of the Elbit acquisition was approximately \$73,914, which was calculated as follows:

Fair value of Elron ordinary shares issued	\$ 70,220
Transaction and other costs	2,719
Fair value of options assumed ^(*)	975

Total	\$ 73,914

^(*) Net of intrinsic value of \$22.

Ordinary shares were valued based on the average price of Elron's 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 the fair value of Elbit's tangible and intangible assets acquired and liabilities assumed, based on an analysis made by an independent valuation appraiser.

Current assets	\$ 12,216
Long-term investments	65,586
Other long-term assets	1,061
Property and equipment, net	6,285
Goodwill (not deductible for tax purposes)	*12,135
Liabilities assumed	(23,369)

Net assets acquired	\$ 73,914

* After reduction of \$6,600 due to reversal of valuation allowance in respect of deferred taxes - see below.

At the acquisition date net deferred tax assets relating to loss carryforwards have been fully offset by a valuation allowance. Subsequent to that date, Elbit recorded a tax benefit in the amount of approximately \$6,600 and \$7,700 in 2002 and 2003, respectively, and reduced its valuation allowance in respect of the abovementioned deferred tax assets. Since the tax benefits recognized were in respect of the loss carryforwards of Elbit at the acquisition date, Elron recorded the entire tax benefit as a reduction to goodwill.

The goodwill recorded relates to the "Other Holdings and Corporate Operations" segment and reflects the synergies that resulted from the combined entity, including a reduction in operational and management costs, the creation of an enhanced platform, a more simplified and efficient organizational structure and greater resources and scope of operations, which benefited Elron's subsidiaries and affiliated companies.

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.)

a. Elbit (Cont.)

Elbit's financial statements have been consolidated in the Company's consolidated financial statements subsequent to the date of the merger (May 15, 2002). See Note 9 for pro forma information.

b. DEP

On May 6, 2002, Elron completed the purchase of shares of 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 RDC, a subsidiary of DEP, in which DEP holds 48.04% of its outstanding shares (50.1% of the voting rights) and Rafael Armament Development Authority ("Rafael"), through its subsidiary Galram Technology Industry Ltd. ("Galram"), holds 47.84%. RDC was established for the purpose of exploiting Rafael's technology in non-military markets.

DEP invests directly and indirectly (through RDC) in high technology companies, which are primarily engaged in the fields of communications, medical devices and semiconductors.

The share purchase enhanced Elron's position in the high technology markets enabling Elron to manage existing DEP investments independently.

The purchase price of the DEP acquisition was \$ 29,502, of which \$ 29,449 represents 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 multiplied by the number of shares to be issued to DIC, and \$ 53 represents transaction costs.

The purchase price has been allocated to the fair value of DEP's tangible and intangible assets acquired and liabilities assumed, based on an 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
Intangible assets	2,339
Liabilities assumed	<u>(11,556)</u>
 Total	 <u><u>\$ 29,502</u></u>

The amount of \$ 38,233, allocated to investments in companies accounted for under the equity method, included amounts allocated to intangible assets of these equity investments and is net of any related deferred taxes. Out of the \$ 38,233, the aggregate amount allocated to identifiable intangible assets of the equity investments was approximately \$ 16,500 and an aggregate amount of approximately \$ 6,500 has been recorded as goodwill. The goodwill is not deductible for tax purposes.

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.)

b. DEP (Cont.)

Net deferred tax assets relating to operating loss carryforwards have been fully offset by a valuation allowance at the share purchase date. In 2003 RDC recorded a tax benefit of approximately \$1,200 and reduced its valuation allowance in respect of the abovementioned deferred tax asset. The tax benefit was recorded as a reduction to goodwill included in investments in affiliated companies.

DEP's financial statements have been consolidated in the Company's consolidated financial statements subsequent to the date of the closing of the share purchase (May 6, 2002). See Note 9 for pro forma information.

c. Galil

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

1. On April 30, 2002, Elron and RDC converted notes of Galil, in which Elron then held 3.7% and in which RDC then held 32.1% in an amount of \$3,160.

During 2002 and 2003, certain existing shareholders of Galil entered into note purchase agreements with Galil for an investment in convertible notes of Galil (the "Notes") in an aggregate amount of up to \$16,000, according to which Elron and RDC together invested in the Notes approximately \$5,700 and \$3,700 in 2002 and 2003, respectively.

2. On June 27, 2002, Elron purchased 10.75% of the outstanding shares of Galil from Lumenis Ltd. ("Lumenis") in consideration for \$850. As part of the agreement, Lumenis has the right to receive a future earn-out payment, conditional 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 of this transaction, Elron's direct interest in Galil increased to 15.09% and together with its indirect share through RDC, Elron has acquired a controlling voting interest in Galil and, accordingly, Galil's financial statements have been consolidated in the Company's consolidated financial statements subsequent to the date of the purchase from Lumenis. See Note 9 for pro forma information.

The amount allocated to technology and the remaining technology which arose from previous acquisitions, amounted to approximately \$ 4,600. The estimated useful life of the technology was 9 years.

3. On July 1, 2003, Galil announced the completion of the merger of Galil's urology business and the Brachytherapy business of Amersham plc (LSE, NYSE, OSE: AHM) ("Amersham"). 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%

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.)

c. Galil (Cont.)

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. Through balance sheet date \$ 3,000 had been paid and the balance is due in June 2004. Until the payment of the balance, 4% of Oncura shares held by Galil, are pledged in favor of Amersham.

Galil and Amersham each entered, separately, into supply and R&D service agreements pursuant to which Galil and Amersham shall provide Oncura with certain exclusive supply, manufacturing and R&D services, upon 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 is to be recorded at fair value. The fair value of the transaction was determined based on an independent valuation of Oncura, according to which the fair value of Oncura is 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 is to be deferred until realization by sale or amortization by Oncura. Accordingly, the investment in Oncura, which is to be 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 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 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, 2003, 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 on July 1, 2004. The loan is included in the balance sheet under "Other receivables and prepaid expenses".

4. In September and December 2003, certain shareholders of Galil granted convertible loans to Galil in the amount of \$1,200 (the "First Loan") and \$2,000 (the "Second Loan") respectively. Elron and RDC together advanced approximately \$ 700 and \$ 1,200, in respect of the First Loan and the Second Loan, respectively.
5. On January 31, 2004, Galil and its shareholders, entered into an agreement to restructure the share capital of Galil pursuant to which all outstanding preferred shares, notes convertible into preferred shares and the First Loan were converted into ordinary shares and all their associated rights were cancelled. As a result of the restructure, Elron's and RDC's respective holdings in Galil increased to 19.1% and 36.8%. Galil has an option under certain conditions to repay the Second Loan or convert it into ordinary shares under the terms of the share capital restructure.

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.)

d. ESW

On September 2, 2003, Elron's majority owned subsidiary, ESI, sold substantially all of its assets and business to Zix Corporation ("Zix"), a publicly traded company on Nasdaq (Nasdaq: ZIXI) and a global provider of e-messaging protection and transaction services. 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 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.

The business sold by ESW represents a component of an entity as defined in SFAS No. 144 and since the criteria for reporting discontinued operations under SFAS No. 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. Comparative data have been reclassified accordingly.

The Zix Common stock is accounted for as available for sale securities in accordance with SFAS No. 115. See Note 5(3) regarding the sale of Zix shares.

e. Mediagate

1. In 2002, Elron converted loans advanced to Mediagate during 2001 and 2002 in the amount of \$3,588 to 32,828,510 preferred F shares and invested approximately \$2,500 through a rights offering for which Elron received 58,562,543 preferred F shares. As a result of these transactions, Elron's interest in Mediagate's outstanding shares increased from 29% to approximately 68% and accordingly the accounts of Mediagate have been consolidated with those of Elron subsequent to the date of the additional investment. See Note 9 for pro forma information.

The amount allocated to technology and the remaining technology which arose from previous acquisitions amounted to approximately \$4,400. The estimated useful life of the technology was 7 years. The excess of the purchase price over the estimated fair values of the identifiable net assets acquired in the amount of approximately \$2,500 was recorded as goodwill, which is not deductible for tax purposes. The goodwill relates to the "Other Holdings and Corporate Operations" segment.

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. Mediagate (Cont.)

2. On December 16, 2003, Mediagate signed an agreement with Telrad Networks Ltd. ("Telrad"), for the sale of its technology and related intellectual property assets. Telrad is an Israeli corporation providing telecommunications solutions worldwide. The closing of the transaction occurred on January 28, 2004. 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. The royalties range from 5% of sales in 2004 and increase gradually up to 15% of sales in 2009.

Based on an independent appraisal, the royalties to be received approximate the carrying value of the technology sold. Accordingly, the above transaction did not have any effect on the Company's consolidated results of operations.

The royalties to be received are pledged to secure bank loans of Mediagate (see Note 17f).

f. Elbit VFlash ("VFlash")

On September 23, 2002, VFlash, a wholly-owned subsidiary of Elbit, sold a significant portion of its assets to 24/7 Real Media Inc. ("24/7"), a publicly traded company on Nasdaq (Nasdaq: TFMS), in exchange for 4,100,000 common shares of 24/7. 24/7 provides marketing and technology solutions to online marketers and publishers.

Concurrently with the above sale, Elron invested through Elbit, \$ 1,000 in consideration for 100,000 convertible preferred shares of 24/7 which were converted in February 2003, into 4,840,271 shares.

The Company viewed the sale of Vflash's principal assets and the purchase of the preferred shares as one transaction and accordingly recorded a gain of approximately \$ 2,000 in respect of the sale based on the closing price of 24/7 at the date of the transaction. The business sold by VFlash represents a component of entity as defined in SFAS No. 144 and since the criteria for reporting discontinuing operations under SFAS No. 144 is met, VFlash's results of operations and the above gain were classified as discontinued operations in the statement of operations.

The common shares had been accounted for as available for sale securities in accordance with SFAS 115. In 2003, all of the 24/7 shares were sold (See Note 5(4)).

NOTE 4:- CASH AND CASH EQUIVALENTS

Includes mainly bank deposits in U.S. dollars, bearing weighted average interest rate of 1.08% per annum (December 31, 2002 - 1.32%).

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 5: - SHORT-TERM INVESTMENTS

	Weighted Average Interest rate	December 31,	
	%	2003	2002
Available-for-sale securities: (1)			
Debentures	5.61	\$ 1,971	\$ -
Zix (2)		7,159	-
24/7 (3)		-	776
Other		-	2,386
		<u>9,130</u>	<u>3,162</u>
Certificate of deposits	3.69	1,558	
Held-to-maturity debentures (4)(5)	5.95	1,237	12
Bank deposits (5)	1.15	25,223	-
Trading securities		10	6
		<u>\$ 37,158</u>	<u>\$ 3,180</u>
(1) Includes unrealized gains		<u>\$ 4,458</u>	<u>\$ -</u>
Includes unrealized losses		<u>\$ 12</u>	<u>\$ 585</u>

- (2) As of December 31, 2003 represents 854,701 shares of Zix which were received in consideration for the sale of ESW's business (see Note 3d) and constitute approximately 3% of the outstanding share capital of Zix.

Of the 1,709,402 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). The remaining shares are subject to a lock-up agreement with Zix and may be sold ratably on a monthly basis until September 2004.

Subsequent to the balance sheet date and through March 9, 2004, Elron sold an additional 271,812 shares of Zix in consideration for approximately \$3,200, resulting in a gain of approximately \$2,300 (\$1,500 net of tax), which will be recorded in the first quarter of 2004.

- (3) In 2003, all the shares of 24/7 received in consideration for the sale of the VFlash business (see Note 3f) were sold for a total consideration of approximately \$5,200, resulting in a realized gain of approximately \$2,000 (\$800 net of tax).
- (4) As of December 31, 2003, the fair value of held-to-maturity debentures approximated their carrying value.
- (5) As of December 31, 2003 the debentures and deposits are used to secure current maturities of long-term loans taken by ESW and ETI.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 6:- TRADE RECEIVABLES, NET

	December 31	
	2003	2002
Open balances *	\$ 3,715	\$ 7,824
Unbilled receivables	1,301	1,414
	<u>\$ 5,016</u>	<u>\$ 9,238</u>
* Net of allowance for doubtful accounts	<u>\$ 398</u>	<u>\$ 845</u>

NOTE 7:- INVESTMENTS IN AFFILIATED COMPANIES

a. Affiliated companies are as follows:

	Note	December 31,	
		2003	2002
		% of	
		outstanding share capital	
Elbit Systems ("ESL")	7d (1)	19.7	19.9
Given Imaging	7d(6)	23.2	30.4
Chip Express	7d(3)	36.1	33.0
NetVision	-	45.7	45.7
Wavion	7d(4)	37.5	44.7
K.I.T e-Learning	7d(5)	45.0	28.6
AMT	7d(2)	28.3	28.3
3DV Systems	7d(8)	47.7	47.7
Oncura	3c	25.0	-
Oren *	7d(7)	40.9	17.3
Pulsicom	-	18.2	17.0
Notal Vision	-	23.6	-
CellAct	-	45.0	45.0
Witcom	-	32.9	32.9
Ingeneo	-	28.0	33.0
Semiconductor Engineering Laboratories ("SELA")		49.5	49.5

* Restated - See Note 7(d)(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.)

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

	December 31	
	2003	2002
As of December 31, 2003		
ESL	\$ 87,672	\$ 82,715
Given Imaging	23,665	32,779
Oncura	29,674	-
Others	15,808	*16,710
	\$ 156,819	\$ *132,204
⁽¹⁾ Includes loans and convertible loans	\$ 3,298	\$ 7,849
⁽²⁾ 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	\$ 45,311	\$ 21,275

*Restated - See Note 7(d)(7)

- c. Fair market value of marketable securities:

	Stock Exchange	December 31	
		2003	2002
		U.S. dollars in millions	
ESL	Tel -Aviv and Nasdaq	\$ 143	\$ 126
Given Imaging	Nasdaq	\$ 107	\$ 71

- d. Additional information

1. ESL

In 2001 and 2002 Elron sold 380,000 shares of ESL, each year, for approximately \$ 6,600 and \$ 5,900, respectively, resulting in a gain of approximately \$3,000 and \$1,800, respectively. Following the sales and exercise of options by employees of ESL, Elron's share in ESL decreased to 19.7%. Elron continues to account for ESL under the equity method due to a shareholders' agreement with the primary shareholder of ESL, the Federmann Group. The shareholders' agreement includes joint voting arrangements with respect to the nomination of an equal number of directors to ESL's board of directors and limitation on the transfer of shares in ESL, including first refusal rights and tag along rights.

2. AMT

In August 2002, Elron completed an investment of approximately \$ 5,000 in convertible notes of A.M.T Advanced Metal Technologies Ltd. ("AMT"). 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 A.C.S. 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.

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. AMT (Cont.)

The investment was part of an aggregate investment in AMT of approximately \$ 8,700 of which the existing shareholders of AMT invested approximately \$ 3,700. The notes 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 a result Elron holds approximately 28% of AMT on a diluted basis (excluding warrants) and "as converted basis".

In addition, Elron and the other investors in AMT were issued warrants to purchase preferred shares of AMT for a total amount of up to approximately \$ 19,140, which may be exercised over various periods up to a maximum of 48 months from one year following the closing.

In December 2002 and in 2003, Elron granted convertible loans to AMT in the aggregate amount of approximately \$1,500. The loans bear interest at 8% and shall be converted, under certain conditions, into convertible notes of AMT upon the same terms and conditions as Elron's original investment.

3. CHIP EXPRESS

a. In 2002, Chip Express Corporation ("Chip Express"), in which Elron held approximately a 35% interest, issued, approximately 22,317,400 redeemable preferred shares in consideration for \$16,520 in a private placement. 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 a convertible note. As a result, Elron's interest in Chip Express decreased to approximately 33%.

b. Subsequent to balance sheet date, on March 4, 2004, Chip Express issued approximately 7,594,936,710 redeemable preferred shares in consideration for \$12,000, in a private placement. Elron purchased approximately 1,632,564,563 redeemable preferred shares in consideration for approximately \$2,600. As a result, Elron's interest in Chip Express decreased to approximately 26%.

4. WAVION

During 2001 and 2002, Elron invested \$1,000 and \$500, respectively, in Wavion Inc. ("Wavion") in which Elron then held approximately 45%, by way of convertible loans.

In 2003, Elron invested \$3,000 in Wavion in consideration for Series B preferred shares, out of an aggregate amount of \$12,500 raised by Wavion in a private placement from Elron and a new investor. In addition to this investment, Elron converted the above mentioned loans into Series A1 preferred shares. As a result, Elron's ownership interest in Wavion decreased to approximately 38%.

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. K.I.T. eLEARNING B.V.

In July 2003 Elron invested \$2,000 in K.I.T. eLearning B.V ("K.I.T. eLearning", formerly Kidum Holding B.V.), in consideration for Series B-2 preferred shares, as part of an aggregate investment of \$4,000, the balance of which was invested by DIC. K.I.T. eLearning was previously the operating subsidiary of KIT in which Elron held approximately 29%. In addition to this investment, Elron's holdings in KIT and a loan in the amount of \$1,500 (which was granted during 2001 and 2002) were converted into shares of K.I.T. eLearning. The loan was converted to Series B-1 preferred shares. The investment in K.I.T. eLearning, which was received in consideration for the shares of KIT, was recorded at the carrying value of Elron's previous investment in KIT. Following the transaction and the loan conversion, Elron holds approximately 45% of K.I.T. eLearning's outstanding shares.

6. GIVEN IMAGING LTD.

- a. During 2002, Elron and RDC sold 98,666 shares and 500,000 shares, respectively, of Given Imaging Ltd. ("Given") in consideration for approximately \$ 1,100 and \$ 5,900, respectively. In addition, a former senior executive of RDC exercised a call option granted to him in 1999, and purchased from RDC 172,800 shares of Given at an exercise price of \$ 0.17 per share (see also Note 14d). As a result of the above transactions, a gain of approximately \$ 5,300 was recorded in 2002.

In 2003, RDC 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 of these transactions, Elron's consolidated interest in Given decreased to approximately 23%.

- b. On May 12, 2003, a Share Purchase Agreement was signed between RDC, Elron and Rafael, according to which, RDC sold two million 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 consolidated interest in Given.
- c. RDC's board of directors decided that RDC would purchase 4.1% of its shares held by former senior employees in consideration for 235,000 shares of Given held by RDC. The purchase is subject to the approval of the court.

7. OREN SEMICONDUCTOR INC. ("OREN")

During 2002, Elron, among other existing shareholders of Oren, invested approximately \$2,500 out of \$6,900 in Oren by way of long-term convertible loans.

In July 2003, Elron invested \$3,000 in Oren, as part of an aggregate investment of \$8,000 from existing shareholders and from Zoran Corporation (Nasdaq: ZRAN).

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. OREN SEMICONDUCTOR INC. ("OREN") (Cont.)

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. Following the investment and the loan conversion, Elron's interest in Oren increased from 17% to approximately 41%.

As a result of this transaction, 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 was previously accounted for by Elron at cost, is 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 Oren were recorded at cost.

Following are the effects of the restatement:

(1) Consolidated balance sheet

	December 31, 2002		
	As reported	Effect of restatement	As restated
Investments in affiliated companies	\$ 131,256	\$ 948	\$ 132,204
Investments in other companies and long-term receivables	97,158	(8,024)	89,134
Accumulated deficit	(18,066)	(7,076)	(25,142)
Total shareholders' equity	266,517	(7,076)	259,441

(2) Consolidated statements of operations and comprehensive loss

	Year ended December 31, 2002		
	As reported	Effect of restatement	As restated
Equity in losses of affiliated companies	\$ (21,911)	\$ (2,278)	\$ (24,189)
Net loss	(39,301)	(2,278)	(41,579)
Total comprehensive loss	(74,003)	(2,278)	(76,281)
Basic net loss per share	(1.50)	(0.08)	(1.58)
Diluted net loss per share	(1.50)	(0.08)	(1.58)

	Year ended December 31, 2001		
	As reported	Effect of restatement	As restated
Equity in losses of affiliated companies	\$ (27,242)	\$ (1,545)	\$ (28,787)
Net loss	(50,814)	(1,545)	(52,359)
Total comprehensive loss	(45,042)	(1,545)	(46,587)
Basic net loss per share	(2.40)	(0.07)	(2.47)
Diluted net loss per share	(2.41)	(0.07)	(2.48)

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 (Cont.)

e. Summarized information

Summarized combined financial information is as follows:

	<u>ESL</u>	<u>Given</u>	<u>Chip Express</u>	<u>AMT</u>	<u>Others</u>
December 31, 2003:					
Balance sheet information:					
Current assets	\$ 577,715	\$ 42,625	\$ 8,141	\$ 1,349	\$ 55,725
Non-current assets	446,021	12,944	2,753	2,175	49,941
Total assets	1,023,736	55,569	10,894	3,524	105,666
Current liabilities	378,017	7,655	3,810	4,822	70,713
Non-current liabilities	188,525	1,192	557	11,264	31,936
Minority interest	4,115	1,924	-	472	-
Redeemable preferred stock	-	-	41,800	-	1,189
Shareholders' equity (deficiency)	452,079	44,798	(35,273)	(13,034)	8,273
Year Ended December 31, 2003:					
Statement of operations information:					
Revenues	\$ 897,980	\$ 40,359	\$ 13,746	\$ 1,359	\$ 89,490
Gross profit	224,419	26,988	2,664	(527)	23,307
Net income (loss) from continuing operations and net income (loss)	45,945	(9,609)	(7,813)	(3,796)	(17,660)
	<u>ESL</u>	<u>Given</u>	<u>Others</u>		
December 31, 2002:					
Balance sheet information					
Current assets	\$ 566,800	\$ 56,059	\$ 47,759		
Non-current assets	433,350	12,669	24,859		
Total assets	1,000,150	68,728	72,618		
Current liabilities	360,780	12,087	56,151		
Non-current liabilities	223,292	882	26,324		
Minority interest	4,717	2,182	86		
Redeemable preferred stock	-	-	44,384		
Shareholders' equity (deficiency)	411,361	53,577	(54,327)		
Year ended December 31, 2002:					
Statement of operations information:					
Revenues	\$ 827,456	\$ 28,904	\$ 88,843		
Gross profit	222,143	16,997	17,659		
Net income (loss) from continuing operations and net income (loss)	45,113	(18,310)	(34,458)		
	<u>ESL</u>	<u>Elbit</u>	<u>Netvision</u>	<u>Others</u>	
Year ended December 31, 2001:					
Statement of operations information:					
Revenues	\$ 764,501	\$ 1,000	\$ 58,909	\$ 46,246	
Gross profit	210,544	499	5,450	15,657	
Net income (loss) from continuing operations	40,796	(31,539)	(3,601)	(87,525)	
Net Income (loss)	40,796	(30,588)	(3,601)	(87,525)	

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

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

- 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, 2008 is approximately as follows:

<u>Total amortization</u>		
2004	-	\$ 2,200
2005	-	\$ 2,100
2006	-	\$ 2,400
2007	-	\$ 2,300
2008	-	\$ 2,300

The remaining weighted average amortization period of the intangible assets is approximately 13 years.

At the balance sheet date, the Company has unamortized goodwill in the amount of \$18,200 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 \$500, \$2,400 and \$3,300, in 2003, 2002 and 2001, respectively. Such impairment losses are included as part of the Company's equity in losses of affiliated companies.

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

	<u>December 31</u>	
	<u>2003</u>	<u>*2002</u>
Marketable securities presented as available- for- sale securities: (1)		
Partner (2)	\$ 124,315	\$ 78,578
Other	556	-
	<u>124,871</u>	<u>78,578</u>
Partnerships	2,136	2,447
Other investments and long-term receivables (3)	1,792	*8,109
	<u>3,928</u>	<u>10,556</u>
	<u>\$ 128,799</u>	<u>\$ 89,134</u>
(1) Includes unrealized gains	<u>\$ 78,607</u>	<u>\$ 14,176</u>

* Restated - See Note 7(d)(7)

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.)

(2) PARTNER COMMUNICATIONS COMPANY LTD. ("Partner")

As of December 31, 2003 Elbit holds 15,856,551 shares of Partner (December 31, 2002, 22,134,777 shares). In 2003, Elbit sold 6,278,226 shares of Partner, in which it previously held 12.2%, in consideration for approximately \$29,300. As a result, Elron recorded a realized gain of approximately \$11,000 (\$7,100 net of tax). As of December 31, 2003, Elbit holds approximately 8.7% of the outstanding shares of Partner. See Note 17(d) regarding the pledging of Partner shares.

(3) During 2003, Elron recorded an impairment loss of approximately \$3,700 in respect of certain investments and receivables, mainly receivables relating to the sale of Textology (previously consolidated subsidiary) and Cellenium (In 2002 - \$1,000).

NOTE 9:- SUPPLEMENTAL PRO FORMA INFORMATION (UNAUDITED)

The pro forma information presents the results of operations of Elron after giving effect to the merger with Elbit, the share purchase of DEP and the acquisition of a controlling interest in Galil and Mediagate as if they had been in effect at the beginning of each of the reported periods, and includes the effect of amortization of intangible assets from these dates.

The following pro forma information is based upon the historical financial statements (after restatement, as discussed in Note 7(d)(7) and after reclassification of discontinued operations) of Elron, Elbit, DEP, Galil and Mediagate. The pro forma data 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, the share purchase or the acquisition of a controlling interest in Galil and Mediagate been consummated at the dates indicated, nor are they necessarily indicative of future operating results or financial condition.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 9:- SUPPLEMENTAL PRO FORMA INFORMATION (UNAUDITED) (Cont.)

Pro forma combined results of operations

	Year ended December 31,		
	2003	2002	2001
	<u>As reported</u>	<u>Proforma</u>	<u>Proforma</u>
Net revenues	\$ 16,547	\$ 17,608	\$ 27,166
Net loss from equity investments	(8,698)	*(16,308)	*(26,971)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	25,754	6,674	3,612
Other expenses, net	<u>14,665</u>	<u>1,801</u>	<u>(18,636)</u>
Total income (expenses)	48,268	*9,775	*(14,829)
Costs and expenses	<u>37,497</u>	<u>52,973</u>	<u>71,056</u>
Income (loss) before tax benefit (taxes on income)	<u>\$ 10,771</u>	<u>\$ *(43,198)</u>	<u>\$ *(85,885)</u>
Loss from continuing operations	<u>\$ (6,970)</u>	<u>\$ *(34,005)</u>	<u>\$ *(69,708)</u>
Net loss	<u>\$ (7,205)</u>	<u>\$ *(54,649)</u>	<u>*(91,713)</u>
Basic net loss from continuing operations per share	<u>\$ (0.24)</u>	<u>\$ *(1.17)</u>	<u>\$ *(2.40)</u>
Diluted net loss from continuing operations per share	<u>\$ (0.24)</u>	<u>\$ *(1.17)</u>	<u>\$ *(2.41)</u>
Basic net loss per share	<u>\$ (0.25)</u>	<u>\$ *(1.88)</u>	<u>\$ *(3.15)</u>
Diluted net loss per share	<u>\$ (0.25)</u>	<u>\$ *(1.88)</u>	<u>\$ *(3.16)</u>
Weighted average number of shares used in computation of basic and diluted net loss per share (thousands)	<u>29,194</u>	<u>29,131</u>	<u>29,070</u>

*Restated - see Note 7 (d)(7).

Pro forma results of operations for the year ended December 31, 2001, include amortization of goodwill in the amount of approximately \$2,300. Goodwill is no longer being amortized in accordance with SFAS No. 142, effective as of January 1, 2002.

NOTE 10:- LONG-TERM DEBENTURES AND BANK DEPOSITS

As of December 31, 2003 the balance included a \$700 debenture, bearing an interest rate of 5.3% per annum with a maturity date in 2006. The fair value of the debenture as of December 31, 2003 approximated its carrying value.

As of December 31, 2002 the balance included \$5,300 debentures and \$23,600 deposits which were classified as long-term assets since they were used to secure long-term loans taken by ETI and ESW (See Note 17(c)). As of December 31, 2003 the abovementioned loans were classified as current liabilities and accordingly these debentures and deposits were presented as short-term investments. (See also Note 5).

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 11:- PROPERTY AND EQUIPMENT, NET

	Year ended December 31	
	2003	2002
Land and Building	\$ 10,177	\$ 10,292
Leasehold improvements	2,279	2,527
Computers, furniture and machinery	2,040	9,032
Motor vehicles	691	989
	<u>15,187</u>	<u>22,840</u>
Less - accumulated depreciation	6,870	11,264
Property and equipment, net	<u>\$ 8,317</u>	<u>\$ 11,576</u>

Depreciation expense amounted to approximately \$1,590, \$2,360 and \$2,628 for the years ended December 31, 2003, 2002 and 2001, respectively.

NOTE 12:- GOODWILL AND OTHER INTANGIBLE ASSETS

	Period of amortization years	December 31	
		2003	2002
Cost:			
Technology and other intangible assets (1)	5-12	\$ 14,140	\$ 25,051
Goodwill (2)		<u>14,698</u>	<u>24,809</u>
		<u>28,838</u>	<u>49,860</u>
Accumulated amortization:			
Technology and other intangible assets (1)		4,172	6,474
Goodwill (2)		<u>2,679</u>	<u>3,271</u>
		<u>6,851</u>	<u>9,745</u>
Amortized cost		<u>\$ 21,987</u>	<u>\$ 40,115</u>

- During 2002 technology and other intangible assets increased by \$7,223 as a result of the acquisition of a controlling interest in Galil and Mediagate (see Note 3). During 2003, technology and other intangible assets were realized as a result of the sale of the urology business of Galil and the business of ESW. (See Note 3c and 3d, respectively).
- The annual estimated amortization expense relating to Elron's intangible assets, other than goodwill existing as of December 31, 2003, for each of the five years in the period ending December 31, 2008 is approximately as follows:

<u>Total amortization</u>		
2004	-	\$ 800
2005	-	\$ 1,000
2006	-	\$ 1,400
2007	-	\$ 1,800
2008	-	\$ 1,600

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 12:- GOODWILL AND OTHER INTANGIBLE ASSETS (Cont.)

3. The changes in the carrying amount of goodwill for the year ended December 31, 2003 and 2002 are as follows:

	<u>Internet products</u>	<u>System and projects</u>	<u>Other Holdings and Corporate operations</u>	<u>Total</u>
Balance as of January 1, 2002	\$ 1,085	\$ 7,748	\$ -	\$ 8,833
Goodwill acquired during the year (net of subsequent adjustments)	-	-	15,062	15,062
Goodwill relating to businesses sold	-	(2,157)	(200)	(2,357)
Balance as of December 31, 2002	<u>\$ 1,085</u>	<u>\$ 5,591</u>	<u>\$ 14,862</u>	<u>\$ 21,538</u>
Goodwill relating to businesses sold	(1,085)	-	(781)	(1,866)
Adjustment of goodwill due to reversal of valuation allowance in respect to deferred tax assets – see Note 3(a) and 3(b)	-	-	(7,653)	(7,653)
Balance as of December 31, 2003	<u><u>\$ -</u></u>	<u><u>\$ 5,591</u></u>	<u><u>\$ 6,428</u></u>	<u><u>\$ 12,019</u></u>

4. Until December 31, 2001, goodwill was amortized over a period of 7-10 years.
5. The following transitional information is presented to reflect net loss and loss per share for the year ended December 31, 2001 adjusted to exclude amortization of goodwill:

	<u>Year ended December 31 2001</u>
Reported net loss	\$ *52,359
Goodwill amortization	1,565
Adjusted net loss	<u>\$ 50,794</u>
Loss per share:	
Reported basic loss per share	\$ *2.47
Goodwill amortization	0.07
Adjusted basic loss per share	<u>\$ *2.40</u>
Reported diluted loss per share	\$ *2.48
Goodwill amortization	0.07
Adjusted diluted loss per share	<u>\$ *2.41</u>

* Restated - see Note 7 (d)(7).

NOTE 13:- SHORT-TERM LOANS FROM BANKS AND OTHERS

Includes primarily loans from banks in U.S. dollars, bearing interest of Libor plus a weighted average of 1.63% (In 2002 Libor plus a weighted average of 2.3%).

As of December 31, 2003, the amount includes a loan of approximately \$900 from the minority shareholders of a subsidiary. The loan bears interest at a rate of Libor plus 2%.

(The Libor rate as of December 31, 2003 and 2002 is 1.16% and 1.4%, respectively).

For liens - see Note 17(c).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- OTHER PAYABLES AND ACCRUED EXPENSES

	December 31	
	2003	2002
Payroll and related expenses ⁽¹⁾	\$ 2,752	\$ 3,462
Provision for income taxes	521	1,247
Accrued expenses	1,364	2,815
Accrued projects expenses	1,323	1,451
Deferred revenues	-	2,914
Employees call options ⁽²⁾	2,146	1,189
Others	5,514	3,438
	<u>\$ 13,620</u>	<u>\$ 16,516</u>
(1) Includes provision for vacation pay	<u>\$ 876</u>	<u>\$ 1,458</u>

(2) EMPLOYEE CALL OPTIONS

- a. As part of the retirement benefit approved by the Company's shareholders in December 1999, a former Chairman of the Board of Directors and President and CEO received an option to purchase from the Company 2% of its holdings in ESW for \$0.50 per share. The option was immediately exercisable and will expire on December 2004. The option is accounted for under the provisions of APB 25. No compensation expense was recorded since at the grant date the exercise price equaled the fair value of ESW's ordinary shares. Following the transfer of assets and liabilities of the systems and projects activities from ESW to ETI in 2000, this option provides, upon exercise, an equal number of shares of common stock of ESW and ETI, for no additional consideration.
- b. In March 2001, the Shareholders of the Company approved the grant of options to its Chairman of the Board to acquire up to 1.5% of any investments made by the Company after January 1, 2001 and an option to acquire up to 0.75% of any investments in private companies held by Elron prior to January 1, 2001 on the same terms and prices paid by Elron. These investments of Elron may be direct or indirect (through DEP). The option shall be exercisable for a period of three years from the later of January 1, 2000 or the date of Elron's last investment in each of the private companies. The options granted are recorded at their fair value.
- c. 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 investments of Elron. The options vest ratably over a three year period and are exercisable for an additional three years. The options granted were recorded at fair value.
- d. 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 2002, a former senior employee of RDC exercised a call option with respect to 172,800 shares of Given at an exercise price of \$ 0.17 per share.
- e. In 2000, RDC granted a senior employee call options to purchase 0.75% of any investments made by RDC after July 2000. The option shall be exercisable for a period of four years.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 14:- OTHER PAYABLES AND ACCRUED EXPENSES (Cont.)

(2) EMPLOYEE CALL OPTIONS (Cont.)

f. The fair value of each option granted (as described in paragraphs b - e above) is estimated using the Black and Scholes option pricing model with the following weighted average assumptions for the years ended December 31, 2003, 2002 and 2001, respectively: (1) expected life of the option of 3.89, 4.97 and 6.97, respectively; (2) dividend yield of 0% for all periods; (3) expected volatility of the options of 0% to 65%, 0% to 92% and 0% to 55%, respectively; (4) risk-free interest rate of 1%, 1.5% and 2.45% , respectively.

In respect of the aforementioned call options, compensation expense (income) amounted to \$957, (\$780) and \$ 352 for the years ended December 31, 2003, 2002 and 2001, respectively.

NOTE 15:- LONG-TERM LOANS FROM BANKS AND OTHERS

a. COMPOSITION

	December 31	
	2003	2002
Long-term loans from banks (1)	\$ 59,079	\$ 61,020
Long-term loans from others (2)	2,163	6,006
Less-current maturities (1)	<u>(44,021)</u>	<u>(17,637)</u>
	<u>\$ 17,221</u>	<u>\$ 49,389</u>

(1) Mainly bank loans of ESW and ETI in U.S. dollars, bearing an annual interest rate of Libor plus a weighted average of 1.23% (in 2002 - Libor plus a weighted average of 0.85%) (the Libor rate as of December 31, 2003 and 2002 was 1.16% and 1.4%, respectively).

As of December 31, 2003, the balance includes also a loan of Mediagate in the amount of approximately \$2,600 bearing an annual interest rate of the Wholesale Interest Rate plus 1% which is determined by the bank (the Wholesale Interest Rate as of December 31, 2003 was approximately 2.2%). The loan will be repaid from future royalties to be received by Mediagate from Telrad (see Note 3(e)).

(2) As of December 31, 2003 and 2002 an amount of \$2,163 and \$6,006, respectively, represents loans from Galram to RDC which are denominated in New Israeli Shekel ("NIS") and of which an amount of \$2,163 and \$3,267, respectively, does not bear interest or linkage. The amount of \$2,163 is included in current maturities of long term loans. As of December 31, 2002, an amount of \$2,739 is linked to the Israeli Consumer Price Index ("CPI").

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

First year (current maturities)	\$ 44,021
Second year	14,642
Third year	13
No specified maturity date (*)	<u>2,566</u>
	<u>\$ 61,242</u>

(*) With respect to Mediagate's loan.

c. Collateral - see note 17.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 16:- INCOME TAXES

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

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 No. 109, the Company has not provided deferred income taxes on this difference between 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 subsidiaries in Israel are classified as an "industrial companies", as defined by the law for the Encouragement of Industry (Taxes), 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.

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

	Year ended December 31,		
	2003	2002	2001
Current taxes	\$ 423	\$ 99	\$ 396
Taxes in respect of prior years	182	119	(812)
Deferred income taxes tax (benefit)	<u>6,229</u>	<u>(3,080)</u>	<u>(2,570)</u>
	<u>\$ 6,834</u>	<u>\$ (2,862)</u>	<u>\$ (2,984)</u>
Domestic	<u>\$ 6,834</u>	<u>\$ (2,862)</u>	<u>\$ (2,984)</u>
Foreign	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</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 16:- INCOME TAXES (Cont.)

d. 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:

	<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, 2003					
Deferred tax assets:					
Provision for doubtful accounts, vacation and others	\$ -	\$ 309	\$ -	\$ -	\$ 309
Accrued severance pay, net	216	-	-	-	216
Trading marketable securities	-	19	-	-	19
Investments in affiliated and other companies, net	82,607	-	-	-	82,607
Property and equipment and other assets	5,218	-	-	(1,509)	3,709
Tax losses carryforward	63,949	-	-	5,721	69,670
Other	-	729	-	-	729
	<u>\$ 151,990</u>	<u>\$ 1,057</u>	<u>\$ -</u>	<u>\$ 4,212</u>	<u>\$ 157,259</u>
Deferred tax liabilities:					
Available-for-sale marketable securities	(1,450)	-	-	(44,896)	(46,346)
	150,540	1,057	-	(40,684)	110,913
Valuation allowance ⁽¹⁾	(148,669)	(1,057)	-	-	(149,726)
	<u>\$ 1,871</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (40,684)</u>	<u>\$ (38,813)</u>
As of December 31, 2002					
Deferred tax assets:					
Provision for doubtful accounts, vacation and others	-	469	-	-	469
Accrued severance pay, net	229	-	-	-	229
Trading securities	-	23	-	-	23
Investments in affiliated companies and other companies, net	61,410	-	-	-	61,410
Property and equipment and other assets	5,863	-	-	(3,245)	2,618
Tax losses carryforward	65,911	-	-	7,855	73,766
Other	-	512	-	-	512
	<u>\$ 133,413</u>	<u>\$ 1,004</u>	<u>\$ -</u>	<u>\$ 4,610</u>	<u>\$ 139,027</u>
Deferred tax liabilities:					
Available for sale marketable securities	-	194	-	(28,260)	(28,066)
Valuation allowance	133,413	1,198	-	(23,650)	110,961
	<u>(130,423)</u>	<u>(1,198)</u>	<u>-</u>	<u>-</u>	<u>(131,621)</u>
	<u>\$ 2,990</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (23,650)</u>	<u>\$ (20,660)</u>

* Restated - see Note 7 (d)(7).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 16:- INCOME TAXES (Cont.)

- (1) As of December 31, 2003, valuation allowance for deferred tax assets, for which their reversal will be allocated to reduce goodwill or other non-current intangible assets, amounts to approximately \$18,300.

Regarding the deferred taxes in respect of losses in Elbit and DEP incurred prior to the acquisition date - see Note 3(a) and 3(b).

- e. 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:

	Year ended December 31,		
	2003	2002	2001
Income (loss) before taxes as reported in the consolidated statements of operations	\$ (10,771)	\$ *(35,941)	\$ *(45,392)
Statutory tax rate	36%	36%	36%
Theoretical tax expense (income)	\$ 3,878	\$ *(12,939)	*(16,341)
Equity in losses of affiliated companies	3,131	*8,708	*10,363
Tax exempt and reduced tax rate	(36)	(637)	-
Non-deductible expenses	1,586	(3,242)	(1,198)
Differences arising from the basis of measurement for tax purposes	2,233	(3,393)	(3,038)
Deferred taxes on losses for which valuation allowance was provided	3,124	8,522	8,042
Reversal of valuation allowance	(7,264)	-	-
Taxes in respect of previous years	182	119	(812)
Actual tax expenses (benefits)	\$ 6,834	\$ (2,862)	\$ (2,984)
Effective tax rate	63.4%	(7.9)%	(6.6)%

* Restated - see Note 7 (d)(7)

- f. As of December 31, 2003 the Company's subsidiaries in the U.S. have estimated aggregate available carryforward tax losses of approximately \$80,000 to offset against future taxable profits, which expire between 2004 and 2022. A valuation allowance for the entire balance was recorded due to the uncertainty of the tax asset's future realization.

As of December 31, 2003 the Company and its Israeli subsidiaries had tax loss carryforwards of approximately \$77,000. Carryforward tax losses in Israel may be carryforward indefinitely and may be set against future taxable income.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 16:- INCOME TAXES (Cont.)

- g. Loss before taxes on income is comprised as follows:

	Year ended December 31,		
	2003	2002	2001
Domestic	\$ 20,671	\$ *(11,211)	\$ *(30,088)
Foreign	(9,900)	(24,730)	(15,306)
	\$ 10,771	\$ (35,941)	\$ (45,394)

* Restated - see Note 7 (d)(7).

NOTE 17:- CONTINGENT LIABILITIES, PLEDGES AND COMMITMENTS

- a. The Company and its subsidiaries have operating lease agreements in respect of their premises for periods ending through 2007. Rent expense amounted to approximately \$558, \$1,675 and \$2,416 for the years ended December 31, 2003, 2002 and 2001, respectively. The future minimum rental payments under these agreements in the years following the balance sheet date are as follows:

First year	\$ 482
Second year	314
Third year	115
Fourth year	28
	\$ 939

- 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, 2003, the aggregate contingent obligation royalty amounted to approximately \$1,600.
- c. Elron provided guarantees to banks of up to approximately \$76,100 to secure bank loans made available to ETI and ESW, of which approximately \$67,500 have been utilized as of December 31, 2003 as bank loans and \$300 as customer guarantees. Of the \$76,100 guaranteed, approximately \$33,500 is to be collateralized by Elron's pledge of its investments in debentures, marketable securities and deposits. As of December 31, 2003, approximately \$27,200 has been pledged.

Elron also provided letters of comfort in connection with credit lines granted to ETI by certain banks, pursuant to which Elron undertook not to dilute its holdings in ETI below a certain percentage. The Company also agreed to subordinate any amounts owed to it by ETI, other than interest on outstanding loans and payments in the ordinary course of business.

- d. As of December 31, 2003 all shares of Partner held by Elbit are pledged to the banks providing financing to Partner, pro rata to the other original shareholders of Partner.

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NOTE 17 - CONTINGENT LIABILITIES, PLEDGES AND COMMITMENTS (Cont.)

- e. The Company has provided letters of comfort in connection with credit lines granted to Netvision by banks. The aggregate amount borrowed under the credit lines at December 31, 2003, amounted to approximately \$21,300. The comfort letters were jointly provided with the other major shareholder of Netvision, pursuant to which the Company and the other shareholder undertook not to dilute their holdings in Netvision below a certain percentage.
- f. Mediagate's bank loan in the amount of approximately \$ 2,600 has been secured by a first ranking pledge over the future royalties to be received from Telrad (See Note 3(e)).
- g. 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 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.

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

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NOTE 18:- SHAREHOLDERS' EQUITY

- a. Share capital
 - 1. 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.
 - 2. On May 15, 2002 under the merger with Elbit, the Company issued 5,617,601 ordinary shares. See Note 3a.
 - 3. On May 6, 2002, under the acquisition of DEP shares, the Company issued 2,261,843 ordinary shares. See Note 3b.
- b. 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 9 years from the date of grant.

In May 2003, the Board of Directors of the Company approved a 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.

As of December 31, 2003, 272,000 options were granted at an exercise price of \$8 per share which price is to be adjusted in the event the Company distributes a dividend. The options vest over a period of four years in four equal annual portions and expire after 5 years from date of grant.

	2003		2002		2001	
	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	557,880	\$ 13.92	404,974	\$ 14.84	119,634	\$ 19.90
Granted	291,333	8.03	*309,244	10.50	326,590	13.18
Exercised	(25,875)	6.84	(87,863)	6.88	(25,000)	12.21
Forfeited	(31,561)	13.10	(68,475)	12.91	(16,250)	22.89
Outstanding - end of the year	<u>791,777</u>	<u>\$ 12.01</u>	<u>557,880</u>	<u>\$ 13.92</u>	<u>404,974</u>	<u>\$ 14.84</u>
Options exercisable at the end of the year	<u>313,320</u>	<u>\$ 15.66</u>	<u>207,681</u>	<u>\$ 14.59</u>	<u>28,875</u>	<u>\$ 17.14</u>

* Includes 240,525 options granted to Elbit's employees as a result of the merger (See Note 3a) of which 54,675 were unvested.

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NOTE 18:- SHAREHOLDERS' EQUITY (Cont.)

b. Options to employees (Cont.)

1. Options to Elron's Employees (Cont.)

The weighted average fair values and weighted average exercise prices of options granted during the years ended December 31, 2003, 2002 and 2001 were:

	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,		
	2003	2002	2001	2003	2002	2001
Weighted average exercise prices	\$ 8.44	\$ 14.86	\$ 19.05	\$ 8.00	\$ 9.29	\$ 12.81
Weighted average fair values on grant date	\$ 1.30	\$ 0.91	\$ 3.98	\$ 2.95	\$ 4.01	\$ 6.52

2. The following table summarizes information regarding outstanding and exercisable options as of December 31, 2003:

Exercise price	Options outstanding			Options exercisable	
	Number outstanding at December 31, 2003	Weighted-average remaining contractual life (years)	Weighted-average exercise price	Number outstanding at December 31, 2003	Weighted-average exercise price
\$ 6.911-8.34	354,166	4.25	\$ 7.98	21,000	\$ 7.19
\$ 10.38-11.69	190,500	3.92	\$ 10.68	97,500	\$ 10.69
\$ 12.51-13.39	72,945	1.93	\$ 13.02	49,904	\$ 13.00
\$ 18.09-19.05	102,396	3.19	\$ 18.59	81,396	\$ 18.52
\$ 21.38	38,770	1.59	\$ 21.38	38,770	\$ 21.38
\$ 29.38	33,000	3.83	\$ 29.38	24,750	\$ 29.38
	<u>791,777</u>			<u>313,320</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. The exercise price of the options granted in February 2000, 2001 and 2002 was \$ 21.38, \$ 21.38 and \$ 13.01, respectively.

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,

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 18 - SHAREHOLDERS' EQUITY (Cont.)

b. Options to employees (Cont.)

commencing two years after the date of the grant. The exercise price of the options granted in June 2001, 2002 and 2003 was \$ 19.05 \$ 8.34 and \$ 8.437, respectively.

As of grant date, the weighted average fair value of the 1999 grant and the 2001 grant was \$ 7.67 and \$ 3.29 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 benefit component 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 No. 123, See Note2(s)). Compensation expense is calculated 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.

4. Compensation expense (income) recorded during 2003 amounted to \$ 386 (2002 - \$ 222, 2001 - \$ (6)).
5. The balance of deferred compensation as of December 31, 2003 amounted to \$1,032.

NOTE 19:- LOSS PER SHARE

Loss per share is computed as follows:

	Year Ended December 31								
	2003			2002			2001		
	Loss	Number of shares (in thousands)	Per share amount	Loss	Number of shares (in thousands)	Per share amount	Loss	Number of shares (in thousands)	Per share amount
Basic	<u>\$(7,205)</u>	29,194	\$(0.25)	<u>*\$(41,579)</u>	26,272	\$(1.58)	<u>*\$(52,359)</u>	21,191	*\$(2.47)
Effect of options of investees	(200)			(209)	-		(246)	-	
Diluted	<u>(7,405)</u>	<u>29,194</u>	<u>\$(0.25)</u>	<u>*\$(41,788)</u>	<u>26,272</u>	<u>\$(1.58)</u>	<u>*\$(52,605)</u>	<u>21,191</u>	<u>*\$(2.48)</u>

*Restated - see Note 7 (d)(7).

Options issued by Elron as described in Note 17 were not included in the computation of diluted loss per share because their effect is anti-dilutive.

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 20:- EQUITY IN EARNINGS (LOSSES) OF AFFILIATED COMPANIES

	Year ended December 31,		
	2003	2002	2001
Affiliated companies:			
Elbit(1)	\$ -	\$ (8,658)	\$ (13,138)
ESL	9,110	9,469	9,064
Given	(3,184)	(4,376)	(1,575)
Others(2)	(14,624)	*(20,624)	*(23,138)
	<u>\$ (8,698)</u>	<u>\$ *(24,189)</u>	<u>\$ *(28,787)</u>

(1) Through the merger date, see Note 3a.

(2) Including equity in net losses of DEP, Galil and Mediagate through their respective acquisition date, see Note 3b, 3c and 3e.

* Restated - see Note 7 (d)(7)

NOTE 21:- GAIN FROM DISPOSAL OF BUSINESSES AND AFFILIATED COMPANIES AND CHANGES IN HOLDINGS IN AFFILIATED COMPANIES, NET

	Year ended December 31,		
	2003	2002	2001
ESL	\$ (35)	\$ 1,603	\$ 2,985
Given	4,548	5,251	-
Galil Medical's urology business (See Note 3c)	21,241	-	-
Others	-	34	194
	<u>\$ 25,754</u>	<u>\$ 6,888</u>	<u>\$ 3,179</u>

NOTE 22:- OTHER INCOME (EXPENSES), NET

	Year ended December 31,		
	2003	2002	2001
Gain (loss) from sale and increase (decrease) in market value of: (see a and b below)			
Partner shares (see Note 8(3))	\$ 11,071	\$ -	\$ -
24/7 shares (see Note 5 (2))	2,019	-	-
Zix shares (see Note 5(1))	4,815	-	-
ArelNet shares	-	(27)	-
Netmanage shares	-	632	56
Broadbase shares ⁽¹⁾	-	-	(3,952)
Kana shares ⁽¹⁾	4	(34)	(691)
Zoran shares and options	-	-	954
Other companies, net	19	101	(32)
Other than temporary decline in investments (see c below)	(3,716)	(1,576)	(966)
Equity in losses of partnerships	(547)	(303)	(25)
Other income	1,000	464	(232)
	<u>\$ 14,665</u>	<u>\$ (743)</u>	<u>\$ (4,888)</u>

⁽¹⁾ Realized and unrealized gains and losses on trading securities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 22:- OTHER INCOME (EXPENSES), NET (Cont.)

- a. Realized gains from sale of available-for-sale securities amounted to approximately \$18,000, \$700 and \$1,000 in the years ended December 31, 2003, 2002 and 2001, respectively. The proceeds from such sales amounted to approximately \$43,600, \$900 and \$10,700 for the years ended December 31, 2003, 2002 and 2001, respectively.
- b. Including unrealized losses from trading securities held as of the end of the year in the amount of \$4, \$54 and \$11 for the years ended December 31, 2003, 2002 and 2001 respectively.
- c. Including other than temporary decline in value of available-for-sale securities in the amount of approximately \$0, \$600 and \$1,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

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

NOTE 23:- FINANCING INCOME (EXPENSES), NET

	Year ended December 31,		
	2003	2002	2001
Income:			
Interest on cash equivalents, bank deposits and debentures	\$ 1,229	\$ 2,314	\$ 4,670
Foreign currency gains	615	1,257	796
	<u>1,844</u>	<u>3,571</u>	<u>5,466</u>
Expenses:			
Interest on short-term credit and long-term loans	1,974	3,208	3,672
Foreign currency losses	623	444	86
	<u>2,597</u>	<u>3,652</u>	<u>3,758</u>
	<u>\$ (753)</u>	<u>\$ (81)</u>	<u>\$ 1,708</u>

NOTE 24: - RESTRUCTURING COSTS

In response to the economic conditions, and in particular, the slowdown in IT spending, ETI underwent restructuring programs in 2001 and 2002 in order to focus its operations on core areas of its business, to reduce expenses and improve efficiency. These restructuring programs mainly included workforce reductions and consolidation of excess facilities. Restructuring charges were recorded in accordance with SFAS No. 144, EITF Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs in a Restructuring)" and SAB No. 100, "Restructuring and Impairment Charges".

Employee termination costs in 2002 and 2001 amounted to \$ 934 and \$ 739, respectively, relating to the termination of 77 and 65 employees, respectively. These termination expenses were fully paid as of December 31, 2003. Facilities related expenses in 2002 and 2001 amounted to \$660 and \$890, respectively, which included termination costs of a facility lease contract and write-offs of leasehold improvements.

As part of the restructuring program, ETI sold in the third quarter of 2001 and at the beginning

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 24: - RESTRUCTURING COSTS (Cont.)

of 2002 certain activities in its E-business field to Forsoft Multimedia Solutions Ltd. and in the defense system fields to Elbit Systems Ltd. ("ESL") in consideration for \$ 3,400 and \$ 5,700, respectively, resulting in immaterial losses.

In 2003, 2002 and 2001 ESW underwent several restructuring programs, the results of which have been classified as discontinued operations. See Note 3(d).

Components of the restructuring charge for the years ended December 31, 2003 and 2002, amounts paid during the periods and remaining accrued liability as of December 31, 2003 and 2002, are as follows:

	Employee termination and severance costs	Write-off of long-lived assets	Facilities termination charges, future rental losses and other exit costs	Total
Accrued restructuring liability at December 31, 2001	\$ -	\$ -	\$ 774	\$ 774
Restructuring charges	934	772	612	*2,318
Payments and write-offs	(916)	(772)	(862)	(2,550)
Accrued restructuring liability at December 31, 2002	18	-	524	542
Restructuring charges	294	97	46	*437
Payments and write-offs	(290)	(97)	(401)	(788)
Accrued restructuring liability at December 31, 2003	<u>\$ 22</u>	<u>\$ -</u>	<u>\$ 169</u>	<u>\$ 191</u>

* An amount of \$437 and \$571 for the years ended December 31, 2003 and 2002, respectively, relates to ESW, for which the results of operation are included in discontinued operations.

NOTE 25:- DISCONTINUED OPERATIONS

During 2003 and 2002, the Company disposed of certain subsidiaries and businesses, which met the definition of a component under SFAS No. 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. Comparative data for the businesses and subsidiaries sold have been reclassified accordingly.

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NOTE 25:- DISCONTINUED OPERATIONS (Cont.)

The following is the composition of discontinued operations:

	Year ended December 31,		
	2003	2002	2001
Loss from operations of discontinued components			
ESW (see Note 3d) *	\$ (4,825)	\$ (8,567)	(10,390)
Vflash (see Note 3f) *	453	(1,852)	-
Other**	-	(2,895)	-
	<u>(4,372)</u>	<u>(13,314)</u>	<u>(10,390)</u>
Gain on disposal			
ESW (see Note 3d)	4,137	-	-
Vflash (see Note 3f)	-	1,991	-
Other	-	-	-
	<u>4,137</u>	<u>1,991</u>	<u>-</u>
	<u>\$ (235)</u>	<u>\$ (11,323)</u>	<u>\$ (10,390)</u>
* Pre-tax Income (loss) of Vflash	<u>\$ 453</u>	<u>\$ (2,405)</u>	<u>\$ -</u>
*Pre-tax loss of ESW	<u>\$ (4,829)</u>	<u>\$ (8,560)</u>	<u>\$ (10,352)</u>

** Includes the results of operations of Textology which was sold in consideration for loans, the balance of which was written-down in 2003 (see Note 8(3)).

Revenues relating to discontinued operations for the years ended December 31, 2003, 2002 and 2001 were as follows:

	Year ended December 31,		
	2003	2002	2001
ESW	\$ 4,740	\$ 8,290	\$ 9,077
V-flash	-	103	-
Other	-	457	-
	<u>\$ 4,740</u>	<u>\$ 8,850</u>	<u>\$ 9,077</u>

As of December 31, 2003 the consolidated financial statements do not include any material assets or liabilities of the components disposed of.

NOTE 26:- RELATED PARTY TRANSACTIONS

a. Balances with related parties:

	December 31	
	2003	2002
Trade receivables:		
Affiliated companies	\$ 1,750	\$ -
Other companies	377	1,308
	<u>2,127</u>	<u>1,308</u>
Other receivables:		
Affiliated companies (see note 3c)	1,034	204
Other companies	62	497
	<u>1,096</u>	<u>701</u>
Long-term receivables:		
Other companies	461	453
	<u>461</u>	<u>453</u>
	<u>\$ 3,684</u>	<u>\$ 2,462</u>

ELRON ELECTRONIC INDUSTRIES LTD. AND ITS SUBSIDIARIES

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NOTE 26:- RELATED PARTY TRANSACTIONS (Cont.)

- b. Income and expenses from affiliated and other companies:

	Year ended December 31,		
	2003	2002	2001
Income:			
Revenues	\$ 4,155	\$ 2,487	\$ 3,284
Interest and commission for guarantees	110	75	126
Participation in Directors' remuneration	35	13	28
Participation in expenses	76	308	724
Costs and Expenses:			
Participation in expenses	191	256	-
Directors' remuneration	33	39	41
Cost of revenue	-	-	728

- c. Option to the Chairman of the Board - see Note 18.
d. Sale of certain activities of ETI to ESL - see Note 24.

NOTE 27:- ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

	Unrealized gains on securities	Foreign currency translation adjustments	Minimum pension liability in an affiliated company	Unrealized loss on derivatives in an affiliated company	Total
Balance as of January 1, 2002	\$ 42,564	\$ (333)	\$ -	\$ -	\$ 42,231
Unrealized losses on available for sale securities (net of tax effect of \$11,773)	(33,035)	-	-	-	(33,035)
Reclassification adjustment for realized gain included in net loss (net of tax effect of \$726)	(1,434)	-	-	-	(1,434)
Reclassification adjustment for other than temporary decline in value included in net loss (net of tax effect of \$205)	364	-	-	-	364
Minimum pension liability in an affiliated company	-	-	(597)	-	(597)
Balance as of December 31, 2002	\$ 8,459	\$ (333)	\$ (597)	\$ -	\$ 7,529
Unrealized gains on available for sale securities (net of tax effect of \$31,605)	55,960	-	-	-	55,960
Reclassification adjustment for realized gain included in net loss (net of tax effect of \$6,933)	(11,113)	-	-	-	(11,113)
Unrealized loss on derivatives in an affiliated company	-	-	-	(108)	(108)
Foreign currency translation adjustment	-	(304)	-	-	(304)
Minimum pension liability in an affiliated company	-	-	(172)	-	(172)
Balance as of December 31, 2003	<u>\$ 53,306</u>	<u>\$ (637)</u>	<u>\$ (769)</u>	<u>\$ (108)</u>	<u>\$ 51,792</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 28:- BUSINESS SEGMENTS

- a. As of December 31, 2003, the Company operates in two business segments: (1) the System and Projects segment through its subsidiary ETI and (2) "Other Holdings and Corporate Operations" in which the Company is directly engaged and includes corporate headquarters and reflects the investments in companies engaged in various fields of advanced technology.

The operations of the System and Projects segment include development and supply of software solutions for the 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, defense industry, 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 reclassified as discontinued operations. (see Note 3d).

- b. Segment information is as follows:

	<u>Internet products</u>	<u>System and projects</u>	<u>Other holdings and corporate operations</u>	<u>Adjustments</u>	<u>Total</u>
2003					
Net revenues	\$ -	\$ 7,390	\$ 9,157	\$ -	\$ 16,547
Other income, net	-	27	14,638	-	14,665
Equity in losses of affiliated companies	-	-	(8,698)	-	(8,698)
Gain from disposals of businesses and affiliated companies and changes in holdings in affiliated companies, net	-	-	25,754	-	25,754
Financial income (expenses), net	-	(1,504)	751	-	(753)
Tax benefit (taxes on income)	-	(37)	(6,797)	-	(6,834)
Net loss	(689)	(2,074)	(4,442)	-	(7,205)
Depreciation and amortization	-	254	1,336	-	1,590
Capital expenditures	39	53	14,138	-	14,230
Total assets as of December 31, 2003	75	15,177	450,222	(14,770)	450,704
Goodwill as of December 31, 2003	-	5,591	6,428	-	12,019

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 28:- BUSINESS SEGMENTS (Cont.)

	<u>Internet products</u>	<u>System and projects</u>	<u>Other holdings and corporate operations</u>	<u>Adjustments</u>	<u>Total</u>
2002					
Net revenues	\$ -	\$ 10,069	\$ 5,110	\$ -	\$ 15,179
Other expenses, net	-	4	(747)	-	(743)
Equity in losses of affiliated companies	-	-	*(24,189)	-	*(24,189)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	-	-	6,888	-	6,888
Financial income (expenses), net	-	(1,562)	1,481	-	(81)
Tax benefit (taxes on income)	-	(99)	2,961	-	2,862
Net loss	(8,567)	(5,912)	*(27,100)	-	*(41,579)
Depreciation and amortization	-	1,473	1,421	-	2,894
Capital expenditures	247	158	33,698	-	34,103
Total assets as of December 31, 2002	6,057	17,601	*383,268	(12,673)	*394,253
Goodwill as of December 31, 2002	1,085	5,591	14,862	-	21,538
2001					
Net revenues	\$ -	\$ 23,782	\$ -	\$ -	\$ 23,782
Other expenses, net	-	(221)	*(4,667)	-	* (4,888)
Equity in losses of affiliated companies	-	-	(28,787)	-	(28,787)
Gain from disposal of businesses and affiliated companies and changes in holdings in affiliated companies, net	-	-	3,179	-	3,179
Financial income (expenses), net	-	(2,832)	4,540	-	1,708
Taxes on income	-	(798)	3,783	-	2,985
Net loss	(10,390)	(15,302)	*(26,667)	-	*(52,359)
Depreciation and amortization	-	(3,985)	(226)	-	(4,211)

* Restated - See Note 7(d)(7).

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NOTE 28- BUSINESS SEGMENTS (Cont.)

c. Revenues according to geographical destination are as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Israel	\$ 6,589	\$ 9,101	\$ 21,736
Overseas (mainly USA)	<u>9,958</u>	<u>6,078</u>	<u>2,046</u>
	<u>\$ 16,547</u>	<u>\$ 15,179</u>	<u>\$ 23,782</u>

d. Revenues from major customers were as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
In the Systems and Project segment:			
Customer A	14%	21%	19%
Customer B	4%	16%	-
Customer C	9%	10%	-
Customer D	-	-	12%
Customer E	-	-	11%
In the Other Holdings and Corporate Operations segment:			
Oncura (See Note 26)	21%	-	-

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

NOTE 29:- 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:

	<u>As reported</u>	<u>Adjustments</u>	<u>As per Israeli GAAP</u>
For the year ended December 31, 2003:			
Net loss	\$ (7,205)	\$ 18,436	\$ 11,231
Basic net loss per share	(0.25)	0.63	0.38
Diluted net loss per share	(0.25)	0.63	0.38
For the year ended December 31, 2002:			
Net loss	* (41,579)	3,211	(38,368)
Basic net loss per share	* (1.58)	0.12	(1.46)
Diluted net loss per share	* (1.58)	0.12	(1.46)
For the year ended December 31, 2001:			
Net loss	* (52,359)	5,844	(46,515)
Basic net loss per share	* (2.47)	0.27	(2.20)
Diluted net loss per share	* (2.48)	0.27	(2.21)

* Restated - see Note 7 (d)(7)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 29:- RECONCILIATION TO ISRAELI GAAP (Cont.)

b. Effect on the balance sheet:

As of December 31, 2003:

	<u>As reported</u>	<u>Adjustments</u>	<u>As per Israeli GAAP</u>
Investments in other companies and long term receivables	\$ 128,799	\$ (124,035)	\$ 4,764
Investment in affiliated companies	156,819	(40,454)	116,365
Total assets	450,704	(176,981)	273,723
Deferred taxes	40,684	(44,813)	(4,129)
Accumulated deficit	(32,347)	21,562	(10,785)
Total equity	296,130	(115,692)	180,438

As of December 31, 2002:

Investments in other companies and long term receivables	*89,134	(70,161)	18,973
Investment in affiliated companies	*132,204	(32,416)	99,788
Total assets	*394,253	(121,988)	272,265
Deferred taxes	23,650	(28,767)	(5,117)
Accumulated deficit	* (25,142)	3,127	(22,015)
Total equity	*259,441	(94,526)	164,915

* Restated - see Note 7 (d)(7)

c. Material adjustments:

The abovementioned adjustments include material differences between U.S. GAAP and Israeli GAAP are as follows:

1. According to U.S. GAAP, the merger of Elron and Elbit and the DEP share purchase as described in Note 3 are accounted for by the purchase method in Elron's financial statements. According to accepted practice in Israel, the merger between Elron and Elbit and the DEP share purchase, are considered transactions with controlling shareholders and accordingly, the assets and liabilities should be recorded according to their carrying values in the transferring company at the dates of the relevant transactions.

In addition, in 2003 and 2002 Elbit recorded tax assets of approximately \$7,600 and \$6,600, respectively, in respect of carryforward losses and in 2003 RDC reversed its valuation allowance by approximately \$1,200. 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 29:- RECONCILIATION TO ISRAELI GAAP (Cont.)

c. Material adjustments (Cont.):

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. According to accepted practice in Israel, only the portion of the tax benefit relating to the interest acquired should be recorded as an adjustment to additional paid-in capital while the portion relating to the interest previously held by the acquirer should be recorded as a tax benefit in net income. The effect on net loss in 2003 and 2002 amounted to a reduction in losses of approximately \$3,800 and \$2,900, respectively.

2. As a result of the purchase of DEP and additional investments in Oren, Elron's aggregate interest in certain companies has increased and enabled Elron to exercise significant influence in these companies. In accordance with U.S. GAAP, Elron's direct holdings in these companies, which were accounted for by Elron at cost or as available-for-sale securities, are accounted for retroactively under the equity method of accounting ("step-by-step acquisition") which resulted in a restatement of Elron's financial statements for all prior periods. According to Israeli GAAP, the equity method should be applied only from the first time Elron could exercise significant influence in these companies.

As a result, 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 will be amortized over a period of five years. Under U.S GAAP no such excess cost exists. The effect on net loss in 2003, 2002 and 2001 amounted to a reduction of losses of approximately \$400, \$300 and \$4,000, respectively.

3. As described in Note 8(3), Elbit sold in 2003, 6,278,226 shares of Partner. According to accepted practice in Israel, the merger between Elron and Elbit which occurred in May 2002, is considered a transaction with controlling shareholders and accordingly the assets and liabilities of Elbit were recorded according to their carrying values in Elbit at the date of the merger (see 1 above). The carrying value of the Partner shares was approximately \$50 and therefore the gain after tax recorded in respect of the above sale of Partner shares based on Israeli GAAP amounts to approximately \$18,700, as compared to approximately \$7,100 under US GAAP.
4. As described in Note 7(d)(3), in 2003 and 2002 RDC sold 753,600 and 500,000 shares of Given, respectively. As described above (see 1 above) the investment in Given was recorded according to its carrying values in DEP at the purchase date. As a result, the effect of the sale of Given shares in 2003 and 2002 amounted to an additional gain of approximately \$2,000 and \$800, respectively.
5. According to U.S. GAAP the transfer of Galil's business in exchange for an interest in Oncura was recorded 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 29:- RECONCILIATION TO ISRAELI GAAP (Cont.)

c. Material adjustments (Cont.):

\$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.

6. According to U.S. GAAP, the gain arising from the initial public offering of Given is accounted for as an equity transaction, as Given was a development stage company at the time. According to Israeli GAAP, this gain is recognized in the statement of operations over three years from the date of the public offering. The effect on net loss in 2003, 2002 and 2001 amounted to an increase in income of approximately \$1,900, \$3,200 and \$1,000, respectively.
7. 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, and charged (or credited) to the income statement. The effect on net loss in 2003 and 2002 amounted to an increase (decrease) in income of approximately \$3,700 and \$(900), respectively.
8. Effective January 1, 2002 the Company adopted SFAS 142, according to which goodwill and intangible assets with indefinite lives are no longer amortized periodically but are reviewed annually for impairment (or more frequently if impairment indicators arise). According to Israeli GAAP, all intangibles, including goodwill should be amortized.
9. 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 to EL-OP.
10. According to U.S. GAAP, the merger of ESL and EL-OP which occurred in 2000 is accounted by the purchase method in ESL's financial statements and accordingly a gain from the decrease in holding in ESL was recorded in Elron's financial statements. According to accepted practice in Israel, the merger between ESL and EL-OP, from the perspective of Elron, is considered a non-monetary exchange of similar assets and accordingly was recorded at book value, with no gain recognized. Therefore, the change recorded in the investment in ESL in Elron's books under Israeli GAAP, was based on the book value of the net assets transferred by Elron.

ANNEX TO THE CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

ANNEX TO THE FINANCIAL STATEMENTS

In thousands of U.S. Dollars

Details relating to major investments as of December 31, 2003:

	% of ownership interest ⁽¹⁾	Carrying value of the investment as of December 31, 2003 ⁽²⁾	Market value of the publicly traded investments as of:	
			December 31, 2003	March 5, 2004
<u>Consolidated Companies:</u>				
Elron Telesoft Inc.	99%	\$ 9,267	\$ -	\$ -
Galil Medical Ltd. ⁽³⁾	33%	1,807	-	-
<u>Affiliated Companies (equity):</u>				
Elbit Systems Ltd. (Nasdaq: ESLT)	20%	87,681	143,023	149,588
Given Imaging Ltd. (Nasdaq: GIVN) ⁽³⁾	17%	20,828	76,875	130,966
NetVision Ltd.	46%	526	-	-
Wavion, Inc.	38%	2,842	-	-
K.I.T elearning B.V.	45%	-	-	-
Chip Express Corporation	36%	2,743	-	-
Pulsicom Israel Technologies Ltd.	18%	395	-	-
3DV Systems Ltd. ⁽³⁾	24%	215	-	-
Advanced Metal Technologies Ltd. (AMT)	28%	3,436	-	-
Witcom Ltd. ⁽³⁾	20%	388	-	-
CellAct Ltd.	45%	327	-	-
SELA ⁽³⁾	24%	649	-	-
Ingeneo Ltd. ⁽³⁾	17%	400	-	-
Notal Vision, Inc.	24%	1,228	-	-
Oren Semiconductor Inc.	41%	2,532	-	-
Oncura ⁽⁴⁾	8%	9,949	-	-
Starling ⁽³⁾	24%	(50)	-	-
<u>Available for sale:</u>				
Partner (Nasdaq: PTNR)	9%	124,315	124,315	122,888
Zix Corporation (Nasdaq: ZIXI)	3%	7,159	7,159	11,239
EVS (Nasdaq: EVSNF.OB)	26%	963	2,409	3,574
<u>Partnership:</u>				
Gemini Israel Fund L.P.	5%	198	-	-
InnoMed Ventures L.P.	14%	1,938	-	-

(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.

SCITEX CORPORATION LTD.

2003 CONSOLIDATED FINANCIAL STATEMENTS

SCITEX CORPORATION LTD.
2003 CONSOLIDATED FINANCIAL STATEMENTS

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The amounts are stated in U.S. dollars (\$).

REPORT OF INDEPENDENT AUDITORS

To the shareholders of

SCITEX CORPORATION LTD.

We have audited the consolidated balance sheets of Scitex Corporation Ltd. (the "Company") and its subsidiaries as of December 31, 2003 and 2002 and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's Board of Directors and 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 associated companies, the Company's investment in which, as reflected in the balance sheets as of December 31, 2003 and 2002 is \$ 3,328,000 and \$ 7,247,000, respectively, and the Company's share in losses of which is \$ 5,637,000, \$ 4,106,000 and \$ 64,407,000 in 2003, 2002 and 2001, respectively. The financial statements of those companies were audited by other independent auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to amounts included for those companies, is based on the reports of the other independent auditors.

We conducted our audits in accordance with auditing standards generally accepted in Israel and in the United States, including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's Board of Directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other independent auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other independent 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, 2003 and 2002 and the consolidated results of operations, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

As discussed in note 2i to the consolidated financial statements, effective January 1, 2002, the Company changed its method of accounting for goodwill to conform with FASB statement of Financial Accounting Standard No. 142 "Goodwill and Other intangible assets".

Tel-Aviv, Israel
March 1, 2004

Kesselman & Kesselman
Certified Public Accountants (Isr.)

SCITEX CORPORATION LTD.
CONSOLIDATED BALANCE SHEETS

A s s e t s	December 31	
	2003	2002
	U.S. dollars in thousands	
CURRENT ASSETS:		
Cash and cash equivalents	52,861	17,814
Short-term investments	8,235	
Restricted deposit	18,262	20,203
Trade receivables	36,002	30,555
Other receivables	9,995	7,321
Inventories (note 14b)	22,575	20,060
Current assets of discontinued operation	161,602	135,269
T o t a l current assets	309,532	231,222
INVESTMENTS AND OTHER NON-CURRENT ASSETS:		
Associated companies	3,328	7,247
Other investments and non-current assets (note 5)	1,301	55,131
Funds in respect of employee rights upon retirement	2,040	1,183
Deferred income taxes	112	1,866
	6,781	65,427
PROPERTY, PLANT AND EQUIPMENT , net of accumulated depreciation and amortization (note 6)	9,204	6,074
GOODWILL (note 7)	5,472	2,171
OTHER INTANGIBLE ASSETS , net of accumulated amortization (note 8)	18,027	11,367
NON-CURRENT ASSETS OF DISCONTINUED OPERATION	48,897	53,295
	397,913	369,556

_____))
Ami Erel) **Chairman of the Board of Directors**

_____))
Raanan Cohen) **Interim President & Chief Executive Officer**

	December 31	
	2003	2002
	U.S. dollars in thousands	
Liabilities and shareholders' equity		
CURRENT LIABILITIES:		
Short-term bank credit and loans (note 14d)	45,351	31,888
Current maturities of long-term loans (note 14d)	2,602	5,248
Note payable issued to an investee company		18,523
Trade payables	14,505	14,834
Taxes on income, net of advances	29,517	26,086
Accrued and other liabilities (note 14c)	25,677	16,951
Current liabilities related to discontinued operation	<u>31,935</u>	<u>21,388</u>
T o t a l current liabilities	<u>149,587</u>	<u>134,918</u>
LONG-TERM LIABILITIES:		
Loans, net of current maturities: (note 14d)		
Banks	6,623	5,493
Other	3,623	
Liability for employee rights upon retirement (note 9)	3,022	1,607
Long-term liabilities related to discontinued operation	<u>5,431</u>	<u>6,359</u>
T o t a l long-term liabilities	<u>18,699</u>	<u>13,459</u>
CONVERTIBLE LONG-TERM LOANS FROM		
RELATED PARTIES (note 14d)	756	
COMMITMENTS AND CONTINGENT LIABILITIES (note 10)		
T o t a l liabilities	<u>169,042</u>	<u>148,377</u>
MINORITY INTEREST		
T o t a l minority interest	<u>4,173</u>	
SHAREHOLDERS' EQUITY (note 11):		
Share capital - ordinary shares of NIS 0.12 par value (authorized - December 31, 2003 and 2002 - 48,000,000 shares; issued and outstanding - December 31, 2003 and 2002 - 43,467,388 shares)	6,205	6,205
Capital surplus	368,104	364,619
Accumulated other comprehensive income (loss)	(552)	801
Accumulated deficit	(144,852)	(146,239)
Treasury shares, at cost (December 31, 2003 and 2002 - 448,975 shares)	<u>(4,207)</u>	<u>(4,207)</u>
T o t a l shareholders' equity	<u>224,698</u>	<u>221,179</u>
	<u>397,913</u>	<u>369,556</u>

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

SCITEX CORPORATION LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year ended December 31		
	2003	2002	2001
U.S. dollars in thousands (except per share data)			
REVENUES:			
Sales	60,653	52,847	59,753
Services	5,638	5,098	4,174
Supplies	<u>36,589</u>	<u>27,716</u>	<u>27,691</u>
Total revenues	102,880	85,661	91,618
COST OF REVENUES:			
Cost of sales	33,766	25,873	27,268
Cost of services	12,438	11,486	12,414
Cost of supplies	<u>12,138</u>	<u>8,562</u>	<u>8,126</u>
Total cost of revenues	<u>58,342</u>	<u>45,921</u>	<u>47,808</u>
GROSS PROFIT	<u>44,538</u>	<u>39,740</u>	<u>43,810</u>
RESEARCH AND DEVELOPMENT COSTS - net (note 14f)	11,070	7,060	6,083
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES (note 14g)	35,339	33,393	37,653
AMORTIZATION OF INTANGIBLE ASSETS (in 2001 - including goodwill)	5,871	2,944	8,460
WRITE-DOWN OF GOODWILL AND OTHER INTANGIBLE ASSETS	2,967		14,986
RESTRUCTURING CHARGES (note 14h)	<u>1,590</u>		<u>500</u>
OPERATING LOSS	(12,299)	(3,657)	(23,872)
FINANCIAL EXPENSES - net (note 14i)	(2,651)	(3,139)	(2,928)
WRITE-DOWN OF INVESTMENT IN AN ASSOCIATED COMPANY			(149,704)
OTHER INCOME (LOSS) - net (note 14j)	<u>787</u>	<u>(26,270)</u>	<u>(13,034)</u>
LOSS BEFORE TAXES ON INCOME	(14,163)	(33,066)	(189,538)
TAXES ON INCOME (note 12)	(2,402)	648	(2,957)
SHARE IN LOSSES OF ASSOCIATED COMPANIES	(5,637)	(4,106)	(67,507)
MINORITY INTERESTS IN LOSSES OF A SUBSIDIARY	<u>3,546</u>		
NET LOSS FROM CONTINUING OPERATIONS	(18,656)	(36,524)	(260,002)
NET INCOME FROM DISCONTINUED OPERATION	<u>20,043</u>	<u>4,494</u>	<u>6,982</u>
NET INCOME (LOSS)	<u>1,387</u>	<u>(32,030)</u>	<u>(253,020)</u>
EARNINGS (LOSS) PER SHARE ("EPS") - BASIC:			
Continuing operations	\$(0.43)	\$(0.84)	\$(6.04)
Discontinued operation	<u>\$ 0.46</u>	<u>\$ 0.10</u>	<u>\$ 0.16</u>
	<u>\$ 0.03</u>	<u>\$(0.74)</u>	<u>\$(5.88)</u>
EARNINGS (LOSS) PER SHARE ("EPS") - DILUTED:			
Continuing operations	\$(0.43)	\$(0.84)	\$(6.04)
Discontinued operation	<u>\$ 0.46</u>	<u>\$ 0.10</u>	<u>\$ 0.16</u>
	<u>\$ 0.03</u>	<u>\$(0.74)</u>	<u>\$(5.88)</u>
WEIGHTED AVERAGE NUMBER OF SHARES USED IN COMPUTATION OF EPS (in thousands):			
Basic	<u>43,018</u>	<u>43,018</u>	<u>43,018</u>
Diluted	<u>43,018</u>	<u>43,018</u>	<u>43,018</u>

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

SCITEX CORPORATION LTD.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Share capital	Capital surplus	Accumulated other comprehensive Income (loss)	Retained earnings (accumulated deficit)	Treasury shares	Total shareholders' equity
	U.S. dollars in thousands					
BALANCE AT JANUARY 1, 2001	6,205	364,619	904	138,811	(4,207)	506,332
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2001:						
Net loss				(253,020)		(253,020)
Other comprehensive income (loss), net, in respect of:						
Currency translation adjustments			(306)			(306)
Available-for-sale securities			7,342			7,342
Derivative instruments designated for cash flow hedge			(200)			(200)
Total comprehensive loss						(246,184)
Issuance of shares by a development-stage associated company			14			14
BALANCE AT DECEMBER 31, 2001	6,205	364,619	7,754	(114,209)	(4,207)	260,162
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2002:						
Net loss				(32,030)		(32,030)
Other comprehensive income (loss), net, in respect of:						
Currency translation adjustments			189			189
Available-for-sale securities			(7,342)			(7,342)
Derivative instruments designated for cash flow hedge			200			200
Total comprehensive loss						(38,983)
BALANCE AT DECEMBER 31, 2002	6,205	364,619	801	(146,239)	(4,207)	221,179
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2003:						
Net income				1,387		1,387
Other comprehensive loss, net, in respect of:						
Currency translation adjustments			(1,353)			(1,353)
Total comprehensive income						34
Share in beneficial conversion feature relating to convertible preferred shares issued by Scitex Vision. See note 3a		3,485				3,485
BALANCE AT DECEMBER 31, 2003	6,205	368,104	(552)	(144,852)	(4,207)	224,698

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

SCITEX CORPORATION LTD.**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year ended December 31		
	2003	2002	2001
	U.S. dollars in thousands		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	1,387	(32,030)	(253,020)
Net income from discontinued operation	(20,043)	(4,494)	(6,982)
Net loss from continuing operations	(18,656)	(36,524)	(260,002)
Adjustments to reconcile net loss from continuing operations to net cash provided by operating activities:			
Income and expenses not involving cash flows:			
Minority interests in losses of subsidiaries	(3,546)		
Share in losses of associated companies - net	5,637	4,106	67,506
Depreciation and amortization	9,406	5,194	10,663
Write-down of goodwill and other intangible assets	2,967		14,986
Restructuring charges	291		500
Loss (gain) on disposal of fixed assets	321	(16)	102
Gain from sale of interest in a subsidiary	(3,774)		
Share in beneficial conversion feature of convertible preferred shares issued by a subsidiary	3,485		
Loss from change in percentage of holding in an associated company			4,408
Gain from sale of available-for-sale securities	(2,823)		
Loss from sale of investments in an associated company			6,041
Write-off and write-down of investments in investee companies and available-for-sale securities	2,493	26,122	5,477
Write-down of investment in an associated company			149,704
Interest on long-term note payable	236	944	944
Interest on long-term loans - net	(603)		
Revaluation of long-term loan	(408)		
Interest on convertible long-term loans from related parties	20		
Deferred income taxes - net	1,754	(64)	(1,802)
Decrease (increase) in short-term investments	(8,235)		9,511
Changes in operating asset and liability items:			
Increase in accounts receivable	(6,496)	(5,244)	(1,356)
Decrease (increase) in inventories	112	1,937	(5,093)
Increase (decrease) in accounts payable and accruals	4,248	(1,394)	(46,783)
Other items - net	(8)	(254)	(248)
Net cash used in continuing operations	(13,579)	(5,193)	(45,442)
Net cash provided by discontinued operation	7,415	9,564	22,289
Net cash provided by (used in) operating activities	(6,164)	4,371	(23,153)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisition of assets and operations consolidated for the first time *	771	(2,181)	(2,860)
Purchase of fixed assets	(3,306)	(10,324)	(15,469)
Proceeds from sale of fixed assets		10	3,490
Proceeds from sale of investment in an associated company			76,071
Proceeds from sale of other investment	53,886		
Purchase of intangible assets	(820)	(1,012)	(5,123)
Restricted deposits	3,427	(20,203)	
Investment in associated companies and other investments	(3,061)	(3,466)	(6,138)
Net cash provided by (used in) investing activities	50,897	(37,176)	49,971
Subtotal - forward	44,733	(32,805)	26,818

SCITEX CORPORATION LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31		
	2003	2002	2001
	U.S. dollars in thousands		
Subtotal - brought forward	<u>44,733</u>	<u>(32,805)</u>	<u>26,818</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Increase in long-term liabilities	612	8,000	5,500
Receipt of Convertible long-term loans from related parties	933		
Discharge of long-term liabilities	(666)	(8,759)	(2,000)
Repayment of long-term note payable	(18,759)		
Increase in short-term bank credit - net	<u>8,194</u>	<u>5,287</u>	<u>6,341</u>
Net cash provided by (used in) financing activities	<u>(9,686)</u>	<u>4,528</u>	<u>9,841</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	35,047	(28,277)	36,659
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>17,814</u>	<u>46,091</u>	<u>9,432</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u><u>52,861</u></u>	<u><u>17,814</u></u>	<u><u>46,091</u></u>
* Acquisition of assets and operations consolidated for the first time:			
Assets and liabilities at the date of acquisition:			
Deficiency in working capital (excluding cash and cash equivalents)	4,754		(361)
Fixed assets - net	(4,447)		(585)
Goodwill arising on acquisition	(2,043)		
Intangible assets arising on acquisition	(11,376)	(2,181)	(1,914)
Long-term loans and other liabilities	6,361		
Minority interests in subsidiary at date of acquisition	<u>7,522</u>		
Cash received (paid)	<u><u>771</u></u>	<u><u>(2,181)</u></u>	<u><u>(2,860)</u></u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Interest paid	<u>4,166</u>	<u>1,703</u>	<u>604</u>
Income taxes paid	<u>2,652</u>	<u>732</u>	<u>20,016</u>

Supplementary information on investing activities not involving cash flows - as to the additional investment in an associated company in December 2002, see note 4b.

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

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - GENERAL:

a. Nature of operations

Scitex Corporation Ltd. (the "Company") is an Israeli corporation, which through its subsidiaries operates in one segment – wide format digital printing. The subsidiaries develop, manufacture and market industrial digital inkjet printing solutions mainly to the graphic arts, packaging and textile markets as well as related services and consumable products. As of the end of 2003, the Company (through its wholly-owned subsidiary) operated also in the high-speed digital printing segment, which was classified as discontinued operation, see b below. In addition, the Company holds interest in other companies that develop digital printing solution to industrial applications. Amounts provided in these notes to the consolidated financial statements pertain to continuing operations - unless otherwise indicates.

b. Sale of the High-Speed Digital Printing segment

On November 25, 2003, the Company entered into an agreement according to which it will sell substantially all of the assets, liabilities and operations of its indirect wholly-owned subsidiary Scitex Digital Printing Inc. ("SDP") related to its High-Speed Digital Printing Business, including most of the distribution channels that served SDP, to Eastman Kodak Company ("Kodak"), for \$ 250 million in cash. Pursuant to the agreement, a \$25 million was held in escrow. \$15 million out of the above escrow amount was released in February 2004 to SDP's parent company ("SDC") account, and the remaining \$10 million will be held for up to two years and will be used for indemnification liabilities under the agreement.

The assets, net of liabilities sold are distinguishable as a component of the Company and classified as "Assets or Liabilities of discontinued operation" in accordance with Statement of Financial Accounting Standards No. 144 ("SFAS 144"), "Accounting for the Impairment on Disposal of Long-Lived Assets" of the Financial Accounting Standards Board of the United States ("FASB"). Direct costs to transact the sale were comprised of, but not limited to, broker commissions, legal and title transfer fees and closing costs, which will be expensed upon the completion of the transaction.

The closing of the transaction occurred on January 5, 2004. As a result of the transaction, the Company is expected to record a net gain of approximately \$ 60 million, approximately \$ 52 million of which will be included in the statement of operations for the first quarter of 2004, and approximately \$ 8 million of which were recognized in the fourth quarter of 2003 as a tax benefit related to expected utilization of carryforward tax losses including capital losses and is recorded under "income from discontinued operation".

Operating results of SDP have been reported in these financial statements as discontinued operations in accordance with SFAS 144 and the Company has reclassified the results of operations, the assets and liabilities of the component to be disposed for the prior period in accordance with provisions of SFAS 144.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 1 - GENERAL (continued):

- 1) The assets and liabilities of SDP classified as discontinued operation in the Consolidated Balance Sheets, are as follows:

	<u>December 31</u>	
	<u>2003</u>	<u>2002</u>
	<u>U.S. dollars in thousands</u>	
A s s e t s		
Current assets:		
Cash and Short-term investments	16,056	15,717
Trade and other receivables	68,811	67,077
Inventories	40,506	31,501
Deferred income taxes	<u>36,229</u>	<u>20,974</u>
T o t a l current assets	<u>161,602</u>	<u>135,269</u>
Investment and other non-current assets	2,040	1,585
Property, plant and equipment , net of accumulated depreciation and amortization	26,223	30,783
Goodwill	19,730	19,730
Other intangible assets , net of accumulated amortization	<u>904</u>	<u>1,197</u>
T o t a l assets	<u>210,499</u>	<u>188,564</u>
L i a b i l i t i e s		
Current liabilities	31,935	21,388
Long-term liabilities:		
Deferred income taxes	3,883	5,033
Other	<u>1,548</u>	<u>1,326</u>
T o t a l liabilities	<u>37,366</u>	<u>27,747</u>

- 2) Revenues and net income from the discontinued operations of SDP are as follow:

	<u>Year ended December 31</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<u>U.S. dollars in thousands</u>		
REVENUES	170,113	157,111	164,596
COST OF REVENUES	<u>101,721</u>	<u>98,573</u>	<u>99,745</u>
GROSS PROFIT	68,392	58,538	64,851
OTHER OPERATION EXPENSES	<u>56,300</u>	<u>52,772</u>	<u>57,812</u>
OPERATING INCOME	12,092	5,766	7,039
FINANCIAL INCOME - net	3,970	1,103	40
OTHER LOSSES - net	<u>(390)</u>	<u>(182)</u>	<u> </u>
INCOME BEFORE TAXES ON INCOME	15,672	6,687	7,079
TAXES ON INCOME	<u>(4,371)</u>	<u>2,193</u>	<u>97</u>
NET INCOME FOR THE YEAR	<u>20,043</u>	<u>4,494</u>	<u>6,982</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES:

a. General:

1) Functional currency

The currency of the primary economic environment in which the operations of the Company and most of its subsidiaries are conducted is the U.S. dollar (“dollar” or “\$”); thus, the dollar is the functional currency of the Company and most of its subsidiaries.

For the Company and those subsidiaries whose functional currency is the dollar, transactions and balances denominated in dollars are presented at their original amounts. Balances in non-dollar currencies are translated into dollars using historical and current exchange rates for non-monetary and monetary balances, respectively. For non-dollar transactions reflected in the statements of operations, the exchange rates at transaction dates are used, except for expenses deriving from non-monetary items, which are translated using historical exchange rates. The currency transaction gains or losses are carried to financial income or expenses, as appropriate.

The financial statements of a subsidiary - relating to the discontinued operation, whose functional currency is its local currency, are translated into dollars in accordance with the principles set forth in Statement of Financial Accounting Standards (“FAS”) No. 52 “Foreign Currency Translation”. The resulting aggregate translation adjustments are presented in shareholders’ equity, under “accumulated other comprehensive income (loss)”.

2) Use of estimates in the preparation of financial statements

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 dates of the financial statements and the reported amounts of revenues and expenses during the reporting years. Actual results could differ from those estimates.

3) Accounting principles

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

b. Principles of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany balances and transactions have been eliminated in consolidation. Unrealized profits from intercompany sales have also been eliminated.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

c. Cash and cash equivalents

The Company and its subsidiaries consider all highly liquid investments, with an original maturity of three months or less at time of investment, that are not restricted as to withdrawal or use, to be cash equivalents.

d. Investments in marketable securities

Trading securities which are carried at fair market value with unrealized gains and losses, are included in "financial income (expenses) - net". Trading securities are presented in the balance sheet under "short-term investments".

Other marketable securities consist of equity securities classified as "available-for-sale" securities and are presented in the balance sheet under "other investments and non-current assets". Available-for-sale securities are carried at fair market value with unrealized gains and losses, and are reported as a separate item under "other comprehensive income (loss)". Realized gains and losses and declines in value that are considered as other than temporary in nature on available-for-sale securities are included under "other loss - net" - see also note 5(b).

e. Other non-marketable investments

These investments are carried at cost, net of write-down for decrease in value, which is not of a temporary nature.

f. Inventories

Inventories are valued at the lower of cost or market. Cost is determined as follows:

Raw-materials - on the moving average basis.

Finished products and products in process - on basis of production costs:

Raw materials - on the moving average basis.

Labor and overhead component - actual manufacturing costs.

g. Investments in associated companies

Associated companies are companies over which significant influence is exercised, but which are not consolidated subsidiaries, and are accounted for by the equity method, net of write-down for decrease in value, which is not of a temporary nature. The excess of cost of investment in associated companies over the Company's share in their net assets at date of acquisition ("excess of cost of investment") represents amounts attributed to know-how and technology. The excess of cost of investment is amortized over a period of 5 years, commencing in the year of acquisition.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

h. Property, plant and equipment

Property, plant and equipment are carried at cost and are depreciated by the straight-line method over their estimated useful life.

Annual rates of depreciation are as follows:

	<u>%</u>
Machinery and equipment	10-33 (mainly 20)
Building	2.5
Office furniture and equipment	6-33 (mainly 20)
Motor vehicles	15-25 (mainly 15)

Leasehold improvements are amortized by the straight-line method over the term of the lease or the estimated useful life of the improvements, whichever is shorter.

i. Goodwill

On January 1, 2002 the Company adopted FAS No. 142 "Goodwill and Other Intangible Assets". Under FAS 142, goodwill is no longer being amortized but tested for impairment at least annually.

Prior to January 1, 2002, goodwill was amortized on a straight-line basis, over periods of 7-15 years.

The Company identified two reporting units that consisted of its operating segments: wide format digital printing and high-speed digital printing – which was classified as discontinued operation (see also note 1b). The Company has utilized expected future discounted cash flows to determine the fair value of the reporting units and whether any impairment of goodwill existed – as of the date of adoption.

The Company has performed its annual goodwill impairment test during the fourth quarter of 2003. No impairment of goodwill resulted from the annual review performed in 2003.

j. Other intangible assets

Other intangible assets which consist mainly of technology, are presented at cost and are amortized by the straight-line method over a period of 5-6 years.

These intangible assets are presented net of write-down in value which is other than temporary, see also note 8.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

k. Impairment in value of long-lived assets

The company has adopted FAS 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("FAS 144") effective January 1, 2002. FAS 144 requires that long-lived assets, to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Under FAS 144, if the sum of the expected future cash flows (undiscounted and without interest charges) of the long-lived assets is less than the carrying amount of such assets, an impairment loss would be recognized, and the assets would be written down to their estimated fair values.

The adoption of FAS 144 - on January 1, 2002 - did not have any material impact on the consolidated financial position and consolidated results of operations of the Company.

l. Deferred income taxes:

- 1) Deferred taxes are determined utilizing the asset and liability method based on the estimated future tax effects of differences between the financial accounting and tax bases of assets and liabilities under the applicable tax laws. Deferred income tax provisions and benefits are based on the changes in the deferred tax asset or tax liability from period to period. Valuation allowances are provided for deferred tax assets when it is more likely than not that all or a portion of the deferred tax assets will not be realized.
- 2) The Company may incur an additional tax liability in the event of an intercompany dividend distribution by non-Israeli subsidiaries; no additional tax has been provided, since the Company does not intend to distribute, in the foreseeable future, dividends which would result in an additional tax liability.
- 3) Taxes that would apply in the event of disposal of investments in non-Israeli subsidiaries have not been taken into account in computing the deferred taxes as long, as it is the Company's intention to hold these investments and not to realize them.
- 4) As stated in note 12a(1)a, upon distribution of dividends from tax-exempt income of "approved enterprises", the amount distributed will be subject to tax at the rate that would have been applicable had the Company not been exempted from payment thereof. The Israeli subsidiary intends to permanently reinvest the amounts of tax-exempt income and does not intend to cause dividend distribution from such income (see note 12a). Therefore, no deferred taxes have been provided in respect of such tax-exempt income.

m. Comprehensive income (loss)

In addition to net loss, other comprehensive income (loss) includes unrealized gains and losses on available-for-sale securities, currency translation adjustments of non-dollar currency financial statements of investee companies and gains and losses on certain derivative instruments designated for cash-flow hedge.

n. Treasury shares

Company shares held by the Company, are presented as a reduction of shareholders' equity, at their cost to the Company.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

o. Revenue recognition:

- 1) Revenues from sales of products and supplies are recognized when an arrangement (usually in the form of a purchase order) exists, delivery has occurred and title passed to the customer, the Company's price to the customer is fixed or determinable and collectability is reasonably assured. With respect to products with installation requirements, revenue is recognized when all of the above criteria are met and installation is completed.

Sales contracts with distributors stipulate fixed prices and current payment terms and are not subject to the distributor's resale or any other contingencies. Accordingly, sales of finished products to distributors are recognized as revenue upon delivery and after title passes to distributors.

- 2) Service revenue is recognized ratably over the contractual period or as services are performed.
- 3) Warranty costs are provided for at the same time as the related revenues are recognized. The annual provision is calculated on the basis of the expected cost of inputs, based on historical experience.
- 4) Emerging Issues Task Force ("EITF") Issue 00-21, "Revenue Arrangements with Multiple Deliverables" addresses the accounting, by a vendor, for contractual arrangements in which multiple revenue-generating activities will be performed by the vendor. It is effective prospectively for all arrangements entered into in fiscal periods beginning after June 15, 2003. EITF Issue 00-21 addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. The Company adopted EITF Issue 00-21 in the year ended December 31, 2003 and it has had no significant impact on its financial position and results of operations.

p. Research and development costs, net

Research and development costs are charged to income as incurred. Royalty-bearing grants received from governments for approved projects are recognized as a reduction of expenses as the related costs are incurred.

q. Advertising

These costs are charged to income as incurred.

r. Shipping and handling costs

Shipping and handling costs are classified as a component of marketing expenses.

s. Allowance for doubtful accounts

The allowance for doubtful accounts is determined as a percentage of specific debts doubtful of collection.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

t. Stock based compensation

The Company and its subsidiaries account for employee stock based compensation in accordance with Accounting Principles Board Opinion No. 25 “Accounting for Stock Issued to Employees” (“APB 25”) and related interpretations. Under APB 25 compensation cost for employee stock option plans is measured using the intrinsic value based method of accounting, and is amortized by the straight-line method against income, over the expected service period.

FAS 123 “Accounting for Stock-Based Compensation”, establishes a fair value based method accounting for employee stock options or similar equity instruments, and encouraged adoption of such method for stock compensation plans. However, it also allows companies to continue to account for those plans the accounting treatment prescribed by APB 25.

The following table illustrates the effect on net income (loss) and earning (loss) per share assuming the Company and its subsidiaries had applied the fair value recognition provisions of FAS 123 to stock-based employee compensation:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands (except for per share data)		
Net loss from continuing operations - as reported	(18,656)	(36,524)	(260,002)
Add: stock based employee compensation expenses, included in reported net loss from continuing operations	-,	-,	-,
Deduct: stock based employee compensation expenses determined under fair value method	<u>(1,018)</u>	<u>(2,242)</u>	<u>(3,753)</u>
Pro-forma net loss from continuing operations	<u>(19,674)</u>	<u>(38,766)</u>	<u>(263,755)</u>
Net income from discontinued operations - as reported	20,043	4,494	6,982
Add: stock based employee compensation expenses, included in reported net income from discontinued operations	-,	-,	-,
Deduct: stock based employee compensation expenses determined under fair value method	<u>(1,305)</u>	<u>(2,109)</u>	<u> </u>
Pro-forma net income from discontinued operations	<u>18,738</u>	<u>2,385</u>	<u>6,982</u>
Pro-forma net loss	<u>(936)</u>	<u>(36,381)</u>	<u>(256,773)</u>
Basic and diluted earning (loss) per share - as reported:			
Continuing operations	(0.43)	(0.84)	(6.04)
Discontinuing operations	<u>0.46</u>	<u>0.10</u>	<u>0.16</u>
Net income (loss)	<u>0.03</u>	<u>(0.74)</u>	<u>(5.88)</u>
Pro-forma earning (loss) per share :			
Continuing operations	(0.46)	(0.90)	(6.13)
Discontinuing operations	<u>0.44</u>	<u>0.05</u>	<u>0.16</u>
Net loss	<u>(0.02)</u>	<u>(0.85)</u>	<u>(5.97)</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

u. Earnings (loss) per share (“EPS”)

Basic EPS are computed based on the weighted average number of shares outstanding during each year excluding the treasury stock held by the Company. Diluted EPS reflects the increase in the weighted average number of shares outstanding that would result from the assumed exercise of options, calculated using the treasury-stock-method (in 2003, 2002 and 2001) such effect was not included since it would have been anti-dilutive). In addition, diluted EPS does not reflect options granted by subsidiaries to be exercised to the subsidiaries shares and convertible loans, since their effect would have been anti-dilutive.

v. Derivatives and hedging activities

The Company has adopted FAS 133 “Accounting for derivative instruments and hedging activities”. FAS 133, as amended, establishes accounting and reporting standards for derivatives and for hedging activities. Under FAS 133, all derivatives are recognized on the balance sheet at their fair value. On the date that the Company enters into a derivative contract, it designates the derivative, for accounting purposes, as:

(1) Hedging instrument, or (2) Non-hedging instrument.

For derivative financial instruments that are designated and qualify as a cash flow hedge, the effective portions of changes in fair value of the derivative are recorded in other comprehensive income (loss), and are recognized in the statement of operations when the hedged item affects earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings. Changes in the fair value of derivatives that do not qualify for hedge accounting are recognized in earnings.

w. First time application of the equity method in respect of an investment previously accounted for under the cost method

As of December 31, 2003, the Company holds approximately 23.47 % of Objet Geometries Ltd. (“Objet”) outstanding shares and 23.09 % on a fully diluted basis. Through December 31, 2001, the Company accounted for this investment under the cost method. Commencing January 2002, the Company changed its method of accounting for this investment from the cost method to the equity method as required by APB 18 (“The equity method of accounting for investments in common stock”).

The consolidated financial statements for the year 2001 have been adjusted retroactively to reflect the adoption of the equity method.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

The effect of such adjustments on the consolidated statements of operations in the year ended December 31, 2001 was as follows:

	<u>As previously reported</u>	<u>Effect of restatement</u>	<u>As reported in these financial statements</u>
	<u>\$ in thousands</u>		
Share in losses of associated companies	<u>(64,763)</u>	<u>(2,744)</u>	<u>(67,507)</u>
Net loss	<u>(250,276)</u>	<u>(2,744)</u>	<u>(253,020)</u>
Loss per share - basic and diluted	<u>\$ (5.82)</u>	<u>\$ (0.06)</u>	<u>\$ (5.88)</u>

x. Recently issued accounting pronouncements:

1. In January 2003, the FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46). Under FIN 46, entities are separated into two populations: (1) those for which voting interests are used to determine consolidation (this is the most common situation) and (2) those for which variable interests are used to determine consolidation. FIN 46 explains how to identify Variable Interest Entities (VIEs) and how to determine when a business enterprise should include the assets, liabilities, no controlling interests, and results of activities of a VIE in its consolidated financial statements. Since issuing FIN 46, the FASB has proposed various amendments to the Interpretation and has deferred its effective dates. Most recently, in December 2003, the FASB issued a revised version of FIN 46 (FIN 46-R), which also provides for a partial deferral of FIN 46. This partial deferral established the effective dates for public entities to apply FIN 46 and FIN 46-R based on the nature of the VIE and the date upon which the public company became involved with the VIE. In general, the deferral provides that (i) for VIEs created before February 1, 2003, a public entity must apply FIN 46-R at the end of the first interim or annual period ending after March 15, 2004, and may be required to apply FIN 46 at the end of the first interim or annual period ending after December 15, 2003, if the VIE is a special purpose entity, and (ii) for VIEs created after January 31, 2003, a public company must apply FIN 46 at the end of the first interim or annual period ending after December 15, 2003, as previously required, and then apply FIN 46-R at the end of the first interim or annual reporting period ending after March 15, 2004. The Company believes that the adoption of FIN 46 and FIN 46-R will not have material impact on its financial position, results of operations and cash flows.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES (continued):

2. In December 2003, the FASB issued SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88 and 106, and a revision of FASB Statement No. 132 ("FAS 132 (revised 2003)") ". This Statement revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement or recognition of those plans. The new rules require additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other postretirement benefit plans. Part of the new disclosures provisions are effective for 2003 calendar year-end financial statements, and accordingly have been applied by the Company in these consolidated financial statements. The rest of the provisions of FAS 132, which have a later effective date, are currently being evaluated by the Company.

y. Reclassifications

Certain comparative figures have been reclassified to conform to the current year presentation.

NOTE 3 - ACQUISITIONS OF BUSINESSES

- a. Scitex Vision Ltd. (hereafter – "Scitex Vision") was formed by the Company and other investors during 1999 under the name Aprion Digital Ltd. Upon the formation of Scitex Vision, the Company transferred to Scitex Vision the activity of its Advanced Printing Products Division, in consideration for Scitex Vision shares, warrants and convertible note in the amount of \$ 20,000,000.

In the second quarter of 2001, the Company exercised all of the warrants that were granted by Scitex Vision, in consideration for \$ 2,500,000, and in the third quarter converted the note into Scitex Vision preferred shares. The excess of cost of investments over the Company's share in Scitex Vision's net assets at dates of transactions, in total amount of approximately \$ 5,000,000, was attributed to technology to be amortized over five years.

At December 31, 2002, the Company held approximately 43% of Scitex Vision's outstanding shares and the balance of the investment, accounted for under the equity method, was zero.

On January 1, 2003, the Company sold all of its shares in its then wholly owned subsidiary - Scitex Vision International Ltd. (then known as Scitex Vision Ltd.) (hereafter - "SV international"), to Scitex Vision, the Company's then associated company, in exchange for additional preferred shares in Scitex Vision. Subsequent to the transaction, the Company holds approximately 75% of Scitex Vision's outstanding shares. The transaction was accounted for, by the Company, as a sale of 25% in SV international and as acquisition of additional shares in Scitex Vision. The fair value of the transaction was approximately \$ 9 million. As a result, the Company recognized a net capital gain of \$ 289,000 under "Other expenses - net" (\$ 3,774,000 capital gain resulting from the sale of a portion in SV international, net of \$ 3,485,000 of dilution loss relating to Scitex Vision's preferred shares anti-dilution mechanism triggered by the transaction). In addition, the Company recognized a capital surplus of \$ 3,485,000 under "Beneficial conversion feature relating to convertible preferred shares issued by Scitex Vision" in its shareholders equity.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 3 - ACQUISITIONS OF BUSINESSES (continued):

This acquisition was accounted for under the purchase method. As a result of the transaction the Company recorded technology and goodwill of approximately \$ 14.8 million and approximately \$ 2 million, respectively, of which approximately \$ 3.8 million was credited to minority interest. The technology is being amortized over 6 years.

Commencing on January 2003 Scitex Vision's financial statements are consolidated with those of the Company.

Here after are certain unaudited proforma combined statements of operations data for the year ended December 31, 2002 as if the acquisition of additional shares in Scitex Vision occurred on January 1, 2002, after giving effect to purchase accounting adjustments. The proforma financial information is not necessarily indicative of the combined results that would have been attained had the acquisition take place at the beginning of 2002, nor is it necessarily indicative of future results:

	Year ended December 31, 2002 (Unaudited)
	U.S. dollars in thousands (except per share data)
Revenues	<u>91,018</u>
Net loss from continuing operations	<u>(45,375)</u>
Net loss	<u>(49,869)</u>
Loss per share for continuing operation - basic and diluted	<u>\$ (1.05)</u>
Net loss per share - basic and diluted	<u>\$ (1.16)</u>

As to lawsuits filed in connection with this transaction see note 10b(1).

- b. In April 2002, SV international acquired some assets and operations from Siantec SARL ("Siantec") and its shareholders in consideration of \$ 2,470,000, of which \$ 1,860,000 was allocated to technology and \$ 610,000 to non-compete covenant. Those intangible assets were originally amortized according to a 6-year amortization rate (as to an impairment of the acquired intangibles, see note 8). This acquisition was made in order to obtain the advanced technology in the subsidiary's products. As part of the transaction additional maximum royalties payment of up to \$ 10,000,000 is to be paid conditional upon sales of systems and ink based on Siantec's technology. The payment of \$ 1,000,000 of the total amount is limited to a 5-year period, and the balance of \$ 9,000,000 is with no time limitation. As of December 31, 2003, no additional payment was made due to this transaction.
- c. In March 2001, SV international acquired the ink technology, other assets and operations from the Techno Ink manufacturing (PTY) Ltd. ("Tech Ink") for an aggregate consideration of \$ 2,860,000. The technology is amortized over 6 years. The agreement provides for additional payments to Tech Ink of up to a maximum of approximately \$ 5,500,000, based on the achievement of specified financial targets, such as reduction in manufacturing costs, during the period from 2001 to 2006. As of December 31, 2003, the total amount recorded to goodwill due to this agreement is \$ 2,441,000, of which \$ 1,258,000 was recorded during 2003.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 4 - INVESTMENTS IN ASSOCIATED COMPANIES:

- a. An investment in Jemtex Ink Jet Ltd. (“Jemtex”), accounted for by the equity method, amounted to \$ 1,303,000 (\$ 2,560,000 – including convertible loan and debentures as described below) and \$ 4,703,000 as of December 31, 2003 and 2002, respectively. In December 2002, the Company signed a share purchase agreement with Jemtex, according to which, the Company invested additional \$ 2,400,000 in three equal quarterly installments of \$ 800,000 each. The first installment and an advance of \$ 250,000 on the last payment were made in December 2002. The additional \$ 1,350,000 was transferred in February and May 2003. The excess of cost of investment over the Company’s share in Jemtex’ net assets at the date of transaction in the amount of \$ 1,371,000 was attributed to technology to be amortized over five years.

In addition, Jemtex granted to the Company for no additional consideration, warrants to purchase (1) 3,181 preferred shares of Jemtex at an exercise price of \$ 251.467 per share, exercisable until January 2, 2004, and (2) 3,181 preferred shares of Jemtex at an exercise price of \$ 251.467 per share exercisable until March 31, 2005. An amount of \$ 51,000 was allocated to the said warrants out of the total above-mentioned investment of \$ 2,400,000.

In August 2003, the Company exercised the warrants to purchase 3,181 preferred shares of Jemtex at an exercise price of \$ 251.467 per share, exercisable until January 2, 2004, and in lieu of 3,181 preferred shares was issued an interest bearing note convertible (principal and interest) into preferred B shares or a more senior class of shares, as determined by the Company, in the amount of \$ 800,000.

In November and December 2003, the Company granted to Jemtex advance payments on account of convertible debentures of \$ 100,000 and \$ 350,000, respectively. See note 16b.

As of December 31, 2003, the Company’s ownership interest in Jemtex is approximately 49.8 % and approximately 47.8 % on a fully diluted basis. However, commencing the third quarter of 2003, the Company is the sole financier of Jemtex’ losses and accordingly is its full share in Jemtex’ losses.

- b. As to the investment in Objet and its first time application of the equity method, see note 2w. The balance of this investment as of December 31, 2003 is approximately \$ 767,000, following an additional investment of approximately \$ 460,000.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 5 - OTHER INVESTMENTS AND NON-CURRENT ASSETS:

a. Composed as follows:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<u>\$ in thousands</u>	
Investment in Creo (see b. below)	-, -	51,062
Other investments (see c. below)	1,301	3,794
Non-current assets	<u>-, -</u>	<u>275</u>
	<u>1,301</u>	<u>55,131</u>

b. Creo

In June and August 2003, the Company sold all of its remaining holdings in Creo Inc. (hereafter - "Creo") shares for a net total consideration of \$ 54,000,000 and recorded a gain of approximately \$ 3,000,000. The investment in Creo shares was accounted for as shares available for sale, and following the sale of the shares the Company realized an amount of approximately \$ 750,000 recorded during 2003 to Other Comprehensive Income in its shareholders' equity. Until December 2001 the investment in Creo was accounted for using the equity method. The Company's share in the losses of Creo in 2001 amounted to \$ 60,183,000. In 2002, due to extended decline in fair market value, it was determined that the impairment in value of the investment was other than temporary. Consequently, the accumulated unrealized loss of \$ 22,283,000, which was charged to "other loss - net" in the statement of operation.

- c.** Other investments represent investments in non-marketable securities in companies operating in the digital printing and digital imaging industry, in which the Company does not exercise significant influence, and which are stated at cost, net of a write-down for decrease in value which is not of a temporary nature, in the amount of \$ 1,301,000. In 2003, due to an extended decline in fair value of an other than temporary nature, the Company recorded an accumulated loss in the amount of \$ 2,493,000 that was charged to "other loss - net" in the statement of operations.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 6 - PROPERTY, PLANT AND EQUIPMENT

Grouped by major classifications, the assets are composed as follows:

	December 31	
	2003	2002
	\$ in thousands	
Machinery and equipment	4,567	4,027
Building	424	411
Leasehold improvements	4,606	1,854
Office furniture and equipment	5,209	4,750
Motor vehicles	16	34
	<u>14,822</u>	<u>11,076</u>
Less - accumulated depreciation and amortization	<u>(5,618)</u>	<u>(5,002)</u>
	<u>9,204</u>	<u>6,074</u>

Depreciation and amortization of property, plant and equipment from continuing operations totaled \$ 3,558,000, \$ 2,250,000 and \$ 2,204,000 in 2003, 2002 and 2001, respectively.

NOTE 7 - GOODWILL

- a. The changes in the carrying value of goodwill in respect of the continuing operations for the year ended December 31, 2002 and 2003, are as follows:

	\$ in thousands
Balance as of January 1, 2002*	988
Goodwill acquired during the year	<u>1,183</u>
Balance as of December 31, 2002	2,171
Goodwill acquired during the year	<u>3,301</u>
Balance as of December 31, 2003	<u>5,472</u>

- * In 2001 the Company recognized a goodwill impairment charge in the amount of \$ 1,925,000, see also note 8. This impairment was due to an evaluation that was performed by a third party appraiser, due to the significant decrease in the production of certain products based on the technology mentioned in note 8. The impairment was made in accordance with the provisions of FAS No. 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of".

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 7 - GOODWILL (continued):

- b. The following table illustrates the Company's results adjusted to eliminate the effect of goodwill amortization expense, including goodwill with respect of an associated company accounted for by the equity method:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands (except for per share data)		
Net loss from continuing operations - as reported	(18,656)	(36,524)	(260,002)
Add back: Goodwill amortization related to continuing operations			708
Goodwill amortization included in Share in losses of an associated Company			23,805
Net loss from continuing operations - adjusted	<u>(18,656)</u>	<u>(36,524)</u>	<u>(235,489)</u>
Net income from discontinued operation - as reported	20,043	4,494	6,982
Add back: Goodwill amortization related to discontinued operation			2,927
Net income from discontinued operation- adjusted	<u>20,043</u>	<u>4,494</u>	<u>9,909</u>
Pro-forma net income (loss)	<u>1,387</u>	<u>(32,030)</u>	<u>(225,580)</u>
Basic and diluted loss per share – as reported			
Continuing operations	(0.43)	(0.84)	(6.04)
Discontinued operation	<u>0.46</u>	<u>0.10</u>	<u>0.16</u>
	<u>0.03</u>	<u>(0.74)</u>	<u>(5.88)</u>
Pro-forma loss per share – adjusted			
Continuing operations	(0.43)	(0.84)	(5.47)
Discontinued operation	<u>0.46</u>	<u>0.10</u>	<u>0.23</u>
	<u>0.03</u>	<u>(0.74)</u>	<u>(5.24)</u>

NOTE 8 - OTHER INTANGIBLE ASSETS:

Composed as of December 31, 2003 and 2002, as follows:

	December 31	
	2003	2002
	\$ in thousands	
Gross carrying amount:	48,239	33,049
Accumulated amortization and impairment:	<u>(30,212)</u>	<u>(21,682)</u>
Amortized balance	<u>18,027</u>	<u>11,367</u>

* See note 3a regarding technology acquired during 2003.

Amortization expense in respect of intangible assets relating to the continuing operation totaled \$ 5,871,000, \$ 2,944,000 and 7,752,000 in 2003, 2002 and 2001, respectively.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 8 - OTHER INTANGIBLE ASSETS (continued):

Estimated amortization expense for the following years, subsequent to December 31, 2003:

	<u>\$ in thousands</u>
Year ending December 31:	
2004	5,067
2005	4,686
2006	3,747
2007	2,255
2008	2,255

In January 2001, SV international acquired the intellectual property related to the manufacturing of inks compatible with its machines from Magic Inks B.V. for consideration of \$ 2,887,000. This intangible asset is amortized over 6 years. As to an impairment of the acquired intangible asset see below.

In 2001 and 2003 the financial statements include a write-down charge due to the impairment of technology and know-how in a subsidiary, in the amounts of \$ 13,061,000 and \$ 2,967,000, respectively. These impairments followed an evaluation performed by a third party appraiser, due to the significant decrease in the production of certain products based on the above-mentioned technologies. The impairment calculation in 2001 and 2003 was prepared in accordance with the provisions of SFAS 121 and SFAS 144, respectively.

NOTE 9 - EMPLOYEE RIGHTS UPON RETIREMENT:

- a. Israeli labor laws and agreements require the payment of severance pay upon dismissal of an employee or upon termination of employment in certain other circumstances. The liability is based upon the length of service and the latest monthly salary (one month's salary for each year worked), and is mainly funded with severance pay and pension funds and with insurance companies (principally with an affiliate of the two major shareholders of the Company), for which the Company and its Israeli subsidiaries make monthly payments. The Company records the long-term obligation as if it was payable at each balance sheet date on an undiscounted basis.
- b. The U.S. subsidiary offers 401(k) matching plans to all eligible employees.
- c. Substantially all of the European subsidiaries make contributions to pension plans administered by insurance companies.
- d. Severance pay, pension and defined contribution plan expenses totaled \$ 1,523,000, \$ 563,000 and \$ 476,000 in 2003, 2002 and 2001, respectively.
- e. The Company expects to contribute in 2004, \$ 626,000 to the insurance companies and provident fund in respect of its severance pay obligation in Israel.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 10 - COMMITMENTS AND CONTINGENT LIABILITIES:

a. Commitments:

1) Royalty commitments:

- (a) A subsidiary is committed to pay royalties of 3%-5% to the Government of Israel on sales of products in the research and development of which the Government participates by way of grants, up to the amount of the grants received (dollar linked), plus annual interest based on the Libor, accruing from January 1, 1999. At the time the funding was received, successful development of the related projects was not assured. In the case of failure of a project that was partly financed by government grants, the subsidiary is not obligated to pay any such royalties to the Israeli Government.

At December 31, 2003, the maximum contingent royalty payable is approximately \$ 4.2 million.

Royalties expense totaled \$ 128,000, \$ 700,000 and \$ 694,000 in 2003, 2002 and 2001, respectively.

- (b) A subsidiary is obligated to pay royalties to certain parties, based on agreements which allow it to use technologies developed by these parties. Such royalties are based on the revenues from sales of products which incorporate these technologies or on quantities of such products sold.

2) Operating leases

Most of the premises occupied by the Company and its subsidiaries are rented under various operating lease agreements. Part of the premises in Israel were leased from an affiliate of the two major shareholders of the Company, see also 3 below.

Minimum lease payments of the Company and its subsidiaries under the above leases, at rates in effect on December 31, 2003, are as follows:

	<u>\$ in thousands</u>
Year ending December 31:	
2004	2,005
2005	1,899
2006	1,751
2007	1,711
2008	1,711
2009 and thereafter	2,317

Most of the rental payments for the Israeli premises are payable in Israeli currency, partially linked to the Israeli CPI, to the dollar or both to the dollar and the U.S. CPI.

Rental expense relating to continuing operations totaled \$ 2,449,000, \$ 1,158,000 and \$ 1,163,000 in 2003, 2002 and 2001, respectively.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 10 - COMMITMENTS AND CONTINGENT LIABILITIES (continued):

- 3) Commencing November 1, 2001, the Company's headquarters are located on the premises of one of its major shareholders. The Company obtains the services of certain executives and other staff as well as certain services from the shareholder, for which the Company pays amounts based on formulas determined in the agreement between the Company and the shareholder.

Expenses due to the said agreement totaled \$ 518,000, \$ 445,000 and \$ 92,000 in 2003, 2002 and 2001, respectively.

b. Contingent liabilities:

- 1) In October 2003, a minority shareholder of Scitex Vision filed a NIS 14 million (approximately \$3.1 million) lawsuit against the Company, Scitex Vision and others, including certain other shareholders of Scitex Vision (among them, the Company's two main shareholders) and the directors of Scitex Vision in the period relevant for the lawsuit (three of whom are present or former office holders of the Company). The lawsuit was brought in connection with the transaction to combine the operations of SV international and Scitex Vision that was completed in January 2003. In particular, the lawsuit alleges that the terms of the transaction and the manner in which it was effected prejudiced the rights of the plaintiff as a minority shareholder. At this time, the Company and Scitex Vision are unable to assess the outcome of this matter, while they intend to defend it vigorously. No provision was recorded for this matter in these financial statements.

In November 2003, the same minority shareholder sent a demand letter to Scitex Vision, whereby it demanded that Scitex Vision will file a lawsuit against the Company and others (including Scitex Vision's directors), alleging breach of fiduciary duties, misrepresentations and misleading in connection with the Company's undertaking to transfer \$15 million to SV international as part of the aforesaid transaction. In January 2004, Scitex Vision rejected these demands. In the event that the minority shareholder decides to commence a derivative action, it is not possible at this stage in time to predict the outcome of such legal proceedings. No provision was recorded for this matter in these financial statements.

In December 2003, the same minority shareholder filed a separate motion against the Company, Scitex Vision and two other shareholders of Scitex Vision (including one of the Company's principal shareholders), in connection with a rights offering that was completed in July 2003. In particular, the motion alleges that the reorganization of Scitex Vision's share capital that was affected in conjunction with the rights offering was invalid and prejudiced the rights of the minority shareholder. In light of its arguments, the plaintiff requested the court to order the respondents to provide information and documents with respect to the reorganization of Scitex Vision's share capital. At this stage in time, it is not possible to predict the outcome of this particular matter. No provision was recorded for this matter in these financial statements.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 10 - COMMITMENTS AND CONTINGENT LIABILITIES (continued):

- 2) In January 2003 a subsidiary has received a letter from the legal advisors of a service provider claiming compensation in the amount of approximately \$ 845,000. The letter of demand alleges that the subsidiary has a contractual relationship with this service provider. At this time it is not possible to assess the outcome of this matter, and the subsidiary intends to defend it vigorously. No provision was recorded for this matter in the financial statements.
- 3) In July 2000 a monetary claim in the amount of approximately \$ 413,000 against the Company was filed with the district court in Jerusalem. In this lawsuit it was claimed that a machine the Company sold to the plaintiff did not function as promised by the Company. In April 2000, the Company sold substantially all of the assets, liabilities and operations related to its Digital PrePrint business to Creo. Therefore, defense is being handled by Creo. In the opinion of the Company's management, since this lawsuit is in the framework of an indemnification agreement with Creo, it will have minimal effect on the Company, if any. Therefore no provision was recorded for this matter.
- 4) In October 2002 the liquidator of a company, which the Company had an investment in, which was fully written-off during 2001, filed a lawsuit against directors and other executives of this company. Among the defendants is a former executive of the Company, for which the Company had directors' insurance. Under the insurance, the maximum amount which the Company might have to pay is approximately \$ 100,000. The Company is vigorously contesting this lawsuit. Management believes that the chances the Company will have to pay the said amount are low. Therefore no provision was recorded for this matter.
- 6) In December 2003, three minority shareholders of Objet, a company in which the Company has a 23.47% interest, filed an approximate NIS 7.8 million (approximately \$1.75 million) lawsuit against Objet, certain of its shareholders, including the Company, and certain of Objet's directors. The lawsuit alleges that the defendants acted in a manner that prejudiced the rights of the minority shareholders, and breached Objet's obligations to such shareholders. Among the remedies being sought by the said minority shareholders are compensation, restitution (with linkage and interest) of the investment amount, or repurchase of the plaintiffs' shares in Objet, and a demand for changes to the terms of certain convertible loans made to Objet by certain of the defendants including the Company. At this time the Company's attorneys are still evaluating the claim, and neither Objet nor the Company is able to give any realistic assessment as to the outcome of this matter, therefore no provision was recorded.
- 7) In 1997, a lawsuit was filed against the Company in Germany, which suit was also defended by a third party, claiming \$5 million (together with interest since 1997) in relation to a purported guarantee which would have required the acquisition by the Company of additional shares in a company now in liquidation. Following prolonged negotiations, it is probable that this lawsuit will be settled by both the Company and the third party in equal shares paying significantly lesser amount than the original claim, and in respect of which the Company recorded a provision.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 10 - COMMITMENTS AND CONTINGENT LIABILITIES (continued):

- 8) Claims have been filed against the Company and its subsidiaries in the ordinary course of business. The Company and its subsidiaries intend to defend themselves vigorously against those claims. Management does not expect that the Company will incur substantial expenses in respect thereof; therefore, no provision has been made for the claims.
- 9) As to contingent royalties, see note 3a and note 3b.
- 10) As to tax assessments of two of the Company's subsidiaries, see note 12h.

c. Guarantees

- 1) In connection with a bank loan received by SV international, the Company granted a guarantee in favor of the bank. As of December 31, 2003 the total amount guaranteed is approximately \$ 1,333,000.
- 2) Scitex Vision granted guarantees in favor of its premises lessor suppliers, certain of its customers and suppliers and a government institution. As of December 31, 2003, the guarantees outstanding are as follows:
 - a. Scitex Vision entered into a surety agreement with a financial institution and suppliers of its premises lessor, under which the Scitex Vision guarantees lease payments in favor of the lessor. As of December 31, 2003 the total amount guaranteed was \$ 255,000. The fair value of the guarantee is immaterial.
 - b. Scitex Vision entered into a surety agreement with a financial institution and certain of its suppliers, pursuant to which Scitex Vision guarantees payments in favor of the suppliers. As of December 31, 2003 the total amount guaranteed was \$ 260,000. The fair value of the guarantee is immaterial.
 - c. Scitex Vision has provided guarantees for payment to a governmental institution in a European country in the total amount of \$ 616,000.
 - d. Scitex Vision entered into a surety agreement with leasing companies and certain of its customers, under which Scitex Vision guarantees lease payments of its customers to the leasing companies. As of December 31, 2003 the total amount guaranteed was \$ 175,000. The fair value of the guarantee is immaterial.

NOTE 11 - SHAREHOLDERS' EQUITY:

a. Share capital:

- 1) The Company's shares are traded on NASDAQ and on the Tel Aviv Stock Exchange ("TASE").

On December 31, 2003 the Company's share closed on NASDAQ and the Tel Aviv Stock Exchange at approximately \$ 5.06 and \$ 5.04, respectively.

- 2) The number of shares stated as issued and outstanding - 43,467,388 shares at December 31, 2003 and 2002 - includes 448,975 shares repurchased by the Company (treasury shares, see note 2n) and held by a trustee for the benefit of employees within the framework of the Company's share option plans. These shares, until purchased by employees pursuant to a share option plan, bear no voting rights or rights to cash dividends.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 11 - SHAREHOLDERS' EQUITY (continued):

b. Share incentive and stock option plans:

- 1) On December 31, 2001, the 2001 annual general meeting of shareholders of the Company approved the adoption of the Scitex 2001 Stock Option Plan that permits the grant of options to officers, employees, directors, consultants and contractors of the Company, its subsidiaries and controlled entities for the purchase of, initially, up to an aggregate of 750,000 shares of the Company. Option awards may be granted under this plan until November 5, 2011. The maximum term of an option may not exceed ten years. Each option can be exercised to purchase one share having the same rights as the other ordinary shares of the Company.
- 2) On December 31, 2003, the 2003 annual general meeting of shareholders of the Company approved the adoption of the Scitex 2003 Share Option Plan that permits the grant of options to employees, directors, consultants and contractors of the Company, its subsidiaries and affiliates, under the provisions of either section 102 or section 3(9) of the Israeli Income Tax Ordinance. Option awards may be granted under this plan until November 23, 2013. The maximum term of an option may not exceed ten years. Each option can be exercised in purchase of one share having the same rights as the other ordinary shares of the Company.
- 3) The 2003 annual general meeting of shareholders also approved an increase in the aggregate number of shares that may be issued under the 2001 plan and the 2003 plan to 1,900,000. At December 31, 2003, no options had been granted under either the 2001 plan or the 2003 plan.
- 4) The 2001 plan replaced two earlier share option plans - the Scitex Israel Key Employee Share Incentive Plan 1991 (with various sub-plans), mainly for directors, officers and other key employees of the Company and its Israeli subsidiaries, and the Scitex International Key Employee Stock Option Plan 1991 (As Amended, 1995), for officers and other key employees of non-Israeli subsidiaries. These plans expired in September 2001, except with respect to outstanding options granted under such plans. The options granted under such plans generally vested ratably over a period of 3-4 years. The maximum term of an option could not exceed ten years. Each option can be exercised in purchase of one share having the same rights as the other ordinary shares.
- 5) The Israeli option plans are subject to the terms stipulated by Section 102 of the Israeli Income Tax Ordinance. Inter alia, these terms provide that the Company will be allowed to claim, as an expense for tax purposes, the amounts credited to the employees as a benefit in respect of shares or options granted under the plan, as follows:

Through December 31, 2002, the amount that the Company was allowed to claim as an expense for tax purposes will be the amount of the benefit chargeable to tax in the hands of the employee.

As from January 1, 2003, the amount that the Company will be allowed to claim as an expense for tax purposes, will be the amount of the benefit chargeable to tax as work income in the hands of the employee, while that part of the benefit that is chargeable to capital gains tax in the hands of the employee shall not be allowable. All being subject to the restrictions specified in Section 102 of the Income Tax Ordinance.

The aforementioned expense will be recognized in the tax year that the benefit is credited to the employee.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 11 - SHAREHOLDERS' EQUITY (continued):

- 6) The options granted under the Company's plans are exercisable for the purchase of shares as follows:

	December 31	
	2003	2002
	Number of options	
At balance sheet date	978,732	1,139,728
During the first year thereafter	8,334	104,430
During the second year thereafter	<u> </u>	<u>8,334</u>
	<u>987,066</u>	<u>1,252,492</u>

- 7) A summary of the status of the Company's plans at December 31, 2003, 2002 and 2001, and changes during the years ended on those dates, is presented below:

	Year ended December 31					
	2003		2002		2001	
	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$
Options outstanding at beginning of year	1,252,492	10.34	1,724,203	10.18	2,246,465	10.06
Changes during the year:						
Granted - at fair value					25,000	8.18
Forfeited and canceled	<u>(265,426)</u>	9.82	<u>(471,711)</u>	9.76	<u>(547,262)</u>	9.59
Options outstanding at end of year	<u>987,066</u>	10.48	<u>1,252,492</u>	10.34	<u>1,724,203</u>	10.18
Options exercisable at end of year	<u>978,732</u>	10.50	<u>1,139,728</u>	10.33	<u>1,425,617</u>	10.09
Options available for future awards	<u>1,900,000</u>		<u>750,000</u>		<u>750,000</u>	

The weighted average fair value of options granted during 2001 is \$ 2.76. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Year ended December 31 2001
Dividend yield per share - in dollars	<u>-,-</u>
Expected volatility	<u>58%</u>
Risk-free interest rate	<u>4.0%</u>
Expected life - in years	<u>2.00</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 11 - SHAREHOLDERS' EQUITY (continued):

- 8) The following table summarizes information about options under the Company's plans outstanding at December 31, 2003:

Range of exercise prices	Options outstanding			Options exercisable	
	Number outstanding at December 31, 2003	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable at December 31, 2003	Weighted average exercise price
\$		Years	\$		\$
8.00 to 8.99	25,000	7.0	8.18	16,666	8.18
9.00 to 9.99	279,999	2.4	9.06	279,999	9.06
10.00 to 10.99	265,417	6.4	10.68	265,417	10.68
11.00 to 11.99	370,500	1.5	11.36	370,500	11.36
12.00 to 12.99	46,150	3.1	12.07	46,150	12.07
8.00 to 12.99	<u>987,066</u>	3.3	10.34	<u>978,732</u>	10.50

- 9) An award in 1999, whereby 50 % of 300,000 options awarded in earlier years to a related party, with an exercise price of \$ 14.75 per option, were re-priced to an exercise price of \$ 11.69 per option (the then market price per share), accompanied by a waiver of the remaining 50 %. Such options were exercisable from 1999 and are exercisable until June 2004. The fair value of each option granted was \$ 3.21. In accordance with FIN 44, the re-priced options are accounted for under variable plan accounting. Under this method of accounting, increases in the fair market value of the underlying shares result in non-cash compensation charges to the statement of operations. At December 31, 2003, 2002 and 2001, the market price of the underlying shares was below \$ 11.69 (the exercise price of the options), thus, no compensation cost has been charged with respect to these options. Future periods may reflect charges depending on the fair market price of the underlying shares.

- 10) Stock option plans of subsidiaries:

- a) On February 7, 2000, the Board of Directors of an Israeli subsidiary approved an employee share option plan (the "Subsidiary Plan"). Pursuant to the Subsidiary Plan, 2,600,000 ordinary shares of the subsidiary are reserved for issuance upon the exercise of 2,600,000 options to be granted to some of the subsidiary's employees. During 2000, the subsidiary granted 2,254,000 options to employees under the Subsidiary Plan, at an exercise price per share of \$ 6.50. The options vest as follows: 33 % after the first year, another 33 % after the second year and another 33 % after the third year starting from the date of beginning of employment of each employee, or the grant date, as determined by the stock option committee, provided the employee is still in the subsidiary's employ. Any option not exercised within 7 years of grant date will expire. During 2001, the subsidiary granted additional 415,000 options with identical conditions to those granted in 2000, and 258,000 options were forfeited. During 2002, no options were granted under the Subsidiary Plan.

The weighted average fair value of options granted by the subsidiary during 2001 is \$ 2.44. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield per share is nil, expected volatility of 50 %, risk-free interest rate of 4.0 %, expected life of 3 years.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 11 - SHAREHOLDERS' EQUITY (continued):

None of these options were exercised and during 2002 all of the outstanding options were waived by the respective grantees.

In April 2002 all of this subsidiary's options were canceled.

In September 2003, the subsidiary's board of directors approved an employee stock option plan (hereafter - the plan), whereunder options to purchase up to 13,179,544 ordinary shares of the subsidiary are to be granted to employees, directors and consultants of the subsidiary without consideration. Each option can be exercised to purchase one ordinary share of NIS 0.01 par value of the subsidiary.

Immediately upon exercise, the ordinary shares purchased in exercise of the option will have the same rights as of the subsidiary's other ordinary shares. Any option not exercised within 10 years from allotment date will expire, unless extended by the board of directors of the subsidiary.

At December 31, 2003, there were 12,531,041 options outstanding subject to the 2003 plan, of which 6,079,265 were vested.

All options were granted at an exercise price of \$ 0.4052, which management determined is not less than the fair value of an ordinary share in the date of grant.

The weighted fair value of options granted by the subsidiary during 2003 is \$ 0.14. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield per share is nil, expected volatility of 48%, risk-free interest rate of 2.2%, expected life of 3 years.

During 2003, no options were exercised.

In addition, approximately 193,474 options to purchase ordinary shares of the subsidiary are held by former directors of the acquired subsidiary.

- b) In consideration of a credit line received by an acquired subsidiary a total amount of 56,180 options were granted to a bank in 2002 and are exercisable in to ordinary shares of the acquired subsidiary in exercise price set at \$8.90 per share. The fair value of the warrant granted to the bank calculated as of December 31, 2003, was immaterial.
- c) On December 6, 2001, the Board of Directors of a United States subsidiary approved an employee share option plan (the "US Subsidiary Plan"). Pursuant to the US Subsidiary Plan, 2,600,000 shares of Common Stock of the subsidiary are reserved for issuance upon the exercise of 2,600,000 options to be granted to some of the subsidiary's employees.

During 2001, the subsidiary had granted 957,000 options to employees under the US Subsidiary's Plan, at an exercise price per share of \$ 6.00. During 2002, the subsidiary granted additional 366,000 options on identical conditions to those grants in 2001, and 66,000 options were forfeited. During 2003, the subsidiary granted additional 143,000 options on identical conditions to those grants in 2001, and no option were forfeited. The options vest as follows: 25 % one year from the grant date and thereafter 6.25 % on the last day of every third calendar month. Any option not exercised within 10 years of grant date will expire.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 11 - SHAREHOLDERS' EQUITY (continued):

The weighted fair value of options granted by the subsidiary during 2003 is \$ 3.99. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield per share is nil, expected volatility of zero, risk-free interest rate range from 4.25% to 5.44%, expected life of 10 years.

The weighted fair value of options granted by the subsidiary during 2002 is \$ 3.24. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield per share is nil, expected volatility of zero, risk-free interest rate range from 5.29% to 5.44%, expected life of 10 years.

The weighted fair value of options granted by the subsidiary during 2001 is \$ 3.25. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield per share is nil, expected volatility of zero, risk-free interest rate of 5.29 %, expected life of 10 years.

As of December 31, 2003, 607,750 options were exercisable.

At December 31, 2003, had all options been exercised, the Company's share in the equity of the US subsidiary would have decreased from 100 % to approximately 93 %. Subsequent to December 31, 2003, the Company sold the operations of the US subsidiary and all options under the US Subsidiary Plan were cancelled. See also note 1b.

c. Retained earnings

Dividends are declared and paid in dollars (except to shareholders of record with an address in Israel, with respect to whom payment is made in Israeli currency ("NIS")).

NOTE 12 - TAXES ON INCOME:

a. The Company and its Israeli subsidiary:

- 1) Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereafter- the law)

By virtue of the "approved enterprise" status granted to certain production facilities under the law, the Israeli subsidiary is entitled to various tax benefits, as follows:

a) Reduced tax rates

The tax benefit period is seven years from the year in which the approved enterprise first earns taxable income. Income derived from the approved enterprise is tax exempt during the first two years of the seven year tax benefit period and is subject to a reduced tax rate of 25 % during the remaining five years of benefits. The period of benefits relating to the approved enterprise will expire in the years 2009-2010.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 12 - TAXES ON INCOME (continued):

In the event of distribution of cash dividends out of income which was tax exempt as above, the Israeli subsidiary would have to pay the 25 % tax in respect of the amount distributed.

The Israeli subsidiary intends to permanently reinvest the amounts of tax-exempt income in the foreseeable future, and not to cause distribution of such dividends.

b) Accelerated depreciation

The Israeli subsidiary is entitled to claim accelerated depreciation for five tax years commencing in the first year of operation of each asset, in respect of machinery and equipment used by the approved enterprise.

c) Conditions for entitlement to the benefits

The entitlement to the above benefits is conditional upon the Israeli subsidiary's fulfilling the conditions stipulated by the law, regulations published hereunder and the instruments of approval for the specific investments in the "approved enterprise". In the event of failure to comply with these conditions, the benefits may be cancelled and the Israeli subsidiary may be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences to the Israeli consumer price index ("CPI") and interest.

2) Measurement of results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985 (hereafter - the Inflationary Adjustments Law)

Under this law, results for tax purposes are measured in real terms, in accordance with the changes in the Israeli CPI, or in the exchange rate of the dollar for a "foreign investors' company". The Company and its Israeli subsidiaries elected to measure their results on the basis of the changes in the Israeli CPI.

Paragraph 9 (f) of FAS 109, "Accounting for Income Taxes", prohibits the recognition of deferred tax liabilities or assets that arise from differences between the financial reporting and tax bases of assets and liabilities that are measured from the local currency into dollars using historical exchange rates, and that result from changes in exchange rates or indexing for tax purposes. Consequently, the abovementioned differences were not reflected in the computation of deferred tax assets and liabilities.

3) Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969

The Israeli subsidiary is an "industrial company" as defined by this law and as such is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment, as prescribed by regulations published under the Inflationary Adjustments Law, and the right to claim public issuance expenses and amortization of patents and other intangible property rights as a deduction for tax purposes.

4) Tax rates applicable in Israel to income not derived from an approved enterprise

Income not eligible for the "approved enterprise" benefits mentioned in (1) above is taxed at the regular rate of 36 %.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 12 - TAXES ON INCOME (continued):

b. Non-Israeli subsidiaries

The non-Israeli subsidiaries are taxed under the laws of their countries of residence.

c. Carryforward tax losses and deductions

Carryforward tax losses and deductions of the Company and its subsidiaries, including capital losses and losses from realization of marketable securities approximated \$ 500 million at December 31, 2003. Most of the carryforward amounts are available indefinitely with no expiration date.

d. Reform of the Israeli tax system

In 2002, Amendment to the Israeli Tax ordinance (No. 132), 2002 (the "Israeli Tax Reform Law") was published. The Israeli Tax reform Law comprehensively reforms certain parts of the Israeli tax system and entered into effect on January 1, 2003, although certain provisions thereof will be applied from later dates.

The Israeli subsidiaries expects that the implementation of the Israeli tax reform will not have a material effect on its tax status and liabilities thereof.

e. Deferred income taxes:

	December 31	
	2003	2002
	\$ in thousands	
Computed in respect of the following:		
Allowance for doubtful accounts and other provisions	1,512	1,188
Carryforward tax losses and credits	168,620	99,076
Inventories	1,440	540
Investments	9,364	23,245
Accrued liabilities and deferred income	1,173	406
Property, plant and equipment	60	64
Intangible assets	2,927	600
	<u>185,096</u>	<u>125,119</u>
L e s s - valuation allowance (attributed mainly to loss carryforwards and expenses deductible upon payment)	<u>(184,984)</u>	<u>(123,253)</u>
	<u>112</u>	<u>1,866</u>
Deferred income taxes are included in the balance sheets as follows:		
Non-current assets	<u>112</u>	<u>1,866</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 12 - TAXES ON INCOME (continued):

f. Loss before taxes on income from continuing operation:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
The Company and its Israeli subsidiaries	(23,616)	(29,198)	(187,906)
Non-Israeli subsidiaries	<u>9,453</u>	<u>(3,868)</u>	<u>(1,632)</u>
	<u>(14,163)</u>	<u>(33,066)</u>	<u>(189,538)</u>

g. Taxes on income included in the statements of operations - from continuing operation:

1) As follows:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
Current:			
Israeli	(404)	400	3,547
Non-Israeli	<u>1,052</u>	<u>(984)</u>	<u>1,212</u>
	<u>648</u>	<u>(584)</u>	<u>4,759</u>
Deferred, see e. above:			
Israeli	1,866	(64)	(1,802)
Non-Israeli	<u>(112)</u>	<u> </u>	<u> </u>
	<u>1,754</u>	<u>(64)</u>	<u>(1,802)</u>
	<u>2,402</u>	<u>(648)</u>	<u>2,957</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 12 - TAXES ON INCOME (continued):

- 2) Following is a reconciliation of the theoretical tax expense, assuming all income is taxed at the regular tax rate applicable to Israeli corporations (see a(4) above) and the actual tax expense:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
Income (loss) before taxes on income	(14,163)	(33,066)	(189,538)
Theoretical tax expense (tax benefit) on the above amount	(5,099)	(11,904)	(68,234)
Effect of lower tax rate for "approved enterprises"	(5,099)	(12,304)	(68,234)
Increase (decrease) in taxes resulting from different tax rates - net	(6,670)	(5,253)	130
Increase in taxes resulting from permanent differences	838	408	666
Change in valuation allowance	61,731	87,602	76,849
Changes in deferred taxes resulting from carryforward tax losses	(49,970)	(71,275)	(4,246)
Increase in taxes resulting from prior years	1,950		
Increase (decrease) in taxes arising from differences between non-dollar currencies income and dollar income - net, and other*	(378)	174	(2,208)
Taxes on income in the consolidated statements of operations	2,402	(648)	2,957

* Resulting mainly from the difference between the changes in the Israeli CPI (the basis for computation of taxable income of the Company and its Israeli subsidiaries, see a(2) above) and the changes in the exchange rate of Israeli currency relative to the dollar.

h. Tax assessments

- 1) The Company has received, or is considered to have receive, final tax assessments through the 1998 tax year.
- 2) In partial settlement of an audit of the Internal Revenue Service (IRS) of the Company's U.S. subsidiaries for the years 1992 through 1996, the Company consented to a "partial assessment" by the IRS for approximately \$ 10.6 million of federal taxes on certain agreed upon issues. This amount excludes interest and state income taxes, which will be assessed by the IRS and are expected to almost double the above amount. The Company has already made advance payments of \$ 21.5 million on account of this audit. In June 2002, the Company received a notice from the IRS proposing to assess \$ 29.6 million of additional federal income taxes for the years 1992 through 1996. This amount excludes state income taxes and interest, which would almost double that figure. In August 2002, the Company appealed the proposed additional assessment. The Company has conducted advanced negotiations with the IRS for settlement of this assessment, which was finalized during February 2004 (see note 16a). The Company's management believes, based on its consultants' advice, that sufficient provision for this matter is included in accrued liabilities.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 12 - TAXES ON INCOME (continued):

- 3) During 2002, a couple of the Company's subsidiaries received tax assessments for which the Company's management believes, based on its consultants' advice, sufficient provision was accrued. During 2003, one of those subsidiaries consented to an assessment by the Israeli authorities for the years 1996-2001 for approximately \$ 2.1 million, of which approximately \$ 1.8 million will be payable in 24 monthly installments commencing April 2004. This assessment was finally signed and settled in January 2004. Sufficient provision was previously accrued in connection with the assessment.

NOTE 13 - FINANCIAL INSTRUMENTS AND RISK MANAGEMENT:

a. Foreign exchange risk management

The Company and its subsidiaries operate internationally, which gives rise to significant exposure to market risks, mainly from changes in foreign exchange rates. Derivative financial instruments (hereafter - derivatives) were utilized by a subsidiary to reduce these risks. The Company did not hold or issue derivative financial instruments for trading purposes.

Commencing 2003, a subsidiary purchases forward-exchange contracts as hedges of certain anticipated sales and related costs denominated in foreign currencies. The subsidiary enters into these contracts to protect itself against the risk that the eventual dollar-net-cash inflows resulting from direct-foreign-export sales and related costs will be adversely affected by changes in exchange rates. These contracts are not qualified for hedge accounting under FAS 133. Accordingly gains and losses for these forward-exchange contracts are recognized in earnings.

As of December 31, 2003 the provision for losses deriving from forward-exchange contracts amounted to approximately \$ 556,000 and is classified as accrued liability.

b. Concentrations of credit risks

At December 31, 2003 and 2002, the Company and its subsidiaries held cash and cash equivalents, most of which were deposited with major Israeli, European and U.S. banks. Substantially, all of the marketable securities held by the Company are debt securities of the U.S. Treasury and highly rated corporations. The Company considers the inherent credit risks to be remote.

Most of the subsidiaries' sales are made in the United States, Latin America, Europe and in the Far East, to a large number of customers. Consequently, the exposure to concentrations of credit risks relating to individual customer receivables is limited. The subsidiary performs ongoing credit evaluations of its customers and generally does not require collateral; however, with respect of certain sales to customers in emerging economies, the subsidiary requires letters of credit. The accounts include sufficient allowance for doubtful accounts.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 13 - FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (continued):

c. Fair value of financial instruments

The financial instruments of the Company and its subsidiaries consist mainly of cash and cash equivalents, short-term investments, long-term investments, current and long-term liabilities.

In view of their nature, the fair value of the financial instruments included in working capital is usually identical or close to their carrying amount. The fair value of long-term liabilities also approximates their carrying value, since they bear interest at rates close to the prevailing market rates.

NOTE 14 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION:

Balance sheets:

	December 31	
	2003	2002
	\$ in thousands	
a. Allowance for doubtful accounts (as included in trade receivables) - the change in allowance for doubtful is composed as follows:		
Balance at beginning of year	2,957	1,620
Addition to allowance	1,233	1,507
Write-off of bad debts		(170)
	<u>4,190</u>	<u>2,957</u>
b. Inventories:		
Components of systems and materials	5,413	3,391
Work in process	1,183	1,517
Finished products	<u>15,979</u>	<u>15,152</u>
	<u>22,575</u>	<u>20,060</u>
c. Accrued and other liabilities:		
Payroll and related expenses	3,863	2,875
Accrued royalties and sales commissions	2,514	1,216
Deferred revenue	5,308	3,853
Provision for warranty*	2,293	2,018
Advances from customers	2,516	1,163
Other	<u>9,183</u>	<u>5,826</u>
	<u>25,677</u>	<u>16,951</u>
* The changes in the balance during the year:		
Balance at beginning of the year	2,018	2,577
Payments made under the warranty	(3,383)	(3,136)
Product warranties issued for new sales	3,658	3,589
Changes in accrual in respect of pre-existing warranties		(1,012)
Balance at end of year	<u>2,293</u>	<u>2,018</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 14 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

d. Short-term credit and long-term loans:

1) Line of credit

In 2003 a subsidiary of the Company signed agreements with banks, which provided for a \$ 49 million revolving line of credit, short-term and long-term loans for various purposes.

Borrowings under the revolving line of credit and long-term loans bore interest of Libor + 1.1 % to Libor + 2.3 %.

The revolving line of credit the short-term and the long-term loans are secured by a negative pledge and restricted deposits of \$ 18,262,000 and require the subsidiary to maintain certain financial and other restrictive covenants.

The subsidiary is currently not in full compliance with one of the restrictive covenants and it is engaged in ongoing discussions with the banks for a temporary waiver of such covenant.

2) Short-term credit and loans

The balance as of December 31, 2003, mainly represents short term credit and loans of Scitex Vision, consisting of: \$ 26,450,000 short-term bank loans denominated in dollars and bearing interest of three month Libor + 1.1% to Libor + 2.25% per annum (as of December 31, 2003 - 2.3% to 3.5%, respectively);

\$ 14,689,000 short-term bank loans denominated in Euro and bearing interest of one month Libor + 1.75 % to Libor + 2.3 % per annum (as of December 31, 2002 - 3.8 % to 4.4 %, respectively) and \$ 712,000 credit lines in various currencies. The short-term bank loan denominated in dollar and bearing interest of Libor +0.5 % per annum in the amount of \$ 3,500,000 relates to SDC.

3) Current maturities of long-term loans (represent loans of Scitex Vision):

	<u>2003</u>	<u>2002</u>
	<u>\$ in thousands</u>	
Banks	1,633	5,248
Other	969	
	<u>2,602</u>	<u>5,248</u>

4) Long-term loans:

a) The long-term loans from banks represent loans of Scitex Vision and mature in the following years subsequent to December 31, 2003:

	<u>2003</u>	<u>2002</u>
	<u>\$ in thousands</u>	
Second year	1,928	3,438
Third year	1,252	2,003
Fourth year	1,252	52
Fifth year and thereafter	2,191	
	<u>6,623</u>	<u>5,493</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 14 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

- b) The long-term loans from banks are denominated in dollars, bear interest of three month Libor + 1.75 % to Libor + 2.25 % per annum (as of December 31, 2003 - 2.9 % to 3.4 %, respectively).
- c) In 2000, ScitexVision entered into a collaboration agreement (hereafter - the agreement) with a European leading supplier (hereafter - the supplier) to the textile, paper and plastic printing industry, for developing inks for printing on textile. Pursuant to the agreement, the supplier shall pay ScitexVision certain royalties on sales of ink for use with ScitexVision's textile printing machines. As of December 31, 2003, no such sales have been made.

Following the agreement, Scitex Vision received from the supplier a long-term convertible loan of \$ 5 million.

The loan received on December 27, 2000, and bore 6% annual interest. The loan should have been interest free if the milestones described in the agreement were met.

According to the original terms of the loan, the loan and the accumulated interest might have been converted by the supplier, at any time during the last three months of the loan period, which ended on December 11, 2003, into ordinary shares of Scitex Vision at a conversion price based on the fair value of such shares, less 15%. According to the agreement if the supplier chooses to request the repayment of the loan, the repayment shall be made by setting-off the loan and any interest accrued thereon against royalties due to Scitex Vision in a subsequent period. The remainder of the loan, if it exists, shall be repaid in cash to the supplier.

On December 30, 2003 an addendum to the agreement was signed, according to which, the original terms of the loan were changed such that the principal of the loan is interest free and payable in four annual installments in the following years subsequent to December 31, 2003:

	December 31
	2003
	U.S. dollars in thousands
Current maturities	969
Second year	1,171
Third year	1,358
Fourth year	1,094
	<u>3,623</u>
	<u>4,592</u>

Scitex Vision has the right to offset royalties due to Scitex Vision against the amount due, on the next agreed installment.

As a result of the above-mentioned change in terms, the company has recorded the loan based on its present value (\$ 4,592,000) using the interest rate, which is applicable to such loans as of the date of change in terms. The difference between the present value and the nominal value of the loan, in the total amount of \$ 408,000, as well as all interest accrued through December 30, 2003, in the total amount of \$ 904,000, were credited to "financial expenses - net".

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 14 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

5) Convertible long-term loans from related parties:

In July 2003, two of the Company's shareholders granted to the Company's subsidiary convertible loans in the amount of approximately \$ 933,000, bearing interest equal to the greater of Libor + 1% (as of December 31, 2003 - 2.1%) or rate of change of the Israeli CPI per annum. The loans are payable in one installment at the end of a five year period if no conversion occurs before the end of the repayment period.

The loans and the accumulated interest may be converted into the ordinary shares of the subsidiary at any time with an exercise price of \$ 0.4052 per share, which equals the fair value of the subsidiary's ordinary shares at the date of grant of the loans.

According to the loans agreements, an automatic conversion shall occur upon certain events. In addition, the lenders were granted with warrants representing 25% of the loan amount, to purchase ordinary shares at an exercise price of \$ 0.4052 per share.

The Company recorded an original discount of \$ 98,500 in respect of the amounts allocated to these warrants out of the total above-mentioned loans of \$ 933,000. This amount is amortized to the interest expense over the maximum term of the loans, which is 5 years.

Pursuant to the conversion terms, whereby the lenders were guaranteed beneficial conversion features, the Company recorded an original discount of \$ 98,500, which represents the difference between the loan allocated amount and the amount payable. This amount is amortized to the interest expense over the maximum term of the loans, which is 5 years.

e. Note payable issued to an investee company

The note was denominated in dollars and was repaid in one payment on April 4, 2003.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 14 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

Statements of operations:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
f. Research and development costs - net:			
Expenses incurred	11,537	7,761	7,082
L e s – royalty-bearing participations from the Government of Israel	<u>467</u>	<u>701</u>	<u>999</u>
	<u><u>11,070</u></u>	<u><u>7,060</u></u>	<u><u>6,083</u></u>
g. Selling, general and administrative expenses:			
Selling*	20,192	19,812	21,277
General and administrative**	<u>15,147</u>	<u>13,581</u>	<u>16,376</u>
	<u><u>35,339</u></u>	<u><u>33,393</u></u>	<u><u>37,653</u></u>
* Including:			
Advertising costs	<u>609</u>	<u>420</u>	<u>410</u>
** Including:			
Related party	<u>518</u>	<u>445</u>	<u>92</u>
Net change in allowance for doubtful accounts and direct write-off of bad debts	<u>698</u>	<u>1,507</u>	<u>1,082</u>

h. Restructuring charges

1. Towards the end of 2001, a subsidiary implemented a restructuring plan, which was completed in 2001, in the form of abandonment of construction in progress, and accrued expenses accordingly. The expenses included the write-off of fixed assets in the amount of approximately \$ 500,000.
2. During 2003, a subsidiary implemented a restructuring plan in the form of reduction in work force, abandonment of leased premises and development of new combined information technology system, and accrued expenses accordingly. The expenses included mainly severance pay and other benefits to approximately 42 employees retiring from their employ in the amount of approximately \$ 130,000, costs related to the disposal of certain activities in the amount of approximately \$ 390,000, and costs related to the development of new combined information technology system in the amount of approximately \$ 500,000.

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 14 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
i. Financial expenses - net:			
Interest income	249	706	713
Gain on trading marketable securities - net	3		136
Interest expense on long-term loans			
from banks	(1,981)	(2,471)	(2,382)
from related parties	(20)		
from others	603		
Bank charges	(276)	(15)	(127)
Revaluation of long-term loan	408		
Other (including foreign exchange transaction losses - net)	(1,637)	(1,359)	(1,268)
	<u>(2,651)</u>	<u>(3,139)</u>	<u>(2,928)</u>
j. Other income (loss) - net:			
Loss from change in percentage of holding of an associated company			(4,408)
Write-down of available-for-sale securities		(22,283)	
Gain from sale of a portion in a subsidiary	3,774		
Share in beneficial conversion feature of convertible preferred shares issued by a subsidiary	(3,485)		
Write-off and write-down of investments in investee companies	(2,493)	(3,839)	(5,477)
Gain (loss) from sale of investments in associated and investee companies	2,822		(6,041)
Other	169	(148)	2,892
	<u>787</u>	<u>(26,270)</u>	<u>(13,034)</u>
k. Earnings income (loss) per share:			

The net loss and the weighted average number of shares used in computation of basic and diluted earnings per share for the years ended December 31, 2003, 2002 and 2001 are as follows:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
Net income (loss) used in the computation of basic and diluted earnings per share	<u>1,387</u>	<u>(32,030)</u>	<u>(253,020)</u>
Weighted average number of shares used in the computation of basic earnings (loss) per share	43,018	43,018	43,018
Add - net additional shares from the assumed exercise of the Company's stock options	<u>-,-</u>	<u>-,-</u>	<u>-,-</u>
Weighted average number of shares used in the computation of diluted earnings (loss) per share	<u>43,018</u>	<u>43,018</u>	<u>43,018</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 15 - SEGMENT INFORMATION:

a. General:

Prior to the sale of SDP's operations, as described in note 1b, the Company had been operating in two reportable segments.

Following the transaction the Company operates only in the wide-format digital printing. The Subsidiaries, develop, manufacture and market industrial digital inkjet printing solutions mainly to the graphic arts, packaging and textile markets as well as related services and consumable products. As to the sale of the high-speed digital printing segment, classified as discontinued operation, see note 1b. In addition, the Company holds interest in other companies that develop digital printing solution to industrial applications.

b. Geographical information:

- 1) Following are data regarding revenues from external customers in respect of continuing operations, classified by geographical area based on the location of the customers:

	Year ended December 31		
	2003	2002	2001
	\$ in thousands		
North America (mostly USA)	19,650	17,814	18,690
Mexico	15,178	8,725	1,221
Europe:			
West	25,313	24,524	29,339
East	11,580	12,980	6,846
Far East	12,460	16,647	29,860
Other countries	18,699	4,971	5,662
	<u>102,880</u>	<u>85,661</u>	<u>91,618</u>

- 2) Following are data relating to property, plant and equipment, net, relating to continuing operations, by geographical area in which the assets are located:

	December 31		
	2003	2002	2001
	\$ in thousands		
Israel	6,154	2,985	2,772
North and South America	802	1,033	1,919
Europe	1,152	753	511
South Africa	949	1,265	1,024
Asia	147	38	
	<u>9,204</u>	<u>6,074</u>	<u>6,226</u>

SCITEX CORPORATION LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

NOTE 16 - SUBSEQUENT EVENTS

- a. In January 2003, the Board of Directors of the Company announced a planned distribution to shareholders of approximately \$2.75 per share (a total of approximately \$118 million), applying a portion of the net proceeds from the SDP sale. Distributions to shareholders will be subject to applicable withholding taxes. The cash distribution to shareholders is subject to the satisfaction of certain conditions, including the approval of Company's shareholders and of the Israeli District Court. There can be no assurance if and when such conditions will be satisfied.
- b. In February 2004, the Company has entered into an agreement with the IRS to resolve a U.S. federal income tax audit of its U.S. subsidiaries for the years 1992 through 1996. Under the terms of the agreement, the Company agreed to an assessment of \$5.7 million of additional federal income taxes for these years to resolve the remaining proposed IRS assessment of an additional \$29.6 million of federal income taxes (as described in note 12h(2)).

When added to a previous "partial agreed assessment" by the IRS for \$10.6 million of federal income taxes, the Company's total additional federal income taxes for these years as a result of the IRS audit will be \$16.3 million. This amount does not include interest and additional state income taxes that will result from the agreement with the IRS. The Company is currently working to determine such amounts.

The Company had previously made advance payments to the IRS of \$21.5 million for federal income taxes relating to the audit period and had established reserves for additional liabilities arising out of the audit. At this stage, after initial review, the Company estimates that the final additional cash cost of the IRS audit (taking into consideration the \$16.3 million of assessment, state taxes and interest thereon, and after application of the \$21.5 million advance payment), will be in the range of \$7 to \$14 million.

The Company's management believes, based on its consultants' advice, that sufficient provision for this matter is included in accrued liabilities.

- c. In February 2004, the Company concluded a \$1.5 million investment in Jemtex in consideration for convertible debentures, which may be repaid at the option of Jemtex until the end of June 2004. Out of the above amount, \$0.45 million were transferred to Jemtex on account of the investment (see note 4a). Following this investment, the Company effectively holds approximately 73% of Jemtex' issued share capital on an "as converted" basis.

סלקום ישראל בע"מ
וחברות מאוחדות שלה
דוחות כספיים
לשנה שנסתיימה ביום 31 בדצמבר 2003

תוכן העניינים

עמוד

1	דין וחשבון רואי החשבון המבקרים
2-3	מאזנים
4	דוחות רווח והפסד
5	דוח על השינויים בהון העצמי
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8-40	באורים לדוחות הכספיים

דוח רואי החשבון המבקרים לבעלי המניות של סלקום ישראל בערבון מוגבל

ביקרנו את הדוחות הכספיים המצורפים של סלקום ישראל בע"מ (להלן - החברה) ושל החברה והחברות המאוחדות שלה (להלן - המאוחד):

- מאזנים של החברה ומאוחד לימים 31 בדצמבר 2003 ו-2002.
- דוחות רווח והפסד, דוח על השינויים בהון העצמי ודוחות על תזרימי המזומנים של החברה ומאוחדים לכל אחת משלוש השנים, שהאחרונה שבהן הסתיימה ביום 31 בדצמבר 2003.

דוחות כספיים אלה הינם באחריות הדירקטוריון וההנהלה של החברה. אחריותנו היא לחוות דעה על דוחות כספיים אלה בהתבסס על ביקורתנו.

ערכנו את ביקורתנו בהתאם לתקני ביקורת מקובלים, לרבות תקנים שנקבעו בתקנות רואי חשבון (דרך פעולתו של רואה חשבון), התשל"ג - 1973. על פי תקנים אלה נדרש מאיתנו לתכנן את הביקורת ולבצע במטרה להשיג מידה סבירה של ביטחון שאין בדוחות הכספיים הצגה מוטעית מהותית. ביקורת כוללת בדיקה מדגמית של ראיות התומכות בסכומים ובמידע שבדוחות הכספיים. ביקורת כוללת גם בחינה של כללי החשבונאות שיושמו ושל האומדנים המשמעותיים שנעשו על ידי הדירקטוריון וההנהלה של החברה וכן הערכת נאותות ההצגה בדוחות הכספיים בכללותה. אנו סבורים שביקורתנו מספקת בסיס נאות לחוות דעתנו.

לדעתנו, הדוחות הכספיים הנ"ל משקפים באופן נאות בהתאם לכללי חשבונאות מקובלים, מכל הבחינות המהותיות, את המצב הכספי של החברה ובמאוחד לימים 31 בדצמבר 2003 ו-2002, את תוצאות הפעולות, השינויים בהון העצמי ותזרימי המזומנים - של החברה ובמאוחד לכל אחת משלוש השנים, שהאחרונה שבהן הסתיימה ביום 31 בדצמבר 2003. כמו כן, לדעתנו, הדוחות הכספיים הנ"ל ערוכים בהתאם לתקנות ניירות ערך (עריכת דוחות כספיים שנתיים), התשנ"ג - 1993.

כמוסבר בביאור 2, הדוחות הכספיים הנ"ל מוצגים בערכים המותאמים על פי השינויים בכוח הקנייה הכללי של המטבע הישראלי, בהתאם לגילויי דעת של לשכת רואי חשבון בישראל.

מבלי לסייג חוות דעתנו, אנו מפנים את תשומת הלב לבאור 18א' בדבר בקשות לאישור תביעות כתובענות ייצוגיות.

סומך חייקין
רואי חשבון

17 בפברואר 2004

סלקום ישראל בע"מ וחברות מאוחדות שלה

מאזנים ליום 31 בדצמבר

מותאם לשקל חדש של חודש דצמבר 2003

חברה		מאוחד		באור	
2002	2003	2200	2003		
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח		
					רכוש שוטף
21,895 *	408,906	170,523 *	454,106	3	מזומנים ושווי מזומנים
958,175	1,040,478	958,175	1,040,478	4	לקוחות
203,027	188,971	404,784	213,485	5	חייבים ויתרות חובה
182,965	114,266	182,965	114,266	6	מלאי
<u>1,366,062</u>	<u>1,752,621</u>	<u>1,716,447</u>	<u>1,822,335</u>		
272,410	333,422	286,382	343,695	7	חייבים ויתרות חובה לזמן ארוך
382,441	96,305	-	-	8	השקעה בחברות מאוחדות
<u>3,595,941</u>	<u>3,247,630</u>	<u>3,628,819</u>	<u>3,276,369</u>	9	רכוש קבוע, נטו
<u>415,183</u>	<u>404,592</u>	<u>415,183</u>	<u>404,592</u>	10	רכוש אחר והוצאות נדחות, נטו
<u><u>6,032,037</u></u>	<u><u>5,834,570</u></u>	<u><u>6,046,831</u></u>	<u><u>5,846,991</u></u>		

חבר מועצת מנהלים

רענן כהן

נשיא ומנהל כללי

ד"ר יצחק פטרבורג

סגן נשיא לכספים

יצחק אידלמן

תאריך אישור הדוחות הכספיים: 17 בפברואר, 2004

* סווג מחדש

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

מותאם לשקל חדש של חודש דצמבר 2003

חברה		מאוחד		באור	
2002	2003	2002	2003		
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח		
התחייבויות שוטפות					
602,712	1,123,175	602,712	1,123,175	11	אשראי לזמן קצר מתאגידים בנקאיים
945,556	821,935	960,350	832,281	12	ספקים ונותני שירותים
220,396 *	289,004	220,396 *	291,079	13	זכאים ויתרות זכות
<u>1,768,664</u>	<u>2,234,114</u>	<u>1,783,458</u>	<u>2,246,535</u>		
התחייבויות לזמן ארוך					
1,986,978	882,128	1,986,978	882,128	14	הלוואות לזמן ארוך מתאגידים בנקאיים
3,437	9,522	3,437	9,522	15	התחייבות בשל סיוע יחסי עובד-מעביד, נטו
65,253	97,013	65,253	97,013	25	מיסים נדחים
-	1,287	-	1,287	16	זכאים ויתרות זכות לזמן ארוך
<u>93,972</u>	<u>65,412</u>	<u>93,972</u>	<u>65,412</u>	17	ספקים ונותני שירותים לזמן ארוך
<u>2,149,640</u>	<u>1,055,362</u>	<u>2,149,640</u>	<u>1,055,362</u>		
התחייבויות תלויות, התקשרויות, ערבבויות ושעבודים					
<u>2,113,733</u>	<u>2,545,094</u>	<u>2,113,733</u>	<u>2,545,094</u>	18	הון עצמי
<u>6,032,037</u>	<u>5,834,570</u>	<u>6,046,831</u>	<u>5,846,991</u>		

* סווג מחדש
 הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

מותאם לשקל חדש של חודש דצמבר 2003

חברה			מאוחד			באור		
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003			
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח			
4,879,963	5,029,810	5,198,044	4,959,768	5,134,782	5,261,673	19	הכנסות ממכירות ושירותים	
2,895,875*	3,098,129*	3,074,193	2,892,705*	3,110,646*	3,075,354	20	עלות המכירות והשירותים	
1,984,088	1,931,681	2,123,851	2,067,063	2,024,136	2,186,319		רווח גולמי	
574,278*	651,135*	612,774	574,278*	651,135*	612,774	21	הוצאות מכירה ושיווק	
625,080	684,086	680,744	621,435	677,853	682,318	22	הוצאות הנהלה וכלליות	
784,730	596,460	830,333	871,350	695,148	891,227		רווח מפעולות רגילות	
(33,401)	(14,155)	(200,381)	(14,770)	(4,861)	(216,082)	23	הוצאות מימון, נטו	
13,512	1,072	6,824	6,245	(4,506)	884	24	הכנסות(הוצאות) אחרות, נטו	
764,841	583,377	636,776	862,825	685,781	676,029		רווח לפני מיסים על הכנסה	
285,620	203,198	229,094	288,291	266,122	244,668	25	מיסים על ההכנסה	
479,221	380,179	407,682	574,534	419,659	431,361		רווח לאחר מיסים על ההכנסה	
95,313	39,480	23,679	-	-	-	8	החלק ברווחי חברות מאוחדות	
574,534	419,659	431,361	574,534	419,659	431,361		רווח נקי	
								<u>רווח למניה:</u>
50,398	36,812	37,839	50,398	36,812	37,839		רווח בסיסי ל-1 ש"ח ע.נ. מניות רגילות (בש"ח)	

* סווג מחדש
הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

מותאם לשקל חדש של חודש דצמבר 2003

<u>סך הכל</u>	<u>עודפים</u>	<u>הון מניות</u>	
<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	
1,119,540	1,119,526	14	יתרה ליום 1 בינואר 2001
			שינויים בשנת 2001
<u>574,534</u>	<u>574,534</u>	<u>-</u>	רווח נקי
1,694,074	1,694,060	14	יתרה ליום 31 בדצמבר 2001
			שינויים בשנת 2002
<u>419,659</u>	<u>419,659</u>	<u>-</u>	רווח נקי
2,113,733	2,113,719	14	יתרה ליום 31 בדצמבר 2002
			שינויים בשנת 2003
<u>431,361</u>	<u>431,361</u>	<u>-</u>	רווח נקי
<u>2,545,094</u>	<u>2,545,080</u>	<u>14</u>	יתרה ליום 31 בדצמבר 2003

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

מותאם לשקל חדש של חודש דצמבר 2003

חברה			מאוחד			
לשנה שהסתיימה ביום 31 דצמבר 2001	לשנה שהסתיימה ביום 31 דצמבר 2002	לשנה שהסתיימה ביום 31 דצמבר 2003	לשנה שהסתיימה ביום 31 דצמבר 2001	לשנה שהסתיימה ביום 31 דצמבר 2002	לשנה שהסתיימה ביום 31 דצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
						תזרימי מזומנים מפעילות שוטפת
574,534	419,659	431,361	574,534	419,659	431,361	רווח נקי
667,947	713,655*	931,106	750,614	865,763*	962,171	התאמות הדרושות כדי להציג את תזרימי המזומנים מפעילות שוטפת (א)
1,242,481	1,133,314	1,362,467	1,325,148	1,285,422	1,393,532	מזומנים נטו שנבעו מפעילות שוטפת
						תזרימי מזומנים לפעילות השקעה
(1,070,475)	(1,280,967)	(684,878)	(1,105,251)	(1,279,073)	(684,878)	רכישת רכוש קבוע
17,292	11,665	23,416	10,025	8,073	23,416	תמורה ממימוש רכוש קבוע
-	-	-	(184,567)	-	188,821	פקדון לזמן ארוך
(34,775)	3,973	(14,121)	-	-	-	השקעה בחברה מאוחדת
-	(286,430)	(34,491)	-	(286,430)	(34,491)	השקעה ברכוש אחר
-	-	337,435	-	-	-	דיודנד שהתקבל
(1,087,958)	(1,551,759)	(372,639)	(1,279,793)	(1,557,430)	(507,132)	מזומנים נטו ששימשו לפעילות השקעה
						תזרימי מזומנים מפעילות מימון
(395,479)	365,432	(448,123)	(395,479)	365,432	(448,123)	אשראי לזמן קצר מתאגידים בנקאיים, נטו
678,381	402,204	-	678,381	402,204	-	קבלת הלוואות לזמן ארוך מתאגידים בנקאיים
(249,571)	(265,510)	(154,694)	(249,571)	(265,510)	(154,694)	פרעון הלוואות לזמן ארוך מתאגידים בנקאיים
(186,797)	(65,916)	-	(186,797)	(65,916)	-	פרעון הלוואות לזמן ארוך מצדדים קשורים ומאחרים
(153,466)	436,210	(602,817)	(153,466)	436,210	(602,817)	מזומנים נטו שנבעו (ששימשו) מפעילות מימון
1,057	17,765	387,011	(108,111)	164,202	283,583	עליה (ירידה) במזומנים ושווי מזומנים
3,073	4,130	21,895*	114,432	6,321	170,523*	יתרת מזומנים ושווי מזומנים לתחילת השנה
4,130	21,895*	408,906	6,321	170,523*	454,106	יתרת מזומנים ושווי מזומנים לסוף השנה

* סווג מחדש הביאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

מותאם לשקל חדש של חודש דצמבר 2003

חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
(א) התאמות הדרושות כדי להציג את תזרימי המזומנים מפעילות שוטפת						
הכנסות והוצאות שאינן כרוכות בתזרימי מזומנים:						
831,872	957,007	999,080	831,872	957,007	999,080	פחת והפחתות
(95,313)	(39,480)	(23,679)	-	-	-	החלק ברווחי חברות מאוחדות
(17,274)	(12,973)	53,301	(17,274)	(12,973)	53,301	מסים נדחים
3,714	(59,498)	17,060	3,715	(59,498)	17,120	שחיקת הלוואות ואשראי ספקים לזמן ארוך, נטו
7,130	35	-	7,130	35	-	ריבית שנצברה על הלוואות ופיקדונות לזמן ארוך, נטו
(12,707)	(41)	(7,216)	(5,440)	5,537	(7,216)	הפסדי (רווחי) הון
(46)	(334)	6,085	(46)	(334)	6,085	שינוי בהתחייבות בשל סיום יחסי עובד-מעביד
-	-	-	-	-	5,940	הפרשה לירידת ערך קרקע
<u>717,376</u>	<u>844,716</u>	<u>1,044,631</u>	<u>819,957</u>	<u>889,774</u>	<u>1,074,310</u>	
שינויים בסעיפי רכוש והתחייבויות						
52,720	(113,894)	(140,878)	52,720	(113,894)	(140,878)	ירידה (עליה) בלקוחות (כולל חובות לקוחות לזמן ארוך)
(95,468)	(132,580)	(22,619)	(129,338)	(22,531)	(14,927)	עליה בחייבים ויתרות חובה (כולל חובות לזמן ארוך)
21,599	(42,086)	68,699	21,599	(42,086)	68,699	ירידה (עליה) במלאי
39,442	265,043	(87,821)	31,665	267,220	(94,127)	עליה (ירידה) בספקים ונותני שירותים (כולל לזמן ארוך)
(67,722)	(107,544) *	69,094	(45,989)	(112,720) *	69,094	עליה (ירידה) בזכאים ויתרות זכות (כולל לזמן ארוך)
<u>(49,429)</u>	<u>(131,061)</u>	<u>(113,525)</u>	<u>(69,343)</u>	<u>(24,011)</u>	<u>(112,139)</u>	
<u>667,947</u>	<u>713,655</u>	<u>931,106</u>	<u>750,614</u>	<u>865,763</u>	<u>962,171</u>	סך הכל

(ב) פעולות שלא במזומן

(1) רכישה באשראי של רכוש קבוע בסך של 258,620 אלפי ש"ח (חברה – 256,939 אלפי ש"ח) בשנה שהסתיימה ביום 31 בדצמבר 2003. (2002 – מאוחד וחברה – 285,260 אלפי ש"ח, 2001 – מאוחד וחברה – 520,239 אלפי ש"ח).

(2) רכישה באשראי של רכוש אחר (רשימות תדרים) בשנת 2001 בסך של 418,994 אלפי ש"ח.

* סווג מחדש

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

באור 1 – כללי

סלקום ישראל בע"מ (להלן "החברה") התאגדה בישראל ביום 31 בינואר 1994. ביום 27 ביוני 1994 החלה החברה בפעילותה וזאת לאחר שקיבלה ממשרד התקשורת רשיון להקמתה, הפעלתה ואחזקתה של מערכת תקשורת סלולרית בישראל ואספקת שירותי טלפון סלולרי בישראל. החברה החלה לספק שירותי תקשורת סלולריים לציבור בישראל ביום 27 בדצמבר 1994. הרשיון הראשוני שניתן לחברה היה לתקופה של 10 שנים ובעקבות זכייתה במכרז התדרים בחודש דצמבר 2001, הוארך עד לשנת 2022, ראה באור 10.

באור 2 - מדיניות חשבונאית

א. הגדרות

בדוחות כספיים אלה-

(1) החברה - סלקום ישראל בע"מ.

(2) צדדים קשורים - כמשמעותם בגילוי דעת מס' 29 של לשכת רואי חשבון בישראל.

(3) בעלי עניין – כמשמעותם בסעיף 1 לחוק ניירות ערך.

(4) חברות מאוחדות – חברות, שדוחותיהן מאוחדים באופן מלא, עם דוחות החברה.

(5) מדד – מדד המחירים לצרכן שמפרסמת הלשכה המרכזית לסטטיסטיקה.

ב. הדוחות הכספיים ערוכים בהתאם לכללי חשבונאות מקובלים בישראל.

ג. שימוש באומדנים

בעריכת הדוחות הכספיים, בהתאם לכללי החשבונאות המקובלים, נדרשת ההנהלה להשתמש באומדנים והערכות העשויים להשפיע על הנתונים המדווחים של נכסים והתחייבויות (לרבות נכסים מותנים והתחייבויות תלויות) לתאריך הדוחות הכספיים וכן על נתוני הכנסות והוצאות בתקופת הדווח.

האומדנים הנ"ל מחושבים בהתאם לנסיין ולנתוני העבר, אולם התוצאות בפועל עלולות להיות שונות מאומדנים אלו.

ד. דוחות כספיים בערכים מותאמים

(1) הדוחות הכספיים ערוכים על בסיס העלות ההסטורית המותאמת לשנויים בכח הקניה הכללי של השקל. תמצית הדוחות הכספיים הנומינליים של החברה ניתנת בבאור 27.

(2) הערכים המותאמים של נכסים לא כספיים מייצגים את עלותם ההיסטורית המותאמת לשנויים שחלו בכח הקניה הכללי של המטבע הישראלי ולא מייצגים בהכרח את שוויים של אותם נכסים בשוק או לחברה.

(3) המונח עלות בדוחות הכספיים משמעותו - עלות מותאמת, אלא אם צויין אחרת.

(4) נתוני השוואה לתקופות דיווח קודמות מוצגים כשהם מותאמים למדד של תום תקופת הדווח הנוכחית.

ה. עקרונות ההתאמה

(1) המאזן:

פריטים בלתי כספיים (בעיקר רכוש קבוע, רכוש אחר, הוצאות והכנסות נדחות, מלאי, הון מניות, והוצאות מראש) הותאמו על פי השינויים שחלו במדד המחירים לצרכן (להלן - "המדד") מהמדד שפורסם בגין חודש ביצוע כל העסקאות עד למדד שפורסם בגין חודש המאזן.

שווין המאזני של ההשקעות בחברות מאוחדות נקבע על בסיס הדוחות הכספיים המבוקרים של החברות הנ"ל המותאמים לשינויים במדד.

פריטים כספיים מוצגים במאזן המותאם בערכם הנומינלי, לאותו תאריך.

(2) דוח רווח והפסד:

פריטי הרווח וההפסד הותאמו על פי השינויים במדד המחירים לצרכן כדלהלן:

א. הכנסות והוצאות הנובעות מפריטים בלתי כספיים (כגון פחת והפחתות, הוצאות והכנסות נדחות, שינויים במלאי והוצאות מראש) או מהפרשות הכלולות במאזן (כגון הפרשות לחופשה, הבראה וכו') הותאמו על בסיס מדדים ספציפיים במקביל להתאמת הסעיף המאזן.

ב. הכנסות והוצאות, למעט סעיף המימון והכנסות והוצאות מפריטים בלתי כספיים, הותאמו על בסיס המדדים בגין חודשי ביצוע העסקאות המתייחסות עד למדד תאריך המאזן.

ג. סעיף המימון, נטו, מוצג בערכים ריאליים. הסעיף כולל שחיקות של יתרות כספיות, הפרשי תיאום שנוצרו כתוצאה מהתאמת הדוחות הכספיים, כאמור לעיל וכן רווחים והפסדים ממכשירים פיננסיים נגזרים אשר אינם עונים על קריטריונים חשבונאים של עסקת גידור (ראה גם יז' להלן).

ד. החלק בתוצאות הפעולות של חברות מאוחדות נקבע על בסיס הדוחות הכספיים המבוקרים של החברות הנ"ל המותאמים לשינויים במדד.

ה. מסים על ההכנסה:

מסים שוטפים מורכבים מתשלומים על חשבון במשך השנה בתוספת סכומים העומדים לתשלום ביום המאזן (או בניכוי סכומים הנתבעים כהחזר ליום המאזן). התשלומים על חשבון הותאמו על בסיס המדד בעת ביצוע כל תשלום, ואילו הסכומים העומדים לתשלום (או הנתבעים כהחזר) נכללו ללא התאמה. לפיכך כוללים המסים השוטפים גם את ההוצאה הנובעת משחיקת ערך התשלומים על חשבון המס מיום ביצוע התשלום ועד לתאריך המאזן. מסים נדחים-ראה באור 2 טז' ובאור 25 ה'.

(3) חברה מאוחדת הפועלת בחוץ לארץ:

דוחותיה הכספיים של חברה זרה מאוחדת הפועלת במדינת חוץ כ"זרוע ארוכה" של הקבוצה, הותאמו על פי השינויים במדד מחירים לצרכן לאחר שתורגמו למטבע ישראלי כדלקמן:

פריטי מאזן כספיים - לפי שער החליפין לתאריך המאזן.
פריטי דוח רווח והפסד - תורגמו לפי שערי חליפין ממוצעים.

באור 2 - מדיניות חשבונאית (המשך)

ו. מטבע חוץ והצמדה

(1) נכסים והתחייבויות במטבע חוץ או הצמודים לו, נכללו לפי שערי החליפין היציגים שפורסמו על ידי בנק ישראל בתאריך המאזן. יתרות הצמודות למדד מוצגות על בסיס המדד האחרון שפורסם לפני תאריך הדוחות הכספיים או על בסיס המדד בגין חודש דצמבר שפורסם לאחר תאריך הדוחות הכספיים, בהתייחס לתנאי ההצמדה שנקבעו לגבי כל יתרה.

הכנסות והוצאות במטבע חוץ נכללות בדוחות הכספיים לפי שערי החליפין המתייחסים שהיו בתוקף בעת זקיפתן.

(2) נתונים לגבי מדדי המחירים לצרכן ושערי חליפין:

שער החליפין של דולר של ארה"ב	מדד המחירים לצרכן	
ש"ח	נקודות	
4.379	178.5793	ליום 31 בדצמבר 2003
4.737	182.0123	ליום 31 בדצמבר 2002
4.416	170.9099	ליום 31 בדצמבר 2001
		עליה (ירידה) במהלך התקופה:
(7.56%)	(1.89%)	לשנה שהסתיימה ביום 31 בדצמבר 2003
7.26%	6.49%	לשנה שהסתיימה ביום 31 בדצמבר 2002
9.27%	1.40%	לשנה שהסתיימה ביום 31 בדצמבר 2001

ז. איחוד הדוחות הכספיים

- (1) הדוחות הכספיים המאוחדים כוללים איחוד החברות בהן מתקיימת שליטה של החברה.
- (2) לצורך האיחוד הובאו בחשבון הסכומים הכלולים בדוחות הכספיים של החברות שאוחדו, לאחר תאומים המתחייבים מיישום כללי חשבונאות אחידים הנקטים בידי הקבוצה.
- (3) כל היתרות והעסקאות בין החברות בוטלו לצורך איחוד הדוחות הכספיים.

ח. מזומנים ושוי מזומנים

כולל פיקדונות בבנקים, שתקופת הפקדתם המקורית, לא עלתה על שלושה חודשים.

ט. הפרשה לחובות מסופקים

ההפרשה לחובות מסופקים מחושבת בעיקרה כהפרשה כללית ובחלקה כהפרשה ספציפית המשקפת בצורה נאותה, לפי הערכת ההנהלה, את ההפסד הגלום בחובות, שגבייתם מוטלת בספק. בקביעת נאותות ההפרשה התבססה ההנהלה, בין היתר, על המידע שבידה בדבר מצבם הכספי של החייבים וכן על טווח הזמן שחלף ממועד פרעון החוב המקורי.

י. מלאי

מלאי הטלפונים הסלולריים, האביזרים הנלווים וחלקי החילוף מוצג לפי העלות או שווי השוק, הנמוך שבהם. במהלך השנה שינתה החברה את שיטת הערכת המלאי משיטת נכנס ראשון יוצא ראשון לשיטת הממוצע הנע. יישום השיטה לא השפיע באופן מהותי על דוחותיה הכספיים של החברה. מלאי טלפונים סלולריים, אביזרים וחלקי חילוף שצריכתו איטית, מוצג בניכוי הפרשה לירידת ערך. מלאי של מכשירי טלפון משומשים, אביזרים משומשים וחלקי חילוף משומשים מופחת במלואו.

יא. השקעה בחברות מאוחדות

ההשקעה בחברות מאוחדות, מוצגת על בסיס השווי המאזני, על פי הדוחות הכספיים המבוקרים של אותן חברות.

באור 2 - מדיניות חשבונאית (המשך)

י.ב. רכוש קבוע

- (1) הנכסים הקבועים מוצגים לפי עלות. הוצאות ישירות ואחרות הנדרשות להבאת הנכסים לכלל הפעלה נזקפות לעלות אותם נכסים.
- (2) הוצאות מימון ריאליות בגין אשראי ששימש למימון רכישת נכסים קבועים, נזקפות לעלות נכסים אלה. ראה באור 2 טו'.
- (3) הפחת מחושב לפי שיטת הקו הישר, על בסיס משך השימוש המשוער של הנכסים.

שיעורי הפחת השנתיים הינם כדלקמן:

%		
15		רשת התקשורת
7-20	(בעיקר 15%)	מכונות וציוד
15		כלי רכב
15-33		מחשבים וציוד תוכנה
6-15		ריהוט וציוד משרדי

שיפורים במושכר - בהתאם לתקופת השכירות (כולל האופציה שבידי החברה להארכת תקופת השכירות), שאינה עולה על אורך חייו הכלכלי של הנכס.

- (4) עלויות אחזקה ותיקונים נרשמות כהוצאות שוטפות בעת התהוותן. עלויות שפורים משמעותיות נזקפות לעלות הרכוש הקבוע.

- (5) עלויות פיתוח תוכנה לשימוש עצמי מטופלות בהתאם לנייר העמדה של לשכת רואי חשבון בארה"ב Internal Use: עלויות פיתוח תוכנה לשימוש עצמי מהוונות לאחר ששלב התכנון המקדמי הושלם, צפוי שהפרויקט יושלם והתוכנה תשמש לביצוע המטרות שיועדו לה. ההיוון מופסק במועד בו התוכנה הושלמה מהותית והיא מוכנה לשימושה המיועד. עלויות פיתוח ישירות של ציוד תוכנה לשימוש פנימי, מופחתות על פני 4 שנים.

י.ג. רכוש אחר והוצאות נדחות

רכוש אחר והוצאות נדחות מוצגים לפי עלותם ומופחתים בהתאם לאורך חייהם המשוער. רשיונות לשימוש בתדרים מופחתים החל מהמועד בו רשת התקשורת נשואת הרשיון מוכנה לשימוש לאחר ביצוע ניסיונות הפעלה.

שיעורי ההפחתה השנתיים הינם כדלקמן:

%		
5-10	(בעיקר 5%)	רשיונות
10-33	(בעיקר 10%)	הוצאות נידחות

י.ד. הכרה בהכנסות

ההכנסות ממכירות ציוד טלפון סלולרי נזקפות עם המשלוח ללקוח. הכנסות הנובעות מהסדרי אשראי לזמן ארוך (מעל שנה) נרשמות על בסיס הערך הנוכחי של תזרימי המזומנים העתידיים, מהוונות לפי אחוזי ריבית השוק במועד העיסקה. ההפרש בין הסכום המקורי של האשראי לבין ערכו הנוכחי, כאמור לעיל, נפרס על פני תקופת האשראי ונרשם כהכנסות ריבית.

ההכנסות ממתן שירותים נרשמות ונזקפות על בסיס יומי.

תקבולים ממכירת כרטיסי חיוג נרשמים כהכנסה דחוייה ומוכרים כהכנסה בהתאם לשימוש.

הנחות מספקים – הנחות הניתנות מספקים מנוכות מעלות המכר במועדים בהם מתקיימים התנאים המזכים את החברה בהן.

באור 2 - מדיניות חשבונאית (המשך)

טו. היוון עלויות אשראי

החברה מהוונת עלויות אשראי בהתאם לתקן חשבונאות מס' 3 בדבר "היוון עלויות אשראי". בהתאם לתקן זה יש להוון עלויות אשראי ספציפיות ועלויות אשראי שאינן ספציפיות לנכסים כשירים. עלויות אשראי שאינן ספציפיות מהוונות לאותה השקעה או לאותו חלק ממנה שלא ממומן באשראי ספציפיות תוך שימוש בשיעור שהוא הממוצע המשוקלל של שיעורי העלות בגין אותם מקורות אשראי שעלותם לא הוונה באופן ספציפי.

סכום עלויות האשראי שהוונו במשך התקופה מסתכם לכ- 9,209 אלפי ש"ח. שיעור ההיוון כפי שחושב על פי התקן הינו כ- 8.05%.

טז. מיסים נדחים

המיסים הנדחים מחושבים לפי שיטת ההתחייבות החשבונאית. בהתאם לשיטה זו, מחושבים המיסים הנדחים בגין הפרשים זמניים (Temporary Differences) שבין ערכם של נכסים והתחייבויות בדוחות הכספיים לבין ערכם של אלה לצרכי מס הכנסה.

המיסים הנדחים מחושבים לפי שיעורי המס שיחולו במועד בו תנצל החברה את המיסים הנדחים או תממש את הטבות המס, כפי שהם ידועים סמוך לתאריך המאזן.

יז. מכשירים פיננסיים נגזרים

החברה אימצה את עקרונות SFAS מס' 133 הדין ב- "טיפול במכשירים פיננסיים נגזרים ופעילויות גידור", שתוקן ביוני 2000 ע"י SFAS מס' 138. גילוי הדעת קובע כללי חשבונאות ודיווח למכשירים פיננסיים נגזרים ופעילויות גידור.

על פי SFAS מס' 133 ו-SFAS מס' 138 כל המכשירים הפיננסיים הנגזרים, כולל אלה שמיועדים למטרות גידור, ירשמו כנכסים או כהתחייבות במאזן וימדדו לפי שווייהם ההוגן. כמו כן גילוי הדעת הנ"ל דורשים ששינויים בשווי ההוגן של המכשירים הפיננסיים הנגזרים יזקפו באופן שוטף לרווח והפסד, אלא אם הם עונים על קריטריונים חשבונאיים של עסקת גידור.

יח. שווי נאות של מכשירים פיננסיים

הדוחות הכספיים כוללים גילוי בגין מכשירים פיננסיים, כגון יתרות מזומנים ושווי מזומנים, לקוחות, אשראי לזמן קצר וארוך, וספקים ונותני שירותים. הגילוי כולל בסיס הצמדה, שיעורי ריבית ומועדי פירעון.

השווי הנאות של המכשירים הפיננסיים הנ"ל אינו שונה באופן מהותי מערכם הפנקסי.

יט. רווח למניה

רווח למניה חושב בהתאם להוראות גילוי דעת 55 של לשכת רואי חשבון בישראל.

כ. השפעת תקני חשבונאות חדשים בתקופה שלפני יישומם

(1) בחודש אוקטובר 2001 פרסם המוסד הישראלי לתקינה בחשבונאות את שני התקנים הבאים: תקן חשבונאות מספר 12 בדבר "הפסקת ההתאמה של דוחות כספיים". בהתאם לתקן זה, תופסק ההתאמה של דוחות כספיים להשפעת השינויים בכוח הקנייה הכללי של המטבע הישראלי החל מיום 1 בינואר 2003.

בחודש דצמבר 2002 פרסם המוסד הישראלי לתקינה בחשבונאות את תקן חשבונאות מספר 17 הקובע כי ישומו תקן 12 יידחה ל-1 בינואר 2004. לפיכך, ההתאמה של הדוחות הכספיים תופסק החל מיום 1 בינואר 2004. עד ליום 31 בדצמבר 2003, תמשיך החברה לערוך דוחות מותאמים בהתאם לגילוי דעת 36 של לשכת רואי חשבון בישראל. הסכומים המותאמים הכלולים בדוחות הכספיים ליום 31 בדצמבר 2003 ישמשו נקודת מוצא לדיווח הכספי הנומינלי החל מיום 1 בינואר 2004. ליישום תקן חשבונאות מספר 12 עלולה להיות השלכה מהותית על התוצאות העסקיות המדווחות של החברה. מידת ההשפעה תלויה בשיעור האינפלציה, בהרכב הנכסים ומקורות המימון של החברה.

(2) במהלך שנת 2001 פרסם המוסד הישראלי לתקינה בחשבונאות את תקן חשבונאות מספר 13 בדבר "השפעת השינויים בשערי חליפין של מטבע חוץ". התקן עוסק בתרגום עסקאות במטבע חוץ ובתרגום דוחות כספיים של פעילויות חוץ לצורך שילובם בדוחות הכספיים של התאגיד המדווח. התקן מחליף את הוראות הבהרות 8 ו-9 לגילוי דעת מספר 36 אשר יבוטלו עם כניסתו לתוקף של תקן חשבונאות מספר 12 המתואר לעיל. תקן זה יחול על הדוחות הכספיים לתקופות המתחילות לאחר 31 בדצמבר 2003.

באור 2 - מדיניות חשבונאית (המשך)

כא. תקני חשבונאות שיושמו לראשונה

- (1) בחודש פברואר 2003 פרסם המוסד הישראלי לתקינה בחשבונאות את תקן חשבונאות מספר 15 – ירידת ערך נכסים. התקן קובע נהלים שעל תאגיד ליישם כדי להבטיח שנכסיו במאזן המאוחד לא יוצגו בסכום העולה על סכום בר השבה שלהם, שהינו הגבוה מבין מחיר המכירה נטו לבין הערך הנוכחי של אומדן תזרימי המזומנים העתידיים הצפויים לנבוע מהשימוש בנכס ומימושו. כמו כן, קובע התקן את כללי ההצגה והגילוי לגבי נכסים שחלה ירידה בערכם.
- החברה מיישמת את התקן בדוחותיה הכספיים החל מיום 1 בינואר 2003. כתוצאה מיישום תקן 15 רשמה החברה ירידת ערך קרקע שנכללה בסעיף הוצאות אחרות בדו"ח רווח והפסד.
- (2) בחודש אוגוסט 2001, פרסם המוסד לתקינה חשבונאית בארה"ב (FASB) את תקן (FAS) מס' 143 "הטיפול החשבונאי במחויבויות בגין סילוק נכסים לזמן ארוך".
- FAS 143 קובע טיפול חשבונאי ומתכונת דיווח במחויבויות משפטיות הקשורות בנטישת ובסילוק נכסים לזמן ארוך הנוצרת מרכישה, הקמה, פיתוח או שימוש שוטף בנכס לזמן ארוך.
- החברה מיישמת את התקן בדוחותיה הכספיים החל מיום 1 בינואר 2003. ליישום התקן לא היתה השפעה על תוצאות הפעולות, המצב הכספי ותזרים המזומנים של החברה.

באור 3 - מזומנים ושווי מזומנים

ההרכב:

חברה		מאוחד	
31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח
21,820 *	278,714	21,820 *	278,714
75	130,192	148,703	175,392
<u>21,895</u>	<u>408,906</u>	<u>170,523</u>	<u>454,106</u>

במטבע ישראלי

במטבע חוץ

* סווג מחדש

באור 4 – לקוחות (מאוחד וחברה)

ההרכב:

31 בדצמבר 2002	31 בדצמבר 2003
אלפי ש"ח	אלפי ש"ח
713,931	691,618
<u>94,293</u>	<u>142,291</u>
808,224	833,909
<u>171,133</u>	<u>149,174</u>
637,091	684,735
<u>321,084</u>	<u>355,743</u>
<u>958,175</u>	<u>1,040,478</u>

חובות פתוחים והכנסות לקבל
המחאות לגביה ושוברי כרטיסי אשראי

בניכוי – הפרשה לחובות מסופקים

חלויות שוטפות של לקוחות לזמן ארוך

באור 5 – חייבים ויתרות חובה

ההרכב:

חברה		מאוחד		
31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
111,806	129,351	111,806	129,351	מוסדות ממשלתיים
31,401	12,976	31,401	12,976	מכשירים פיננסיים נגזרים
25,524	32,614	25,524	32,614	הוצאות מראש
18,664	-	18,664	-	מיסים נדחים (1)
15,632	14,030	28,569	25,407	אחרים
203,027	188,971	215,964	200,348	
-	-	188,820	13,137	חלויות שוטפות של חייבים לזמן ארוך (2)
<u>203,027</u>	<u>188,971</u>	<u>404,784</u>	<u>213,485</u>	

(1) ראה באור 25 ה'.

(2) כולל פקדון במט"ח, ראה באור 7(ב).

באור 6 – מלאי (מאוחד וחברה)

א. ההרכב:

31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	
129,701	84,875	טלפונים סלולריים
15,254	14,988	חלקי חילוף
38,010	14,403	אביזרים
<u>182,965</u>	<u>114,266</u>	

ב. מלאי טלפונים סלולריים, אביזרים וחלקי חילוף מוצגים בניכוי הפרשה לירידת ערך בסך 27,102 אלף ש"ח, (31.12.02 – 34,502 אלף ש"ח).

באור 7 – חייבים ויתרות חובה לזמן ארוך

ההרכב:

חברה		מאוחד		
31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003	
506,696	697,402	506,696	697,402	חובות פתוחים והכנסות לקבל (א)
133,507	48,688	133,507	48,688	המחאות לגביה ושוברי אשראי (א)
-	-	202,792	13,137	פקדון (ב)
5,965	8,401	5,965	18,674	אחר
646,168	754,491	848,960	777,901	סך הכל
50,712	63,326	50,712	63,326	בניכוי הכנסת ריבית נדחית (ג)
595,456	691,165	798,248	714,575	
1,962	2,000	1,962	2,000	הפרשה לחובות מסופקים
593,494	689,165	796,286	712,575	
321,084	355,743	509,904	368,880	בניכוי חלויות שוטפות
272,410	333,422	286,382	343,695	

מועדי הפרעון הינם כלהלן:

חברה	מאוחד	
31 בדצמבר 2003	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	
231,191	231,191	2005
93,830	93,830	2006
8,401	18,674	2007 ולאחריה
333,422	343,695	

(א) חובות הלקוחות לזמן ארוך מקורם במכירת ערכות טלפון בתשלומים (בעיקר 36 תשלומים חודשיים).

(ב) הפקדון הינו דולרי ונושא ריבית שנתית בשיעור משתנה. שיעור הריבית ליום 31 בדצמבר 2003 הינו 4%.

(ג) הכנסת ריבית נדחית מהווה את ההפרש בין סכום החוב המקורי לבין ערכו הנוכחי. הערך הנוכחי מחושב על בסיס שיעור הריבית הרלוונטי לתאריך העסקה (11%-12%).

באור 8 - השקעה בחברות מאוחדות (חברה)

א. הרכב ההשקעה:

31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	
1,759	1,759	עלות המניות
348,851	389,170	רווחים שנצברו
-	(337,435)	דיבידנד שחולק (1)
31,831	42,811	שטר הון (2)
<u>382,441</u>	<u>96,305</u>	

ב. התנועה בהשקעות הינה כדלקמן:

31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	
284,010	382,441	יתרה לתחילת השנה
(3,973)	12,046	השקעות במהלך השנה (2)
102,404	39,253	החלק ברווחים
-	(337,435)	דיבידנד שחולק (1)
<u>382,441</u>	<u>96,305</u>	יתרה לסוף השנה

(1) הדיבידנד חולק מעודפי חברות בנות בחו"ל, כחלק מתהליך פירוקן מרצון שיושלם במהלך 2004.

(2) חברת בת הנפיקה שטר הון לחברה, שאינו צמוד ואינו נושא ריבית, שייפרע החל מיום 1.1.2005.

באור 9 - רכוש קבוע, נטו (מאוחד)

ההרכב:

סך הכל	שיפורים במושכר	מחשבים, ריהוט וציוד משרדי	כלי רכב	מכונות וציוד	רשת תקשורת	* קרקע ומבנה	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
7,647,575	119,328	1,197,518	98,292	88,406	6,111,153	32,878	יתרה ליום 1 בינואר 2003
658,239	9,247	166,911	7,893	12,053	462,135	-	תוספות
(46,559)	-	(4,122)	(10,706)	-	(31,731)	-	גריעות
8,259,255	128,575	1,360,307	95,479	100,459	6,541,557	32,878	יתרה ליום 31 בדצמבר 2003
4,018,756	54,022	554,689	32,634	59,154	3,318,257	-	יתרה ליום 1 בינואר 2003
988,489	20,748	198,118	13,985	14,136	741,502	-	זקיפת פחת
(30,359)	-	(3,338)	(5,783)	-	(21,238)	-	גריעת פחת
4,976,886	74,770	749,469	40,836	73,290	4,038,521	-	יתרה ליום 31 בדצמבר 2003
(6,000)	-	-	-	-	-	(6,000)	הפרשה לירידת ערך
3,276,369	53,805	610,838	54,643	27,169	2,503,036	26,878	יתרה מופחתת ליום 31 בדצמבר 2003
3,628,819	65,306	642,829	65,658	29,252	2,792,896	32,878	יתרה מופחתת ליום 31 בדצמבר 2002

* כולל קרקע חכורה בסך של 21,872 אלפי ש"ח. הקרקע נחכרה ממינהל מקרקעי ישראל בשנת 2001 לתקופה של 49 שנה, וכן מבנה בהקמה בסך של 10,601 אלפי ש"ח.

מידע נוסף:

- עלות רשת התקשורת כוללת עלויות הנדרשות להקמת מערכת תקשורת סולרית, בסך של 197,201 אלף ש"ח (31 בדצמבר 2002 – 188,295 אלף ש"ח) בגין עלויות הנדסה ועלויות תפעוליות שהונו (כולל ייעוץ מקצועי, שכר והוצאות מימון).
- עלות המחשבים כוללת עלויות פיתוח תוכנות לשימוש פנימי שהונו בסך של 238,996 אלף ש"ח (31 בדצמבר 2002 - 194,296 אלף ש"ח).
- אשר לשעבודים ראה באור ג' 1.

באור 9 - רכוש קבוע, נטו (חברה)

ההרכב:

רשת	מכונות	כלי	מחשבים, ריהוט	שיפורים	סך הכל	
תקשורת	וציוד	רכב	וציוד משרדי	במושכר	אלפי ש"ח	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
						עלות
6,111,153	88,406	98,292	1,197,518	119,328	7,614,697	יתרה ליום 1 בינואר 2003
462,135	12,053	7,893	165,050	9,247	8656,37	תוספות
(31,731)	-	(10,706)	(4,122)	-	(46,559)	גריעות
6,541,557	100,459	95,479	1,358,446	128,575	68,224,51	יתרה ליום 31 בדצמבר 2003
						פחת שנצבר
3,318,257	59,154	32,634	554,689	54,022	4,018,756	יתרה ליום 1 בינואר 2003
741,502	14,136	13,985	198,118	20,748	89988,4	זקיפת פחת
(21,238)	-	(5,783)	(3,338)	-	(30,359)	גריעת פחת
4,038,521	73,290	40,836	749,469	74,770	64,976,88	יתרה ליום 31 בדצמבר 2003
2,503,036	27,169	54,643	608,977	553,80	3,247,630	יתרה מופחתת ליום 31 בדצמבר 2003
62,792,89	29,252	65,658	642,829	65,306	3,595,941	יתרה מופחתת ליום 31 בדצמבר 2002

מידע נוסף:

- א. עלות רשת התקשורת כוללת עלויות הנדרשות להקמת מערכת תקשורת סולרית, בסך של 197,201 אלף ש"ח (31 בדצמבר 2002 - 188,295 אלף ש"ח) בגין עלויות הנדסה ועלויות תפעוליות שהונו (כולל ייעוץ מקצועי, שכר והוצאות מימון).
- ב. עלות המחשבים כוללת עלויות פיתוח תוכנות לשימוש פנימי שהונו בסך של 238,996 אלף ש"ח (31 בדצמבר 2002 - 194,296 אלף ש"ח).
- ג. בדבר שעבודים ראה באור 18 ג' 1.

א. ההרכב:

<u>סך הכל</u>	<u>הוצאות נדחות (3)</u>	<u>רשיונות (1)(2)</u>	
<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	
429,835	1,700	428,135	עלות
25,243	1,539	23,704	הפחתה מצטברת
<u>404,592</u>	<u>161</u>	<u>404,431</u>	עלות מופחתת ליום 31 בדצמבר 2003
<u>415,183</u>	<u>335</u>	<u>414,848</u>	עלות מופחתת ליום 31 בדצמבר 2002

(1) בחודש דצמבר 2001 זכתה החברה במכרז של משרד התקשורת למתן זכות שימוש בתדרים נוספים לצרכי רשת הרט"ן. בעקבות הזכייה תוכל החברה לתת שירותים בטכנולוגיית GSM/GPRS ובעתיד בטכנולוגיית UMTS. בעקבות הזכייה הוארך רשיון החברה ל-20 שנים נוספות, עד לשנת 2022. עבור תדרי ה-GSM/GPRS שילמה החברה 189 מיליון ש"ח בראשית פברואר 2002. עבור תדרי ה-UMTS שילמה החברה 132 מיליון ש"ח במהלך השנים 2002 ו-2003 ותשלם עוד 107 מיליון ש"ח במהלך התקופה משנת 2004 עד יוני 2006.

(2) העלות כוללת תשלום בסך 8,892 אלף ש"ח (31 בדצמבר 2002 - זהה) בגין הוצאות שנשא צד קשור להשגת הרשיון.

(3) ההוצאות הנדחות כוללות הוצאות בקשר לשכירות של חנויות ומשרדים.

באור 11 - אשראי לזמן קצר מתאגידים בנקאיים (מאוחד וחברה)

<u>31 בדצמבר</u>	<u>31 בדצמבר</u>	<u>31 בדצמבר</u>	
<u>2002</u>	<u>2003</u>	<u>2003</u>	
<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	<u>שעור ריבית (%)</u>	
448,123	-		הלוואות לזמן קצר מבנקים - בלתי צמודות
154,589	1,123,175	8.03-5.60	חלויות שוטפות של הלוואות לזמן ארוך מבנקים
<u>602,712</u>	<u>1,123,175</u>		

בדבר שעבודים-ראה ביאור 18 ג'.

חברה		מאוחד		ההרכב:
31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
180,185	126,143	180,185	120,582	חובות פתוחים:
295,077	216,280	295,077	216,280	במטבע ישראלי
438,206	437,647	453,000	453,554	במט"ח (בעיקר בדולרים של ארה"ב)
913,468	780,070	928,262	790,416	הוצאות לשלם (בעיקר במטבע ישראלי)
32,088	41,865	32,088	41,865	חלויות שוטפות של ספקים ונותני שירותים לזמן ארוך (1)
945,556	821,935	960,350	832,281	

(1) ליום 31 בדצמבר 2003, כולל סך של 41,865 אלפי ש"ח התחייבות לתשלום למשרד התקשורת בגין רכישת רשיונות תדרים (31.12.02 - 32,088 אלפי ש"ח). ראה גם באור 10.

באור 13 - זכאים ויתרות זכות

חברה		מאוחד		ההרכב:
31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
118,171 *	166,080	118,171 *	166,080	עובדים והתחייבויות נלוות (1)
8,357	37,790	8,357	37,790	מוסדות ממשלתיים
36,621	34,019	36,621	34,019	הכנסות מראש
3,487	4,994	3,487	4,994	מקדמות מלקוחות
53,760	46,121	53,760	48,196	אחרים
220,396	289,004	220,396	291,079	

(1) ליום 31 בדצמבר 2003, כולל סך של 39,814 אלפי ש"ח בגין תוכנית תמריץ לעובדים.

* סיווג מחדש

באור 14 – הלוואות לזמן ארוך מתאגידים בנקאיים (מאוחד וחברה)

א. ההרכב:

31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	שיעור ריבית (%)	
1,112,353	1,018,303	605.60-6	צמודות מדד
1,029,214	987,000	10.03-6.52	לא צמודות
2,141,567	2,005,303		
154,589	1,123,175		בניכוי חלויות שוטפות
<u>1,986,978</u>	<u>882,128</u>		

ב. מועדי פרעון

אלפי ש"ח	
490,878	2005
320,000	2006
65,000	2007
<u>6,250</u>	2008
<u>882,128</u>	

בדבר שעבודים-ראה ביאור 18 ג'.

באור 15 - התחייבות בשל סיום יחסי עובד-מעביד, נטו

התחייבות החברה בגין סיום יחסי עובד-מעביד מחושבת על פי דיני העבודה הקיימים בישראל, ומכוסה בעיקרה על ידי הפקדות בקרן פנסיה ו/או רכישת פוליסות בחברת ביטוח. ההתחייבות מחושבת על בסיס המשכורת האחרונה ששולמה לכל עובד מוכפלת במספר שנות עבודתו. לחברה אישור ממשרד העבודה והרווחה, בהתאם לסעיף 14 לחוק פיצויי פיטורין, 1963, על פיו הפקדותיה השוטפות בקרנות פנסיה ו/או בפוליסות בחברות ביטוח, פוטרות אותה מכל התחייבות נוספת לעובדים, בגינם הופקדו הסכומים כאמור לעיל.

התחייבות בשל סיום יחסי עובד מעביד, המוצגת במאזן, מייצגת את התחייבות החברה בגין עובדים מסויימים בגינם לא הופקדו סכומים בקרן פנסיה או בחברת ביטוח.

באור 16 – זכאים ויתרות זכות לזמן ארוך (מאוחד וחברה)

החברה אימצה תוכנית תמריץ לעובדים בעמדות ניהול. על פי תוכנית זו תעניק החברה בונוסים לעובדים המתבססים על שווי החברה. בתנאים מסוימים עשויה תוכנית זו להיות מומרת לתוכנית אופציות. בהתאם לאמור לעיל, ביצעה החברה הפרשה בסך של 41 מיליון ש"ח.

באור 17 - ספקים ונותני שרותים לזמן ארוך (מאוחד וחברה)

<u>31 בדצמבר 2002</u>	<u>31 בדצמבר 2003</u>	ההרכב:
<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	
126,060	107,277	ספקים ונותני שרותים לזמן ארוך *
<u>32,088</u>	<u>41,865</u>	בניכוי חלויות שוטפות
<u>93,972</u>	<u>65,412</u>	

* היתרה נושאת ריבית חשב כללי בשיעור של 6.7% נכון ל - 31.12.2003.

א. התחייבויות תלויות:

1. בחודש ספטמבר 1999, הוגשה לבית המשפט המחוזי בתל-אביב יפו תביעה נגד החברה, על ידי אחד ממנוייה, אליה צורפה בקשה להכיר בה כתובענה ייצוגית, בשם מנויי החברה בגין נזקים בסך כ- 6.2 מיליארד ש"ח בקשר לחיובים עבור שירותי רשת, שירותים שונים לרבות ביטוח ואחריות של ציוד קצה וכן בגין חיובים הקשורים למכירת אביזרים. במהלך שנת 2000, סכום התביעה הייצוגית הנ"ל עודכן ל- 5.2 מיליארד ש"ח. לאחר שבחודש אוקטובר 2000 דחה בית המשפט המחוזי, בתל-אביב יפו את הבקשה לאישור התובענה כייצוגית, הוגשה בנובמבר 2000 לבית המשפט העליון בקשת רשות ערעור, על החלטה זו. להערכת הנהלת החברה, בהסתמך על דעת יועציה המשפטיים, לחברה טענות הגנה טובות כנגד הבקשה ולפיכך, לא נכללה כל הפרשה בגין הבקשה הנ"ל בדוחות הכספיים.
2. בחודש דצמבר 2002, הוגשה לבית המשפט המחוזי בתל-אביב יפו תובענה נגד החברה, בקשר עם תעריפי שיחות נכנסות, בהם חויבו מנויים של מפעילים אחרים בעת התקשרות ללקוחות החברה בתקופה שקדמה להתקנת תקנות קישור גומלין. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית, הסכום הנתבע הנו כ-1.6 מיליארד ש"ח (נכון למועד הגשתה). בשלב זה אין באפשרות הנהלת החברה ויועציה המשפטיים להעריך את ההשפעות האפשריות של התביעה ותוצאותיה על החברה משום שהיקפה ותוכנה כתביעה ייצוגית, ייקבע רק אם וכאשר בית המשפט יחליט בדבר אישור התביעה כתביעה ייצוגית, יקבע את היקף קבוצת התובעים המיוצגים ויגדיר אלו עילות וסעדים יידונו במסגרת התביעה הייצוגית. לפיכך, לא נכללה כל הפרשה בגין תובענה זו בדוחות הכספיים.
3. בחודש אוגוסט 2001, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה על ידי אחד ממנוייה, אליה צורפה בקשה להכיר בה כתובענה ייצוגית, בקשר עם תעריפי זמן אויר ודמי מנוי שלטענתו נגבו שלא בהתאם לנוסחו של הסכם ההתקשרות עליו חותמים לקוחותיה של החברה בעת הצטרפותם לרשת (הסכם רט"). אם תובענה זו היתה מוכרת כתובענה ייצוגית הסכום הנתבע היה כ-1.26 מיליארד ש"ח (נכון למועד הגשתה) וכן פיצויים עונשיים בשיעור שלא יפחת מ-100% מהנזק. בחודש פברואר 2004, לאחר תאריך המאזן, נדחתה על ידי בית המשפט הבקשה לאישור התובענה כתובענה ייצוגית.
4. בחודש ספטמבר 2000, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה, על ידי אחד ממנוייה, בקשר עם חיובי מע"מ על פרמיות ביטוח ומתן שרותי ביטוח לא חוקיים. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תאושר כתובענה ייצוגית הסכום הנתבע הוא כ- 402 מליון ש"ח (נכון למועד הגשתה). להערכת הנהלת החברה, בהסתמך על דעת יועציה המשפטיים, לחברה טענות הגנה טובות נגד אישור התובענה הנ"ל כתובענה ייצוגית, ולפיכך לא נכללה כל הפרשה בגין תובענה זו בדוחות הכספיים.
5. בחודש ספטמבר 2000, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה, על ידי אחד ממנוייה, בקשר עם תעריפי השיחות למנויי פלאפון. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית, הסכום הנתבע הוא כ- 43 מליון ש"ח (נכון למועד הגשתה). להערכת הנהלת החברה, בהסתמך על דעת יועציה המשפטיים, לחברה טענות הגנה טובות נגד אישור התובענה הנ"ל כתובענה ייצוגית. לפיכך לא נכללה כל הפרשה בגין תובענה זו בדוחות הכספיים.

א. התחייבויות תלויות (המשך):

6. בחודש ספטמבר 2000, קיבלה החברה מכתב התראה בקשר עם הפרת פטנט, לכאורה, במסגרת השימוש שעושה החברה במערכת ה"טוקמן". כמו כן נתקבלה בחודש ינואר 2001 טיוטת עקרונות מוצעת, המפרטת את תנאי רשיון השימוש בפטנט, במידה וינתן רשיון שימוש כאמור. בשלב זה לא ניתן להעריך את ההשפעה הכספית, אם בכלל, על התוצאות העסקיות של החברה בגין האמור לעיל. לפיכך לא נכללה כל הפרשה בגין דרישה זו בדוחות הכספיים.
7. בתחילת שנת 2001 נתבקשה החברה להמציא לאגף המכס במשרד האוצר פרטים הנוגעים לייצורם של מכשירי טלפון נייד, המיובאים באופן עצמאי על ידי החברה בפטור מתשלום מכס בהתאם להסכמי סחר בינלאומיים. החברה הגישה מסמכים לאגף המכס לאימות הצהרותיה לענין מקור יצור הטלפונים במועד היבוא והנושא נמצא בבדיקה של רשויות המכס. בשלב זה, הנהלת החברה אינה יכולה להעריך את ההשפעה הכוללת (אם בכלל) של האמור על התוצאות העסקיות של החברה.
8. בחודש מאי 2002, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה ונגד פלאפון, פרטנר ומירס בקשר עם הקצאת מספרי טלפון סלולריים עבור שירותי מידע, בידור ופנאי. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו היתה מוכרת כתובענה ייצוגית, הסכום הנתבע מכל הנתבעות היה כ- 600 מיליון ש"ח (נכון למועד הגשתה), מבלי לייחד את הסכום הנתבע מהחברה. בחודש יוני 2003, נמחקו על ידי בית המשפט התובענה והבקשה לאשרה כתובענה ייצוגית.
9. בחודש אוגוסט 2001, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה על-ידי אחד ממנוייה, בקשר עם תעריפי שיחות יוצאות במסלול טוקמן וגבייה של עמלת הפצה בגין כרטיסי טוקמן. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית, הסכום הנתבע הוא כ-135 מיליון ש"ח (נכון למועד הגשתה). להערכת הנהלת החברה, בהסתמך על יועציה המשפטיים, לחברה טענות הגנה טובות נגד אישור התובענה הנ"ל כתובענה ייצוגית. לפיכך, לא נכללה כל הפרשה בגין תובענה זו בדוחות הכספיים.
10. בחודש מאי 2001, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה על-ידי אחד ממנוייה, בקשר עם תעריפי שיחות יוצאות במסלול טוקמן. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו היתה מוכרת כתובענה ייצוגית, הסכום הנתבע היה כ- 35 מיליון ש"ח (נכון למועד הגשתה). בחודש מרס 2003, נדחו על ידי בית המשפט התובענה והבקשה לאשרה כתובענה ייצוגית.
11. בחודש דצמבר 2001, הוגשה לבית המשפט המחוזי בתל אביב-יפו תובענה נגד החברה על ידי אחד ממנויה, בקשר עם גביית מלוא התשלום בגין יחידת מניה בשיחה מתנתקת. לתובענה צורפה בקשה לאשר את התובענה כתובענה ייצוגית. אם תובענה זו היתה מוכרת כתובענה ייצוגית, הסכום הנתבע היה 73 מיליון ש"ח (נכון למועד הגשתה). בחודש אוקטובר 2003, נדחו התובענה והבקשה לאשרה כתובענה ייצוגית על ידי בית המשפט המחוזי.

א. התחייבויות תלויות (המשך):

12. בחודש ספטמבר 2002, הוגשה לבית המשפט המחוזי בתל-אביב יפו תובענה נגד החברה על ידי אחד ממנוייה, בקשר עם דמי השלמת שיחה לרשת חברת בזק, אשר גובה החברה ממנוייה. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו היתה מוכרת כתובענה ייצוגית הסכום הנתבע היה כ-15 מליון ש"ח (נכון למועד הגשתה). בחודש דצמבר 2003, נדחתה על ידי בית המשפט הבקשה לאישור התובענה כתובענה ייצוגית.

13. א. רשויות מוניציפליות שונות השיגו באשר לחוקיות פעולתם של מספר רב של אתרי בסיס של החברה, בשל העדר היתרי בנייה. חלק מאתרים אלו נמצאים בשלבים שונים של תהליך רישוי בניה ואפשר שחלק מאתרים אלה ידרשו מיקום מחדש. התוצאות העסקיות של החברה יושפעו לרעה במידה ולא ינתנו היתרים לאתרים אלו, דבר שיחייב מיקומם מחדש. בחודש יוני 2002 נכנסה לתוקף תוכנית מתאר ארצית למתקני תקשורת (תמ"א) 36 א' שנועדה להקל על קבלת היתרי בנייה של אתרי בסיס. גם לאחר אישור התמ"א, רישוי האתרים עודנו תהליך מורכב וחלק מהאתרים שהוקמו ידרשו מיקום מחדש. כמו כן לא ניתן להעריך האם אישור התמ"א לכשעצמו ייצור לחברה חבויות נוספות. בשלב זה, לא ניתן להעריך את ההשפעה הכספית הכוללת על התוצאות העסקיות של החברה בגין האמור לעיל ולפיכך לא נכללה כל הפרשה בדוחות הכספיים.

ב. בדיוני המועצה הארצית לתכנון ובניה, הוחלט כי החברות הסלולריות ובכללן החברה ישפו את הועדות המקומיות לתכנון ובניה, בגין תביעות פיצויים שיוגשו כנגדן על פי סעיף 197 לחוק התכנון והבניה, התשכ"ה – 1965, בקשר עם אישור תמ"א 36. אף שהוחלט כי בסוגיה זו תתבקש החלטה נלווית של הממשלה, תמ"א 36 אושרה ע"י הממשלה ללא התייחסות ספציפית לנושא כתבי השיפוי. במהלך חודש יולי 2003 קיבלה החברה מכתב ממינהל התכנון הדורש מהחברות הסלולריות ובכללן החברה להפקיד את כתבי השיפוי שאם לא כן בכוונתם להביא את הדבר בהקדם האפשרי בפני המועצה הארצית לשם התליית התוכנית. החברה מגבשת את עמדתה בעניין. על פי חוות דעת יועציה המקצועיים של החברה, מתן שיפוי כנדרש עלול להשפיע לרעה על התוצאות העסקיות של החברה. כמו כן, קבלת החלטה על התליית תוכנית המתאר הארצית צפויה להערים קשיים מרובים על הליכי הרישוי להקמת אתרים חדשים ולרישוי אתרים ללא היתרי בניה. יציין, כי במספר עררים בהם הועלתה כלפי החברות הסלולריות דרישה כללית לחתימה על כתבי שיפוי כאמור, נדחתה דרישה זו בוועדת הערר המחוזית במחוז ת"א. בשלב זה, לא ניתן להעריך את ההשפעה הכספית הכוללת על התוצאות העסקיות של החברה בגין האמור לעיל. לפיכך לא נכללה כל הפרשה בגין האמור לעיל בדוחות הכספיים.

14. א. במסגרת ההליכים לקבלת היתרי בניה להצבת מתקני תקשורת לאחר אישורה של תמ"א 36 א' קיבלה החברה דרישות רבות לתשלום היטל השבחה כתנאי למתן היתר. החברה פעלה ופועלת בהתאם להוראות הדין ונוקטת בהליכים משפטיים כדי להתמודד עם דרישות אלו. החברה טוענת, בין היתר, כי בהתאם להוראות חוק התכנון והבניה, התשכ"ה – 1965, אין באישור תכנית מיתאר ארצית כדי להקים חבות בהיטל השבחה. בשלב זה אין החברה יכולה להעריך את ההשפעה הכוללת של האמור לעיל, על תוצאותיה העסקיות.

ב. בחודש יולי 2001, הוגשה לבית משפט השלום תובענה אזרחית על ידי הועדה המקומית לתכנון ובניה מטה אשר, נגד חברות סלולריות ובכללן החברה בקשר עם קיומה של חבות נטענת בהיטל השבחה בגין מתקני תקשורת סלולרית המוקמים בהתאם להוראות תקנות תכנון ובניה מסוימות. בתחילת שנת 2002 התובענה הופסקה ובחודש אפריל 2002 הוגשה בקשה לחידוש התובענה. הבקשה נדחתה, אולם ניתן להגיש תובענה זו מחדש. להערכת הנהלת החברה, בהסתמך על דעת יועציה המשפטיים, הקמת מתקן בהתאם לתקנות כאמור אינה מקימה כל חבות בהיטל השבחה, ולפיכך לא נכללה כל הפרשה בדוחות הכספיים בגין כל האמור לעיל.

א. התחייבויות תלויות (המשך):

15. א. בחודש יוני 2001 נתגלעה מחלוקת בין החברה לבין משרד התקשורת בעקבות תיקון תקנות הבזק (תמלוגים) התשס"א-2001 וההשלכות של התיקון על שיעור התמלוגים שעל החברה לשלם. בעניין מחלוקת זו עתרה החברה לבג"צ.
- בחודש מאי 2003, במסגרת דיון שהתקיים בעתירה, הודיעה החברה לבית המשפט על משיכת העתירה שהגישה. מאחר שלחברה הפרשה מלאה בגין הסכום במחלוקת, אין למשיכת העתירה כל השפעה על תוצאותיה הכספיות.
- ב. בחודש יולי 2003, התקבל מכתב ממשרד התקשורת בעניין המחלוקת בין החברה לבין משרד התקשורת בנוגע לפרשנות המונח "שירותי בזק" בתקנות הבזק (תמלוגים) ובו הודעה כי מטעמים שונים, אין החברה חייבת בתמלוגים בגין הכנסותיה משירותי אחריות, ביטוח ותיקונים.
16. בחודש אוגוסט 2002, החליטה החברה לתת כתב פטור מאחריות ושיפוי לנושאי המשרה, בעבר, בהווה ובעתיד, של החברה או של תאגיד אחר שהחברה מחזיקה באמצעי שליטה בו. במסגרת זו, התחייבה החברה, בכפוף לדיון, לפטור מראש את נושאי המשרה מכל אחריות בשל כל נזק שייגרם לה עקב הפרת חובת הזירות שלהם כלפיה, בפעולתם בתוקף תפקידם כנושאי משרה כאמור. כמו כן, התחייבה החברה לשפות מראש את נושאי המשרה בשל כל חבות או הוצאה שתוטל עליהם, כמפורט בכתב השיפוי. ההתחייבות לשיפוי מוגבלת לסוגי האירועים ולסכומים כמפורט בכתב השיפוי. סכום השיפוי המרבי, אותו התחייבה החברה להעמיד לכל נושאי המשרה במצטבר, לא יעלה על סך כל תגמולי הביטוח שיתקבלו מחברת ביטוח בגין סוגי האירועים המפורטים בכתב השיפוי בתוספת סכום השווה ל- 30% מההון העצמי של החברה לפי דוחותיה הכספיים ליום 31 בדצמבר, 2001, כשהוא מותאם לעלייה במדד המחירים לצרכן.
17. בחודש אוקטובר 2002, התקבלה דרישה ממשרד התקשורת לתשלום אגרה בגין תדרי GSM. על פי הדרישה על החברה לשלם שיעור מלא של האגרה, שכן המועד הקובע לצורך קביעת שיעור האגרה הוא מועד קבלת רשיון הרט"ן המקורי של סלקום. לדעת הנהלת החברה ויועציה המשפטיים, מועד הקצאת התדר והרשיון לעשות שימוש בתדר (המאוחר מבין השניים) הוא המועד הקובע לעניין אגרות תדרים ולא מועד קבלת רשיון הרט"ן המקורי ולכן על החברה לשלם מחיר מופחת של אגרות תדרי ה-GSM בשנים 2002-2005. משרד התקשורת העביר לחברה מכתב ובו דרישה מהחברה לשלם את השיעור המלא. בתגובה העבירה החברה למשרד התקשורת חוות דעת משפטית התומכת בעמדת החברה. בחודש אוקטובר 2003, התקבל מכתב ממשרד התקשורת ובו דרישה לשלם את הסכומים שטרם שולמו, ולא, יחלט המשרד לחברה את הערבות שניתנה לו עם קבלת הרשיון. כמו כן הודיע משרד התקשורת על כוונתו לתקן את התקנות באופן שתואם את עמדותיו. יחד עם זאת, התיר מנכ"ל המשרד לחברה להגיש ערר על ההחלטה בפני שר התקשורת והערר הוגש בחודש דצמבר 2003. בחודש פברואר 2004, לאחר תאריך המאזן, נשמע הערר בפני שר התקשורת. השר טרם פרסם את החלטתו בערר. כמו כן, מחלוקת דומה קיימת גם בנושא תדרי ה-UMTS אשר בגינם הגיעה דרישת תשלום ממשרד התקשורת בחודש דצמבר 2003. לדעת הנהלת החברה ויועציה המשפטיים במקרה האמור על החברה לשלם מחיר מופחת של אגרות תדרי ה-UMTS בשנים 2003 – 2006. הנהלת החברה סבורה, על פי חוות דעת יועציה המשפטיים, שהשיטה הנקוטה על ידה היא השיטה החוקית ולפיכך, לא נכללה כל הפרשה בדוחות הכספיים, בגין הסכום במחלוקת העומד על סך של כ- 24 מיליון ש"ח, נכון לתאריך המאזן.

א. התחייבויות תלויות (המשך):

18. בחודש אפריל 2003, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה ונגד פלאפון ופרטנר. לטענת התובעים לכל אחת מהחברות יש מעמד מונופוליסטי בשער הכניסה של הודעות SMS לרשת הסלולרית שהיא מפעילה. עוד טוענים התובעים, כי החברות ניצלו את מעמדן המונופוליסטי וקבעו תעריף אחיד בלתי הוגן לקישור גומלין במשלוח הודעות SMS באמצעות מערכת הסכמים שכרתו ביניהן. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית הסכום הנתבע מכל הנתבעות ביחד הינו כ-90 מליון ש"ח (נכון למועד הגשתה), מבלי לייחד את הסכום הנתבע מהחברה. בשלב זה אין באפשרות הנהלת החברה ויועציה המשפטיים להעריך את ההשפעות האפשריות של התביעה ותוצאותיה על החברה משום שהיקפה ותוכנה כתביעה ייצוגית, יקבע רק אם וכאשר בית המשפט יחליט בדבר אישור התביעה כתביעה ייצוגית, יקבע את היקף קבוצת התובעים המיוצגים ויגדיר אילו עילות וסעדים יידונו במסגרת התביעה הייצוגית. לפיכך, לא נכללה כל הפרשה בגין הנ"ל בדוחות הכספיים.
19. בחודש אוגוסט 2003, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה, על ידי אחד ממנוייה, בה נטען נגד שיטת עיגול הסכומים של תעריפי השיחות של סלקום, שיטת ההצמדה למדד של תעריפי השיחות של סלקום וכן נטען כי תעריף מסוים שאושר על ידי משרד התקשורת בשנת 1996 אושר שלא כדין. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית הסכום הנתבע הוא 150 מליון ש"ח (נכון למועד הגשתה). בשלב זה אין באפשרות הנהלת החברה ויועציה המשפטיים להעריך את ההשפעות האפשריות של התביעה ותוצאותיה על החברה משום שהיקפה ותוכנה כתביעה ייצוגית, יקבע רק אם וכאשר בית המשפט יחליט בדבר אישור התביעה כתביעה ייצוגית, יקבע את היקף קבוצת התובעים המיוצגים ויגדיר אילו עילות וסעדים יידונו במסגרת התביעה הייצוגית. לפיכך, לא נכללה כל הפרשה בגין הנ"ל בדוחות הכספיים.
20. בחודש ינואר 2004, לאחר תאריך המאזן, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה, על ידי שניים ממנוייה, בקשר עם פרסומי מבצע שיווק "יום הולדת" של החברה שלטענת התובע היו מטעים. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית הסכום הנתבע הוא כ-40 מליון ש"ח (נכון למועד הגשתה). בשלב זה אין באפשרות הנהלת החברה ויועציה המשפטיים להעריך את ההשפעות האפשריות של התביעה ותוצאותיה על החברה משום שהיקפה ותוכנה כתביעה ייצוגית, יקבע רק אם וכאשר בית המשפט יחליט בדבר אישור התביעה כתביעה ייצוגית, יקבע את היקף קבוצת התובעים המיוצגים ויגדיר אילו עילות וסעדים יידונו במסגרת התביעה הייצוגית. לפיכך, לא נכללה כל הפרשה בגין הנ"ל בדוחות הכספיים.
21. בחודש ינואר 2004, לאחר תאריך המאזן, הוגשה לבית המשפט המחוזי בתל אביב יפו תובענה נגד החברה, על ידי אחד ממנוייה, בקשר לתעריפן של שיחות שבוצעו מהמשיבון הסלולרי באמצעות השירות "בומרינג", במסגרת אחת מתוכניות השיווק אותן הציעה החברה ללקוחותיה. לתובענה צורפה בקשה לאשר אותה כתובענה ייצוגית. אם תובענה זו תוכר כתובענה ייצוגית הסכום הנתבע הוא כ-10 מליון ש"ח (נכון למועד הגשתה). בשלב זה אין באפשרות הנהלת החברה ויועציה המשפטיים להעריך את ההשפעות האפשריות של התביעה ותוצאותיה על החברה משום שהיקפה ותוכנה כתביעה ייצוגית, יקבע רק אם וכאשר בית המשפט יחליט בדבר אישור התביעה כתביעה ייצוגית, יקבע את היקף קבוצת התובעים המיוצגים ויגדיר אילו עילות וסעדים יידונו במסגרת התביעה הייצוגית. לפיכך, לא נכללה כל הפרשה בגין הנ"ל בדוחות הכספיים.
22. בחודש דצמבר 2003 הוגשה נגד סלקום במסגרת הליכי בוררות תביעה על סך 37 מיליון דולר, על ידי חברה ששימשה משכיר מורשה של מכשירי סלקום ללקוחות טוקמן. לתובעת טענות במישור החוזי וכן טענות בדבר הפרת הוראות הדין והרשיון. בשלב זה אין באפשרות הנהלת החברה ויועציה המשפטיים להעריך את ההשפעות האפשריות של התביעה ותוצאותיה, אם בכלל, על החברה. לפיכך לא נכללה הפרשה בגין התביעה הנ"ל בדוחות הכספיים.

א. התחייבויות תלויות (המשך):

23. מכשירים פיננסיים נגזרים

החברה, במסגרת פעילותה השוטפת, חשופה למגוון סיכונים שוק, שהעיקריים שבהם חשיפה לשינויים בשער החליפין של הדולר וסיכון האינפלציה. ניהול הסיכונים והחשיפות מבוצע על ידי החברה באופן שוטף, במטרה להקטין את השפעת התנודתיות בגורמי השוק על תוצאות פעולותיה.

החברה משתמשת בעסקאות במכשירים פיננסיים נגזרים להגנה על תוצאותיה העסקיות ותזרים המזומנים שלה. החברה מתקשרת עם מוסדות בנקאיים בעסקאות הגנה ובהם חוזי אקדמה (עסקאות Forward) ואופציות על מנת להקטין את החשיפה הנובעת מיתרות ספקים, הלוואות לזמן ארוך והתקשרויות לרכישת מלאי וציוד.

החברה אינה מחזיקה מכשירים פיננסיים נגזרים למטרות מסחר. יחד עם זאת, מאחר ועסקאות אלו אינן עונות על כל הקריטריונים שנקבעו לשם סיווגן כעסקאות הגנה בהתאם לכללי החשבונאות המקובלים, לפיכך תוצאות עסקאות אלה נזקפות לסעיף המימון בדוח רווח והפסד על בסיס שוטף.

להלן הרכב העסקאות במכשירים פיננסיים נגזרים ליום:

2002	31 בדצמבר	2003	31 בדצמבר	
שווי הוגן	ערך נקוב	שווי הוגן	ערך נקוב	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
5,105	1,264,779	(2,305)	306,530	חוזי אקדמה על שער חליפין
26,296	1,657,950	12,976	1,007,645	אופציות על שער חליפין
31,401	2,922,729	10,671	1,314,175	

24. לחברה קיימות התחייבויות בקשר לרשיון שהוענק לה בשנת 1994:

1. הקמת רשת תקשורת בהתאם לתנאים ולוחות זמנים שנקבעו.
 2. לא למשכן נכס מהנכסים המשמשים לביצוע הרשיון ללא הסכמה מראש של משרד התקשורת.
 3. תשלום תמלוגים – ראה ביאור 18 א' (15) לעיל.
- החברה בדעה כי הינה עומדת בכל התחייבויותיה הנ"ל.

ב. התקשרויות:

1. בחודש יולי 2001, חתמה החברה על הסכם עם נוקיה ישראל תקשורת בע"מ (להלן "נוקיה") במסגרתו תרכוש החברה מנוקיה רשת סלולארית מתקדמת חדשה בטכנולוגיית GSM/GPRS. ההסכם כולל התקנה, הטמעה ותחזוקה של הרשת למשך 5 שנים וכן אופציה להאריך את ההסכם התחזוקה ב-10 שנים נוספות. בהסכם נכללות אופציות שניתנו לחברה לרכישת טכנולוגיות מתקדמות אחרות.
2. בחודש נובמבר 2001, הקימה החברה חברה בת בבעלות מלאה, סלקום נכסים (2001) בע"מ (להלן "סלקום נכסים"), אשר מטרתה לעסוק בניהול ובהקמת פרויקטי נדל"ן. בסוף חודש נובמבר 2001, זכתה סלקום נכסים במכרז של מנהל מקרקעי ישראל לפיתוח וחקירה של מגרש בן 74.4 דונם באזור התעשייה של העיר מודיעין. הסכם הפיתוח כולל התחייבות של סלקום נכסים להשלים את הבניה במגרש בתום 36 חודשים ממועד אישור העסקה (29 בנובמבר 2001) ואולם סלקום נכסים טרם החלה בתכנון ובבניה. בשלב זה טרם התקבלה החלטה בסלקום נכסים בהתייחס למקרקעין אלו.
- בנוסף, חתמה סלקום נכסים בחודש אוגוסט 2003 על הסכם שכירות עם מבני תעשייה ביחס לנכס מקרקעין בעיר נתניה בו אמורים להיבנות בנייני משרדים וחניונים, בהיקף של כ- 56,000 מ"ר. תקופת השכירות הינה ל-10 שנים כאשר קיימת לסלקום נכסים אופציה להארכתה עד ל-14 שנים ו-11 חודשים נוספים. הפרויקט צפוי להסתיים ברבעון האחרון של שנת 2004.
3. ליום 31 בדצמבר 2003 לחברה התחייבות לרכישת ציוד לרשת התקשורת וציוד טלפון סלולרי בסך הנאמד בכ- 164 מליון ש"ח.
4. הסכמי שכירות עיקריים:
 1. משרדים ומחסנים - הסכמי שכירות לתקופה של עד 25 שנה
 2. תחנות מיתוג - הסכמים לשכירת 9 תחנות לתקופה של עד 13 שנה.
 3. אתרי תא - הסכמים לשכירת 1,750 אתרי תא לתקופה של עד 12 שנים.
 4. מרכזי שירות, חנויות קמעונאיות ודוכנים - הסכמים לשכירות של 19 מרכזי שירות והתקנות, 6 חנויות ו 7 דוכנים לתקופה של עד 10 שנים.

דמי השכירות השנתיים החזויים (מחושבים לפי דמי השכירות בתוקף ל-31.12.03) הינם כדלקמן:

<u>אלפי ש"ח</u>	
165,499	2004
149,089	2005
134,724	2006
122,906	2007
549,639	2008 ולאחריה
<u>1,121,857</u>	

ג. שעבודים וערבויות:

1. התחייבויות מובטחות בשעבוד:

31 בדצמבר 2003	
אלפי ש"ח	
800,128	הלוואות לזמן ארוך
1,081,175	הלוואות לזמן קצר
<u>1,881,303</u>	

כדי לספק בטחונות להלוואות האמורות שיעבדה החברה את כל נכסיה.

2. ערבויות בנקאיות שניתנו על ידי החברה:

- א. לממשלת ישראל (להבטחת ביצוע תנאי הרשיון) - 20 מיליון דולר ארה"ב.
- ב. לספקים ומוסדות ממשלתיים - 12,841 אלף ש"ח.
- ג. להבטחת מתן שירותים וציוד טלפון סולרי - 2,395 אלף ש"ח.

באור 19 – הכנסות ממכירות ושירותים

ההרכב:

חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
286,384*	502,294*	498,428	286,384*	502,294*	498,428	מכירות של ציוד טלפון סולרי **
4,593,579*	4,527,516*	4,699,616	4,673,384*	4,632,488*	4,763,245	שירותים
<u>4,879,963</u>	<u>5,029,810</u>	<u>5,198,044</u>	<u>4,959,768</u>	<u>5,134,782</u>	<u>5,261,673</u>	

* סווג מחדש

** כולל מכירות בתשלומים בסך של 376,860 אלפי ש"ח (2002 – 326,795 אלפי ש"ח, 2001 – 170,578 אלפי ש"ח).

						ההרכב:
חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
						א. לפי מקורות ההכנסה
704,327 *	848,654 *	709,645	704,327 *	848,654 *	709,645	עלות ציוד טלפון סלולרי
2,191,548	2,249,475	2,364,548	2,188,378	2,261,992	2,365,709	עלות מתן השירותים
<u>2,895,875</u>	<u>3,098,129</u>	<u>3,074,193</u>	<u>2,892,705</u>	<u>3,110,646</u>	<u>3,075,354</u>	
						ב. לפי מרכיביה
784,358 *	889,994 *	639,964	784,358 *	889,994 *	639,964	קניות של ציוד טלפון סלולרי
208,325	214,909	230,253	208,325	214,909	230,253	דמי שכירות והוצאות נלוות
34,078	(28,863)	73,101	34,078	(28,863)	73,101	(עליה) ירידה במלאי
(2,526)	(10,251)	(4,402)	(2,526)	(10,251)	(4,402)	הפרשה לירידת ערך
192,288	129,404	175,456	192,288	129,404	175,456	משכורות והוצאות נלוות אחרות
735,025	893,620	882,160	735,025	893,620	882,160	תשלומים למפעילי רשתות תקשורת אחרים
652,344	724,882	741,502	652,344	724,882	741,502	פחת
(9,930)	(2,226)	982	(9,930)	(2,226)	982	הפחתות ומחיקות טלפונים להחלפה, טלפונים משומשים, אביזרים וחלקי חילוף
159,284	128,238	137,392	159,284	128,238	137,392	תמלוגים
142,629	158,422	197,785	139,459	170,939	198,946	אחרות
<u>2,895,875</u>	<u>3,098,129</u>	<u>3,074,193</u>	<u>2,892,705</u>	<u>3,110,646</u>	<u>3,075,354</u>	

* סווג מחדש

ההרכב:

לשנה שנסתיימה ביום 31 בדצמבר 2001	לשנה שנסתיימה ביום 31 בדצמבר 2002	לשנה שנסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
236,132	257,036	251,458	משכורות והוצאות נלוות
104,328 *	107,250 *	109,063	עמלות
100,096	128,372	116,306	פרסום ויחסי ציבור
11,704	12,254	12,964	פחת
122,018	146,223	122,983	אחרות
<u>574,278</u>	<u>651,135</u>	<u>612,774</u>	

באור 22 - הוצאות הנהלה וכלליות

ההרכב:

חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
160,380	135,474	175,807	160,380	135,474	175,807	משכורות והוצאות נלוות
167,824	219,870	244,614	167,824	219,870	244,614	פחת והפחתות
88,400	81,447	76,352	88,400	81,447	76,352	דמי שכירות ואחזקה
59,964	83,805	76,456	59,964	83,805	76,456	שירותים מקצועיים
30,736	50,643	64,343	30,736	50,643	64,343	חובות אבודים ומסופקים
117,776	112,847	43,172	114,131	106,614	44,746	אחרות
<u>625,080</u>	<u>684,086</u>	<u>680,744</u>	<u>621,435</u>	<u>3677,85</u>	<u>682,318</u>	

* סווג מחדש

ההרכב:

חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
(114,809)	(82,241)	(160,043)	(114,809)	(82,241)	(160,043)	בגין הלוואות לזמן ארוך
(33,939)	(18,517)	(42,001)	(33,939)	(18,517)	(42,001)	בגין הלוואות לזמן קצר
100,074	92,835	(84,389)	100,074	92,835	(84,389)	בגין עסקאות במכשירים פיננסיים נגזרים
36,510	36,122	49,688	36,510	36,122	49,688	בגין עסקאות מכירה בתשלומים
(21,237)	(42,354)	36,364	(2,606)	(33,060)	20,663	בגין פריטים אחרים
(33,401)	(14,155)	(200,381)	(14,770)	(4,861)	(216,082)	

באור 24 - הכנסות (הוצאות) אחרות, נטו

ההרכב:

חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
12,707	41	7,216	5,440	(5,537)	7,216	רווח (הפסד) הון
805	1,031	(392)	805	1,031	*(6,332)	הכנסות (הוצאות) אחרות
13,512	1,072	6,824	6,245	(4,506)	884	

* כולל הפרשה לירידת ערך קרקע בסך 5,940 אלפי ש"ח.

באור 25 - מיסים על ההכנסה

א. החברה נישומה לצרכי מס על בסיס דוחות לא מאוחדים. המס הישראלי מחושב על בסיס התוצאות הכספיות במטבע המקומי כפי שנקבעו לצרכים סטטוריים. ההבדלים העיקריים בין התוצאות הכספיות לצרכי מס לבין התוצאות הכספיות בדוח הכספי הם: הפרשים בין הרווח המותאם על פי הדוחות הכספיים לבין הרווח למס הכנסה, תוצאות של חברת בת זרה והפרשים קבועים.

ב. לחברה שומות מס סופיות עד שנת המס 1998. בינואר 2004 קיבלה החברה שומה המתייחסת לשנת המס 1999 מרשויות המס. בהתאם לשומה נדרשת החברה לשלם לשלטונות המס סך של 159 מיליוני ש"ח הכולל ריבית והפרשי הצמדה, וזאת מעבר לתשלומי המס ששילמה החברה בגין שנת המס האמורה. לטענת שלטונות המס, החברה תבעה בניכוי הוצאות שוטפות, שיש לנכותן על פני תקופה ארוכה יותר ביחס למכירת ציוד קצה ולפחת על רכוש קבוע. השומה עוסקת בהפרשי עיתוי בלבד, השלכותיה האפשריות הן לפיכך על הוצאות המימון והחשיפה המקסימלית בגינה נאמדת לכדי 15 מיליון ש"ח. בכוננת החברה להשיג על השומה האמורה. להערכת מנהלי החברה ויועציה המקצועיים, לחברה נימוקים טובים לדחיית השומה ולפיכך לא בוצעה הפרשה בקשר עם השומה האמורה. בשנת 2002, החברה הגיעה להסדר שומות עם רשויות המס בישראל בסוגיית הניהול והשליטה בחברות מאוחדות, בנוגע לרווחים שנצברו עד 31.12.02. החברה רשמה בשל ההסדר האמור בשנת 2002 הוצאות מס בגין שנים קודמות בסך 33,506 אלפי ש"ח ואינה צפויה לחבות מס נוספת בשל דיבידנדים שיחולקו מחברות מאוחדות מעודפים שנצברו עד ליום 31.12.02.

ג. החברה נישומה על פי חוק מס הכנסה (תיאומים בשל אינפלציה), התשמ"ה-1985 (להלן-החוק). החוק הנהיג מדידה של התוצאות לצורכי מס על בסיס ריאלי על מנת למנוע מיסוי של רווחים אינפלציוניים. יחד עם זאת, תיאום הרווח הנומינלי לפי חוקי המס אינו זהה תמיד להתאמה האינפלציונית לפי גילויי הדעת של לשכת רואי חשבון בישראל וכתוצאה מכך נוצרים הפרשים בין הרווח המתואם על פי הדוחות הכספיים לבין הרווח המתואם לצורכי מס הכנסה. בפברואר 2004, העביר שר האוצר לאישורה של ועדת הכספים צו בדבר הקפאתו של החוק ביחס לשנת המס 2003. אישור צו זה על ידי ועדת הכספים יקטין את הוצאות המס של החברה בכ-6,000 אלפי ש"ח.

ד. ביאור המס התיאורטי:

התאמה בין המס התיאורטי על פי הרווח המותאם לפני מס לבין הוצאות מס שנכללו בספרים:

חברה			מאוחד			
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
764,841	583,377	636,776	862,825	685,781	676,029	רווח לפני מס לפי דוח רווח והפסד
275,343	210,016	229,239	310,617	246,881	243,370	מס מחושב לפי שיעור מס עיקרי-36% תוספת (חסכון) בחבות המס בגין:
1,057	2,475	(2,090)	1,057	2,475	(2,090)	שחיקת מקדמות
4,492	(930)	4,985	4,492	(930)	7,561	הוצאות לא מוכרות והכנסות פטורות, נטו
1,459	-	-	1,459	33,506	-	מיסים בגין שנים קודמות
4,900	-	(939)	(29,035)	(17,504)	(939)	הכנסות חברה זרה החייבות בשיעורי מס שונים הפסדי הון (ניצול הפסדי הון) שלא נרשמו בגינם מיסים נדחים
(1,248)	(8,812)	852	84	1,245	(281)	אחרים
285,620	203,198	229,094	288,291	266,122	244,668	

ה. מיסים נדחים (מאוחד וחברה)

ליום 31 בדצמבר 2002	ליום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	
9,448	7,521	הפרשות בגין זכויות לעובדים
62,315	54,423	הפרשה לחובות מסופקים
(118,352)	(161,834)	הפרשים בין ערך הנכסים הקבועים וההוצאות הנדחות בדוחות הכספיים המותאמים לבין ערכם לצרכי מס
(46,589)	(99,890)	

המיסים הנדחים נכללים במאזן כדלקמן:

ליום 31 בדצמבר 2002	ליום 31 בדצמבר 2003
אלפי ש"ח	אלפי ש"ח
18,664	-
-	(2,877)
<u>(65,253)</u>	<u>(97,013)</u>
<u>(46,589)</u>	<u>(99,890)</u>

חייבים ויתרות חובה
זכאים ויתרות זכות
התחייבויות לזמן ארוך

ו. מיסים על הכנסה:

חברה			מאוחד		
לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003	לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח
301,435	216,171	175,793	304,106	245,589	191,367
1,459	-	-	1,459	33,506	-
<u>(17,274)</u>	<u>(12,973)</u>	<u>53,301</u>	<u>(17,274)</u>	<u>(12,973)</u>	<u>53,301</u>
<u>285,620</u>	<u>203,198</u>	<u>229,094</u>	<u>288,291</u>	<u>266,122</u>	<u>244,668</u>

מיסים שוטפים
מיסים בגין שנים קודמות
מיסים נדחים

א. יתרות מאזניות:

ליום 31 בדצמבר 2002	ליום 31 בדצמבר 2003
אלפי ש"ח	אלפי ש"ח
53	-
121	-

מזומנים ושווי מזומנים
בשקלים חדשים
בדולרים של ארה"ב

ב. החברה התקשרה בעסקות במכשירים פיננסיים נגזרים עם צדדים קשורים כלהלן:

סך הכל		אופציה על שער חליפין		חוזי אקדמה על שער חליפין		מועדי פרעון: 2003
31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003	31 בדצמבר 2002	31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
1,287,400	-	883,054	-	404,346	-	

ג. עסקאות עם צדדים קשורים ובעלי עניין מתבצעות במהלך העסקים הרגיל בתנאים מסחריים רגילים.

לשנה שהסתיימה ביום 31 בדצמבר 2001	לשנה שהסתיימה ביום 31 בדצמבר 2002	לשנה שהסתיימה ביום 31 בדצמבר 2003
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח

1. הכנסות:

מכירות של ציוד טלפון סלולרי

46	9	-
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2. הוצאות:

משכורות והוצאות נלוות לצדדים
קשורים (1 מקבל שכר)
יעוץ מקצועי ואחרות
הוצאות מימון, נטו

5,946	4,277	2,445
9,563	3,090	1,069
10,918	-	-

החברה מנהלת עסקאות במהלך העסקים הרגיל עם תאגידים שהם בעלי עניין. בתוקף סמכותה לפי תקנה 64 לתקנות ניירות ערך (עריכת דוחות כספיים שנתיים) התשנ"ג 1994, פטרה רשות ניירות ערך את החברה מתיאור עסקאות המתבצעות עם בעלי עניין בחברה (שהינם קבוצת אי.די.בי וחברות מוחזקות שהינן בעלי עניין גם מכוח החזקה הדדית) והחברות המוחזקות על ידם.

		מאזנים	א.
31 בדצמבר 2002	31 בדצמבר 2003		
אלפי ש"ח	אלפי ש"ח		
		רכוש שוטף	
22,315 *	408,906	מזומנים ושווי מזומנים	
976,596	1,040,478	לקוחות	
243,827	189,038	חייבים ויתרות חובה	
185,727	114,415	מלאי	
1,428,465	1,752,837		
277,647	333,422	חייבים ויתרות חובה לזמן ארוך	
387,768	94,802	השקעה בחברות מאוחדות	
3,429,993	3,145,666	רכוש קבוע, נטו	
396,956	387,131	רכוש אחר והוצאות נדחות, נטו	
5,920,829	5,713,858		
		התחייבויות שוטפות	
614,299	1,123,175	אשראי לזמן קצר מתאגידים בנקאיים	
963,733	821,935	ספקים ונותני שירותים	
224,632*	286,127	זכאים ויתרות זכות	
1,802,664	2,231,237		
		התחייבויות לזמן ארוך	
2,025,176	882,128	הלוואות לזמן ארוך מתאגידים בנקאיים	
3,503	9,522	התחייבות בשל סיום יחסי עובד מעביד, נטו	
18,038	63,258	מיסים נדחים	
-	1,287	זכאים ויתרות זכות לזמן ארוך	
95,779	65,412	ספקים ונותני שירותים לזמן ארוך	
2,142,496	1,021,607		
1,975,669	2,461,014	הון עצמי	
5,920,829	5,713,858		

* סווג מחדש

באור 27 - תמצית דוחות כספיים נומינליים של החברה (המשך)

ב. דוחות רווח והפסד

לשנה שנסתיימה ביום 31 בדצמבר 2001	לשנה שנסתיימה ביום 31 בדצמבר 2002	לשנה שנסתיימה ביום 31 בדצמבר 2003	
אלפי ש"ח	אלפי ש"ח	אלפי ש"ח	
4,647,733	5,064,672	5,264,629	הכנסות ממכירות ושירותים
2,697,936 *	3,035,239 *	3,053,806	עלות המכירות והשירותים
1,949,797	2,029,433	2,210,823	רווח גולמי
539,928 *	651,396 *	619,080	הוצאות מכירה ושיווק
587,566	685,927	675,289	הוצאות הנהלה וכלליות
822,303	692,110	916,454	רווח מפעולות רגילות
53,028	136,200	180,671	הוצאות מימון, נטו
12,864	1,738	7,796	הכנסות אחרות
782,139	557,648	743,579	רווח לפני מיסים על הכנסה
285,875	170,442	295,790	מיסים על ההכנסה
496,264	387,206	447,789	רווח לאחר מיסים על הכנסה
93,266	53,799	37,556	החלק ברווחי חברות מאוחדות
<u>589,530</u>	<u>441,005</u>	<u>485,345</u>	רווח נקי

* סווג מחדש

באור 27 - תמצית דוחות כספיים נומינליים של החברה (המשך)

ג. דוח על השינויים בהון העצמי

<u>סך הכל</u>	<u>עודפים</u>	<u>הון מניות (1)</u>	
<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	<u>אלפי ש"ח</u>	
945,134	945,123	11	יתרה ליום 1 בינואר 2001
			שינויים בשנת 2001
<u>589,530</u>	<u>589,530</u>	-	רווח נקי
1,534,664	1,534,653	11	יתרה ליום 31 בדצמבר 2001
			שינויים בשנת 2002
<u>441,005</u>	<u>441,005</u>	-	רווח נקי
1,975,669	1,975,658	11	יתרה ליום 31 בדצמבר 2002
			שינויים בשנת 2003
<u>485,345</u>	<u>485,345</u>	-	רווח נקי
<u>2,461,014</u>	<u>2,461,003</u>	<u>11</u>	יתרה ליום 31 בדצמבר 2003
			(1) הון מניות ליום 31 בדצמבר 2003:
	<u>הונפק ונפרע</u>	<u>רשום</u>	
	<u>שקל חדש</u>	<u>שקל חדש</u>	
	11,400	1,000,000	מניות רגילות 0.1 ש"ח ע.ג. כל אחת

**ג'י.וי.טי (הולדינג) אן.וי. וחברות
מאוחדות שלה**

**דוחות כספיים
לשנה שנסתיימה ביום
31 בדצמבר 2003**

תוכן עניינים

עמוד	
2	דוח רואי החשבון המבקרים
3	מאזנים מאוחדים
4	דוחות רווח והפסד מאוחדים
5	דוח על השינויים בגרעון בהון וברווח (הפסד) כולל אחר
6	דוחות מאוחדים על תזרימי המזומנים
7-25	ביאורים לדוחות הכספיים המאוחדים

דוח רואי החשבון המבקרים לבעלי המניות של חברת ג'י.וי.טי (הולדינג) א.נ.וי

ביקרנו את המאזנים המאוחדים המצורפים של ג'י.וי.טי. (הולדינג) א.נ.וי וחברות בנות (להלן: "החברה") לימים 31 בדצמבר 2003 ו- 2002 ואת דוחות רווח והפסד, הדוחות על השינויים בגרעון בהון וברווח וברווח (הפסד) כולל אחר, והדוחות על תזרימי המזומנים לכל אחת מהשנים שהסתיימו באותם תאריכים. דוחות כספיים אלה הינם באחריות הדירקטוריון והנהלה של החברה. אחריותנו היא לחוות דיעה על דוחות כספיים אלה בהתבסס על ביקורתנו.

ערכנו את ביקורתנו בהתאם לתקני ביקורת המקובלים בארצות הברית. על פי תקנים אלה, נדרש מאיתנו לתכנן את הביקורת ולבצעה במטרה להשיג מידה סבירה של ביטחון שאין בדוחות הכספיים הצגה מוטעית מהותית. ביקורת כוללת בדיקה מידגמית של ראיות התומכות בסכומים ובמידע שבדוחות הכספיים. ביקורת כוללת גם בחינה של כללי החשבונאות שישומו ושל האומדנים המשמעותיים שנעשו על ידי הדירקטוריון והנהלה של החברה וכן הערכת נאותות ההצגה בדוחות הכספיים בכללותה. אנו סבורים שביקורתנו מספקת בסיס נאות לחוות דעתנו.

לדעתנו, הדוחות הכספיים הנ"ל משקפים באופן נאות בהתאם לכללי חשבונאות מקובלים בארצות הברית, מכל הבחינות המהותיות, את המצב הכספי של החברה לימים 31 בדצמבר 2003 ו- 2002 ואת תוצאות הפעולות, השינויים בגרעון בהונה העצמי וברווח (הפסד) כולל אחר ותזרימי המזומנים של החברה לתקופות שהסתיימו באותם תאריכים.

הדוחות הכספיים המאוחדים המצורפים נערכו בהנחה כי החברה תוכל להמשיך ולפעול כ"עסק חי" בעתיד. כמתואר בביאור 2 לדוחות הכספיים לחברה הלוואה המירה להון שמועד פרעונה חלף, בנוסף, החברה לא עמדה באמות מידה פיננסיות ותשלומי ריבית. לפיכך, קיים ספק משמעותי בדבר המשך פעילותה כ"עסק חי". בביאור 2 מתוארות תוכניות ההנהלה בנוגע לנושאים אלו. בדוחות הכספיים לא נכללו כל התאמות העשויות לבבוע כתוצאה מאי ודאות זו.

אמסטרדם, 22 במרס, 2004

KPMG רואי חשבון, א.נ.וי.

מאזנים מאוחדים ליום 31 בדצמבר

דולר ארה"ב

2002	2003	באור	
אלפי דולר	אלפי דולר		
נכסים			
			רכוש שוטף:
12,164	16,975	ד'3	מזומנים ושווי מזומנים
22,031	29,260	4	לקוחות
1,526	1,392		מסים לקבל
2,287	1,994		חייבים אחרים והוצאות מראש
<u>38,008</u>	<u>49,621</u>		
8,930	10,802		מסים לקבל לזמן ארוך
<u>350,858</u>	<u>395,348</u>	5	רכוש קבוע, נטו
<u>397,796</u>	<u>455,771</u>		סך הכל נכסים
התחייבויות וגרעון בהון			
			התחייבויות שוטפות
6,232	4,923	6	אשראי מתאידיים בנקאיים
72,365	31,162	10	הלוואות המירות לזמן ארוך
29,864	68,155	12	חלויות שוטפות של התחייבויות לזמן ארוך והתחייבויות לזמן קצר
4,114	8,897	7	חלויות שוטפות של חכירות הוניות לזמן ארוך
7,315	13,764		ספקים
7,930	34,402		ריבית לשלם
656	801	8	הכנסות נדחות
5,729	15,009		הוצאות לשלם
<u>134,205</u>	<u>177,113</u>		סך הכל התחייבויות שוטפות
418,289	368,236	12	התחייבויות לזמן ארוך בניכוי חלויות שוטפות
8,256	4,213	7	התחייבויות בגין חכירות הוניות בניכוי חלויות שוטפות
187,180	236,903	11	אגרות חוב להמרה לבעלי מניות
8,088	9,090	8	הכנסות נדחות
<u>756,018</u>	<u>795,555</u>		סך הכל התחייבויות
		13	גרעון בהון העצמי ורווח (הפסד) כולל אחר
350	359		הון מניות רגילות 0.01 דולר ארה"ב ערך נקוב
			רשום: 60,000,000 מניות
			מונפק ונפרע: 2003 - 35,888,889 מניות
			(2002 - 35,000,000)
89,122	94,814		פרמיה על מניות
(449,101)	(418,037)		גרעון שנצבר
1,407	(16,920)		רווח (הפסד) כולל אחר
<u>(358,222)</u>	<u>(339,784)</u>		סך הכל גרעון בהון
<u>397,796</u>	<u>455,771</u>		סך הכל התחייבויות וגרעון בהון

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

דוחות רווח והפסד מאוחדים לשנה שנסתיימה ביום 31 בדצמבר

דולר ארה"ב

2002	2003	באור	
אלפי דולר	אלפי דולר		
99,547	126,079		הכנסות ממתן שרותים
(63,040)	(57,586)		עלות מתן השרותים
<u>36,507</u>	<u>68,493</u>		רווח גולמי
			הוצאות תפעוליות
6,543	3,135		טכנולוגיה ומידע
25,543	28,873		הנהלה וכלליות
15,507	17,608		מכירה ושיווק
<u>36,769</u>	<u>44,813</u>		פחת והפחתות
<u>84,362</u>	<u>94,429</u>		סך הכל הוצאות תפעוליות
(47,855)	(25,936)		הפסד תפעולי
-	34,812	10א'	רווח בגין הסדר ליישוב חוב
(4,569)	(3,145)		הפסדי הון והוצאות אחרות
<u>(199,723)</u>	<u>25,401</u>	14	הכנסות (הוצאות) מימון, נטו
(252,147)	31,132		רווח (הפסד) לפני מסים
-	68	15	מסים על הכנסה
<u>(252,147)</u>	<u>31,064</u>		רווח (הפסד) נקי

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

דוח על השינויים בגרעון בהון ורווח (הפסד) כולל אחר

דולר ארה"ב

מספר מניות מונפקות	הון מניות	פרמיה על מניות	גרעון שנצבר	רווח (הפסד) כולל אחר	סך הכל גרעון בהון	
לשנה שנסתיימה ביום 31 בדצמבר 2002						
35,000,000	350	87,934	(196,954)	(16,333)	(125,003)	יתרה ליום 1 בינואר 2002
	-	-	(252,147)	-	(252,147)	הפסד נקי
	-	-	-	17,740	17,740	התאמות הנובעות מהפרשי תרגום
	-	-	-	-	(234,407)	הפסד כולל אחר
	-	1,188	-	-	1,188	הנפקת הון
35,000,000	350	89,122	(449,101)	1,407	(358,222)	יתרה ליום 31 בדצמבר 2002
לשנה שנסתיימה ביום 31 בדצמבר 2003						
	-	-	31,064	-	31,064	רווח נקי
	-	-	-	(18,327)	(18,327)	התאמות הנובעות מהפרשי תרגום
	-	-	-	-	12,737	רווח כולל אחר
	9	5,692	-	-	5,701	הנפקת הון
35,888,889	359	94,814	(418,037)	(16,920)	(339,784)	יתרה ליום 31 בדצמבר 2003

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

דוח תזרים מזומנים מאוחד לשנה שנסתיימה ביום 31 בדצמבר

דולר ארה"ב

2002 אלפי דולר	2003 אלפי דולר	באור
		מזומנים מפעילות שוטפת
(252,147)	31,064	רווח (הפסד) נקי
		התאמות הדרושות כדי להציג את תזרימי המזומנים לפעילות שוטפת:
36,769	44,813	פחת והפחתות
-	(34,812)	רווח בגין הסדר ליישוב חוב
126,324	(101,690)	השפעת שינויים בשער החליפין על התחייבויות והוצאות ריבית שלא במזומן
(15,380)	(140)	ירידה בלקוחות ובהוצאות מראש
(4,047)	12,252	עליה (ירידה) בספקים
11,425	57,523	עליה בריבית לשלם
(4,956)	(762)	ירידה בהתחייבויות שוטפות אחרות
(102,012)	8,248	מזומנים, נטו שנבעו מפעילות (ששימשו לפעילות) שוטפת
		תזרימי מזומנים מפעילות השקעה
(120,426)	(13,640)	רכישת רכוש קבוע וציוד
(120,426)	(13,640)	מזומנים נטו ששימשו לפעילות השקעה
		תזרימי מזומנים מפעילות מימון
(6,938)	(860)	פעילות מימון לזמן קצר, נטו
-	(32,169)	פירעון הלוואות
1,838	199	קבלת הלוואות וחכירות הוניות
62,260	36,700	הנפקת הלוואות המירות לזמן ארוך
107,607	-	הלוואות מספקים לזמן ארוך
1,002	-	הנפקת הון
165,769	3,870	מזומנים, נטו שנבעו מפעילות מימון
23,483	6,333	התאמות הנובעות מהפרשי תרגום
(33,186)	4,811	עליה (ירידה) במזומנים ושווי מזומנים
45,350	12,164	יתרת מזומנים ושווי מזומנים לתחילת השנה
12,164	16,975	יתרת מזומנים ושווי מזומנים לסוף השנה
		פעילות מימון שלא במזומן במהלך שנת הדוח
186	92	זקיפת הוצאות ריבית לפרמיה על מניות
-	5,609	מימוש אופציית רכש באמצעות הנפקת הון ופרמיה

9א'

הבאורים לדוחות הכספיים מהווים חלק בלתי נפרד מהם.

באור 1 - תאור הפעילות העסקית

ג'י.וי.טי (הולדינג) א.ן.וי. (להלן - "ג'י.וי.טי" או "החברה") היא חברה הרשומה באנטילים ההולנדיים שהתאגדה בשנת 1994 והתחילה את פעילותה במרס 2000. החברה עוסקת בתכנון, פריסה ניהול והפעלה של רשתות טלקומוניקציה ותשתיות באמצעות חברות בנות כפי שמתואר להלן.

לחברה חברה בת בבעלות מלאה, גלובל וילאג' טלקום (הולנד) ב.וי., אמסטרדם (להלן - "ג'י.וי.טי הולנד") שנרכשה ב- 8 במרס 2000.

ג'י.וי.טי הולנד מחזיקה בבעלות מלאה בחברת גלובל וילאג' טלקום מנג'מנט, דלוויר בארה"ב, (להלן - "ג'י.וי.טי מנג'מנט"), שנרכשה ב- 10 במרס 2000. ג'י.וי.טי, מנג'מנט, אשר החלה בפעילותה ב- 15 באפריל 2000, מספקת שירותי תמיכה וניהול לחברה ולחברות הבנות המוחזקות באופן ישיר ועקיף ("הקבוצה").

ב- 20 בספטמבר 1999 הקימה ג'י.וי.טי ברזיל הולדינג, חברה בת בבעלות מלאה של ג'י.וי.טי. הולנד, חברה בת בבעלות מלאה, גלובל וילג' טלקום אל טי די איי (להלן - "ג'י.וי.טי ברזיל"), דרכה מתבצעת הפעילות העסקית. לג'י.וי.טי ברזיל הוענק רשיון ראי לחברת ברזיל טלקום אס.איי על ידי ממשלת ברזיל בשנת 2000. כתוצאה מכך הוענקה לג'י.וי.טי ברזיל הזכות לספק כספקית שניה שירותי קול, נתונים ושירותי אינטרנט באזור 2 במסגרת של תוכנית ההפרטה בשוק הטלקום בברזיל. האזור שנכלל בזכיון כולל אוכלוסייה של כ- 40 מיליון נפש בקירוב ומקיף תשע מדינות, ואת ברזיליה, בירתה של ברזיל, כאשר סה"כ שטח הזכיון מהווה כ-30% משטחה של ברזיל. הזכיון הוענק כחלק מתוכנית ההפרטה של ממשלת ברזיל. ג'י.וי.טי ברזיל פועלת ב- 55 ערים לאחר שלחברה אושר לספק שירותים נוספים באזור 2 ממוחזר לו בפברואר 2003 ע"י אנטאל, סוכנות מפקחת עצמאית בתחום התקשורת.

מאז תחילת פעילותה בדצמבר 2000, הפכה ג'י.וי.טי ברזיל למפעיל תקשורת מוכר בברזיל. רשת התקשורת של ג'י.וי.טי ברזיל היא בעלת כיסוי נרחב עד לבית הלקוח באזור 2, עם קיבולת גישה של כמיליון קווי תקשורת ו- 20,000 בניינים מקושרים. רשת הנחושט וטבעות הסיבים האופטיים התוך עירוניות הכוללות של ג'י.וי.טי ברזיל הינן באורך של כ- 8,500 ק"מ - מה שמאפשר לג'י.וי.טי ברזיל להשיג מסה קריטית של כחצי מליון קוים פעילים.

ב- 1 באוגוסט 2002 הקימה החברה את פופ אינטרנט אל.טי.די.אי (להלן - "פופ") המהווה מיזם להספקת שירותי אינטרנט. פופ מוחזקת בשיעור של 15% על ידי ג'י.וי.טי ברזיל ועל ידי החברה 85% נוספים.

במהלך המחצית השנייה של שנת 2003 הקימה ורכשה החברה שלוש חברות לא פעילות כחלק מתוכנית עתידית. שלוש החברות כוללות את ג'י.וי.טי. קפיטל א.ן.וי., אינוב. א.ן.וי. ווסרוק הולדינג ב.וי., חברות באנטילים ההולנדיים אשר עדיין לא החלו בפעילות נכון ל- 31 בדצמבר 2003.

באור 2 - עסק חי

החברה לא עמדה באמות מידה פיננסיות בקשר לאשראי ספקים כמתואר בבאור 12. כתוצאה מכך החברה והספקים נכנסו בשנת 2003 לתהליך משא ומתן בדבר שינוי תנאי המימון. במהלך המשא ומתן הפסיקה החברה את תשלומי הריבית לספקים המממנים ולאיי סי.איי בגין ההלוואה ההמירה. ההלוואה ההמירה הונפקה ל- אי.סי.אי תמורת 27,000 אלפי דולר כמתואר בבאור 10' ועמדה לפירעון ב- 30 בנובמבר 2003. נכון למועד דוחות כספיים אלה אין בידי החברה מספיק מקורות על מנת לפרוע את ההלוואה הנ"ל.

בינואר 2004 חתמו החברה והספקים על מסמך עקרונות ביחס לכל מימון הספקים וביחס להלוואה של אי.סי.אי (ראה באור 18). השפעתו של יישום ההסכם המתואר בבאור 18 לכשייחתם תהיה סיווגם של 121,000 אלפי דולר מהתחייבויות לזמן קצר להתחייבויות לזמן ארוך. בהתאם לאמור לעיל ועד לחתימת הסכם סופי עם הספקים קיים ספק משמעותי בדבר יכולתה של ג'י.וי.טי (הולדינג) א.ן.וי. להמשיך ולפעול כעסק חי. בדוחות הכספיים הנ"ל לא נכללו כל התאמות לגבי ערך הנכסים וההתחייבויות וסיווגם, שתהיינה דרושות אם ג'י.וי.טי (הולדינג) א.ן.וי. לא תוכל להמשיך ולפעול כ"עסק חי".

באור 3 - כללי דיווח ומדיניות חשבונאית

א. כללי

הדוחות הכספיים ליום 31 בדצמבר 2003 ולשנה שנסתיימה באותו תאריך (להלן - דוחות כספיים) ערוכים בהתאם לעקרונות חשבונאים מקובלים בארצות הברית.

העקרונות החשבונאים ששימשו להכנת הדוחות הכספיים עקביים לעקרונות החשבונאים ששימשו בהכנת הדוחות הכספיים של החברות הבנות המוחזקות באופן ישיר ועקיף.

ב. איחוד הדוחות הכספיים

הדוחות המאוחדים כוללים את הדוחות הכספיים של החברה ושל החברות הבנות המוחזקות באופן ישיר או עקיף על ידי ג'.י.טי הולנד, ג'.י.טי מנג'מנט, ג'.י.טי ברזיל הולדינג, ג'.י.טי ברזיל, פופ ושלוש החברות הלא פעילות - ג'.י.טי קפיטל אן.י., אינוב אן.י. ו- ווסרוק הולדינג בי.וי.

יתרות ועסקאות הדדיות מהותיות בין החברות שאוחדו בוטלו.

ג. תרגום של מטבע חוץ

נכסים והתחייבויות של החברה ושל חברות בנות המוחזקות באופן ישיר ועקיף המדווחים במטבעות זרים מתורגמים לדולר של ארה"ב המהווה המטבע הפונקציונלי של החברה, בהתאם לשער החליפין היציג לתאריך המאזן. עסקאות שבוצעו במהלך השנה מתורגמות לדולר של ארה"ב בהתאם לשער היציג במועד ביצוע העסקה. רווחים או הפסדים הנוצרים כתוצאה מתרגום עסקאות נזקפים לדוח רווח והפסד.

מטבע הפונקציונלי של ג'.י.טי ברזיל הולדינג, ג'.י.טי ברזיל ופופ הוא ריאל ברזילאי. כל הרווחים או הפסדים הנוצרים כתוצאה מתרגום עסקאות במטבע השונה מזה של ג'.י.טי ברזיל הולדינג, ג'.י.טי ברזיל ופופ מוצגים בדוח רווח והפסד כרווחים או הפסדים מעסקאות במטבע חוץ. הנכסים וההתחייבויות של ג'.י.טי ברזיל הולדינג, ג'.י.טי ברזיל ופופ תורגמו מהמטבע הפונקציונלי לדולר ארה"ב בהתאם לנדרש בתקן חשבונאות מספר 52 "תרגום מטבעות זרים", תוך שימוש בשער חליפין של R\$2.89 ו-R\$3.53 ל-1.00 דולר של ארה"ב ב- 31 בדצמבר 2003 וב- 31 בדצמבר 2002 בהתאמה. הכנסות והוצאות תורגמו בהתאם לשער החליפין במועד ביצוע העסקה בפועל, למעט מקרים בהם הדבר לא מעשי, אשר בהם נעשה התרגום בהתאם לשער החליפין החודשי הממוצע בתקופת ביצוע העסקה. רווחים או הפסדים מהפרשי תרגום מטבעיים מוצגים בסך הכל גרעון בהון כרווח (הפסד) כולל אחר.

ד. מזומנים ושווי מזומנים

שווי מזומנים בסך של 16,975 אלפי דולר ו-12,164 אלפי דולר ב-31 בדצמבר 2003 וב-31 בדצמבר 2002 בהתאמה, כוללים פיקדונות יומיים מתחדשים ופיקדונות, שהתקופה עד למועד פדיונם, בעת ההשקעה בהם, לא עלתה על שלושה חודשים. לצורך דוחות על תזרימי מזומנים מאוחדים, החברה מתייחסת לכל המכשירים הפיננסיים הנזילים שמועד הפדיון, בעת ההשקעה בהם, לא עלה על שלושה חודשים, כשווי מזומנים. הסכומים שצוינו לעיל כוללים מזומנים מוגבלים, המוחזקים באמצעות ג'.י.טי ברזיל להבטחת התוכנית הנדחית של ICMS, בסך של 330 אלפי דולר.

ה. לקוחות

חובות הלקוחות מוצגים בניכוי ההפרשה לחובות מסופקים. הדוחות הכספיים כוללים את האומדנים הטובים ביותר של החברה בגין הפרשות לחובות מסופקים, המשקפים בצורה נאותה, לפי הערכת ההנהלה, את ההפסד הגלום בחובות, שגבייתם מוטלת בספק. בקביעת נאותות הפרשות התבססה ההנהלה, בין היתר, על הערכת הסיכון על סמך ניסיון העבר, מצב הענף ונתונים מאקרו כלכליים לאומיים. החברה עורכת בדיקה חודשית של חשבונות הלקוחות תוך התמקדות בחובות אשר מועד פירעונם עלה על 90 יום. חובות מסופקים, אשר לדעת הנהלת החברה אין סיכוי לגבותם, נמחקים מספרי החברה. לחברה אין חשיפה חוץ מאזנית המיוחסת לחשבונות פתוחים עם לקוחותיה.

באור 3 - כללי דיווח ומדיניות חשבונאית (המשך)**ו. מכשירים פיננסיים נגזרים ועסקאות גידור**

בהתאם להוראות תקן חשבונאות מספר 133 ותקן חשבונאות מספר 138, שהינם בתוקף החל מ-1 בינואר 2001, כל המכשירים הנגזרים מוצגים במאזן בהתאם לערכם ההוגן. במועד ההתקשרות בחוזה הנגזר, החברה מייעדת את הנגזר לגידור שווי הוגן של נכס או התחייבות שהוכרו או של התקשרות איתנה שלא הוכרה (גידור "שווי הוגן"), לגידור תזרים מזומנים של עסקה חזויה או של נכס או של התחייבות (גידור "תזרים מזומנים"), לגידור שווי הוגן במטבע חוץ או גידור תזרים מזומנים במטבע חוץ (גידור "מטבע חוץ"), או גידור ההשקעה, נטו בפעילויות חוץ. החברה מתעדת באופן מסודר ופורמלי את כל הקשרים שבין הפריטים המגודרים והנגזרים המגדרים וכמו-כן את מטרות ואסטרטגיית מדיניות ניהול הסיכונים שלה לגבי פעילויות גידור. תהליך זה כולל ייחוס כל הנגזרים שיועדו כגידור שווי הוגן, גידור תזרים מזומנים או גידור מטבע חוץ לנכסים או התחייבויות מסויימים המוצגים במאזן, או להתקשרויות איתנות מסויימות של החברה או לעסקאות צפויות. החברה גם מעריכה באופן מסודר, הן במועד ההתקשרות בעסקת הגידור והן על בסיס שוטף, האם הנגזרים המשמשים בעסקאות הגידור הינם אפקטיביים לגבי הגנה על השינויים בשוויים ההוגן או בתזרים המזומנים של הפריטים המגודרים. כשנקבע שנגזר אינו אפקטיבי במידה גבוהה לענין הגידור או כאשר הפסיק להיות אפקטיבי, החברה מפסיקה את חשבונאות הגידור בו מאותו מועד והלאה. שינויים בשווי ההוגן של נגזרים שהינם אפקטיביים במידה גבוהה כמגדרים ושהינם מיועדים וכשירים לגידור מטבע חוץ, נזקפים לדוח רווח והפסד במידה והינם משמשים לגידור שווי הוגן, או לרווח (הפסד) כולל אחר במידה והינם משמשים לגידור תזרים מזומנים.

ז. רכוש קבוע

הנכסים הקבועים מוצגים לפי העלות. רכוש קבוע הנמצא בחכירה הונית, מוצג לפי הערך הנוכחי של תשלומי החכירה המינימליים, למעט הוצאות סטטוטוריות, או לפי הערך ההוגן של רכוש קבוע חכור. הפחת על רכוש קבוע מחושב לפי שיטת הפחת השווה על בסיס משך השימוש המשוער של הנכסים. רכוש קבוע בחכירה הונית ושיפורים במושכר מופחתים בשיטת הפחת השווה על פני תקופת החכירה או תקופת השימוש המשוער של הנכס, כנמוך מביניהם. סעיף תשתית תקשורת בהקמה כולל את עלות הציוד והוצאות שהוצאו לפני תחילת השימוש בנכס.

ח. מסים לקבל

סעיף מסים לקבל כולל זיכוי ממס ערך מוסף שמקורו ברכישות של רכוש קבוע, בעיקר מיובא, שהקבוצה משתמשת בו לצורך קיזוז חבויות ממס ערך מוסף שיחול על הכנסות ממתן שירותי תקשורת.

ט. הוצאות מראש וחייבים שוטפים אחרים

סעיף הוצאות מראש וחייבים אחרים כולל מלאי, מקדמות לספקים ואחרים וניכוי מס במקור. מלאי מוצג לפי העלות או שווי השוק, כנמוך שבהם. עלות המלאי נקבעת על בסיס ממוצע. הערך של הוצאות מראש וחייבים שוטפים אחרים משקף את השווי ההוגן של נכסים אלה, בהתחשב בכך שיתרות אלה הינן לזמן קצר.

י. הוצאות ייסוד והקמה

בהתאם להוראות SOP 98-5 של ה-AICPA, "Start-up Activities", החברה זוקפת הוצאות ייסוד והקמה לרווח והפסד בעת התהוותן.

יא. פרסום

הוצאות פרסום נזקפות לרווח והפסד בעת התהוותן. הוצאות הפרסום הסתכמו לסך של 4,327 אלפי דולר ו-4,455 אלפי דולר בשנים 2003 ו-2002, בהתאמה.

באור 3 - כללי דיווח ומדיניות חשבונאית (המשך)**יב. מסים על ההכנסה**

מסים על ההכנסה מוכרים לפי שיטת "הנכסים וההתחייבויות". מסים נדחים ועתודה למס מוכרים בשל תוצאות המס העתידיות הנובעות מהפרשים שבין ערכי נכסים והתחייבויות בספרים לבין ערכיהם לצרכי מס, וכן בשל הפסדים שוטפים והפסדים להעברה. יתרות המסים הנדחים (נכס או התחייבות) מחושבות בהתאם לגישת ההתחייבות לפי שיעורי המס שיחולו בעת ניצול המסים הנדחים, או בעת מימוש הטבות המס, כפי שהם ידועים סמוך לתאריך אישור הדוחות הכספיים.

יג. אופציות לעובדים

החברה מיישמת את שיטת הערך הפנימי שנקבעה ב- APB מס' 25 של המוסד לתקינה חשבונאית בארה"ב "רישום מניות המונפקות לעובדים" ובהבהרה מס' 44 המתייחסת אליו "הטיפול החשבונאי בתוכניות לתגמול עובדים". לפי שיטה זו, לגבי תוכניות קבועות, מכירים בתגמול כהוצאה במועד בו התבצע התגמול אך ורק במידה ומחיר השוק של המנייה שעליה כתובה האופציה עולה על מחיר המימוש של האופציה. תקן חשבונאות מספר 123, "רישום תגמול מבוסס מניות" קבע כללי חשבונאות ודיווח המתבססים על שיטת השווי ההוגן של תגמול עובדים מבוסס מניות. כפי שהותר על ידי תקן חשבונאות מספר 123 החברה בחרה להמשיך לפעול לפי שיטת הערך הפנימי המתוארת לעיל. הטבלה שלהלן מציגה את ההשפעה על הרווח הנקי, לו שיטת השווי ההוגן הייתה מיושמת לגבי כל תגמול העובדים תוך התייחסות לתקופת החסימה ("Vesting"), בכל תקופת דיווח.

2002	2003	
אלפי דולר	אלפי דולר	
(252,147)	31,064	רווח (הפסד) נקי, כפי שדווח
-	-	בתוספת הוצאה המתייחסת לתגמול העובדים מבוסס המניות, הכלול ברווח הנקי
(168)	(335)	בניכוי הוצאת תגמול העובדים מבוססת המניות לפי שיטת השווי ההוגן, לגבי כל התגמולים, לאחר מס
<u>(252,315)</u>	<u>30,729</u>	רווח (הפסד) נקי פרופורמה

יד. השווי ההוגן של מכשירים פיננסיים

השווי ההוגן של מכשיר פיננסי מוגדר כשווי שבו המכשיר היה נסחר בעסקה בין קונה מרצון למוכר מרצון. הערך הפנקסני של המכשירים הפיננסיים של הקבוצה, כמו מזומנים ושווי מזומנים, לקוחות, הוצאות מראש וחייבים אחרים, התחייבויות לשלם לבנקים, ריבית לשלם, ספקים והוצאות לשלם, משקף בקירוב את השווי ההוגן של מכשירים אלה, בשל הזמן הקצר לפירעון של פריטים אלו. הערך הפנקסני של הסדרי מימון של הציוד משקף גם הוא בקירוב את השווי ההוגן בשל הריבית המשתנה.

טו. השימוש באומדנים

בעריכת הדוחות הכספיים בהתאם לכללי חשבונאות מקובלים הנהלה השתמשה באומדנים והערכות המשפיעים על הנכסים וההתחייבויות, וכן נכסים מותנים והתחייבויות תלויות שניתן להם גילוי בדוחות הכספיים. יובהר שהתוצאות בפועל עלולות להיות שונות מאומדנים אלה.

באור 3 - כללי דיווח ומדיניות חשבונאית (המשך)**טז. ירידת ערך נכסים**

החברה מיישמת את תקן חשבונאות מספר 144 "הטיפול החשבונאי בירידת ערך נכסים לזמן ארוך" לגבי נכסים לזמן ארוך, למעט מוניטין. בהתאם לתקן, יש לבחון האם חלה ירידה בערכו של נכס לזמן ארוך, כגון מבנים וציוד בר-פחת, כאשר מתרחש אירוע או שינוי בנסיבות, המצביעים על כך שערכו הפנקסני של אותו נכס אינו בר השבה. מבחן זה נעשה באמצעות השוואה של הערך הפנקסני של הנכס לאומדן תזרימי המזומנים הבלתי-מהוונים הצפויים מהנכס. במידה והערך הפנקסני של הנכס עולה על הסכום בר-ההשבה, יש להכיר בהפרשה לירידת ערך בגובה ההפרש בין ערכו הפנקסני של הנכס לבין השווי ההוגן שלו. נכסים המיועדים למכירה מוצגים לפי הנמוך מבין הערך הפנקסני והשווי ההוגן בניכוי הוצאות המכירה והפחתתם מופסקת.

יז. הכרה בהכנסה

לחברה ישנן הכנסות מאספקת שירות טלקומוניקציה, לרבות תקשורת בין אזורית ובינלאומית, תקשורת בין רשתות ושירותי תקשורת אחרים. החברה מכירה בהכנסות משירותים במועד בו השירותים מתבצעים על-ידה, או במקרה של חוזה ארוך-טווח, באופן יחסי על פני תקופת השירות. במקרה של חוזים מרובי-רכיבים, ההכנסה מפוצלת לגבי כל רכיב באופן המתבסס על השווי ההוגן היחסי של רכיב זה, לו היה נמכר בנפרד.

יח. שינויי אומדן

עד ל- 31 בדצמבר 2002, החברה הכירה בעלות של חיבור קווים לבית הלקוח כהוצאה שוטפת, היות ולא הייתה ודאות באשר להשבת העלויות.

החל מחדש ינואר 2003, תוצאותיה העסקיות של החברה תומכות בהשבת העלויות ולכן עלויות אלה מהונות ומופחתות על פני תקופה של 24 חודשים. העלות שהוונה במשך השנה הייתה בסך של 6,963 אלפי דולר, וההפחתה שנזקפה לדוח רווח והפסד הסתכמה לסך של 1,581 אלפי דולר.

יט. סיווג מחדש

נתונים מסויימים בשנת 2002 סווגו מחדש להציגם באופן עקבי לנתוני 2003.

כ. הפרשות ותלויות

הפרשות להפסדים בשל תלויות, הנובעות מתביעות, קנסות והיטלים וכן מכל מקור אחר, מוכרות כאשר קיום ההתחייבות הוא קרוב לוודאי והסכום הנובע מכך ניתן להערכה באופן סביר. החברה מבצעת הפרשה להפסדים כאשר אותם הפסדים הינם קרובים לוודאי וניתנים להערכה באופן סביר. הפרשות כאמור מותאמות עקב מידע חדש שהתקבל או שינוי בנסיבות.

כא. יישום לראשונה של תקני חשבונאות

בחודש יוני 2001 פורסם תקן חשבונאות מספר 143 "הטיפול החשבונאי במחויבויות בגין סילוק נכסים לזמן ארוך" על ידי המוסד לתקינה חשבונאית בארה"ב. תקן חשבונאות מספר 143 קובע כי על החברה להכיר בשווי ההוגן של התחייבות בגין סילוק ונטישת נכסים כהתחייבות בתקופה שבה נוצרה מחויבות משפטית בנוגע לסילוק של נכסים לזמן ארוך, הנובעת מרכישה, בנייה, פיתוח ו/או שימוש רגיל באותם נכסים. החברה מכירה גם בנכס מקביל המופחת לאורך חיי הנכס האמור. לאחר מדידת ערכה ההתחלתי של ההתחייבות לסילוק נכסים, ערכה של התחייבות זו מותאם בסוף כל תקופת דיווח כדי לשקף את ערך הזמן והשינויים באומדן תזרימי המזומנים העתידיים הכרוכים באותה התחייבות. החברה יישמה את הוראות תקן חשבונאות מספר 143 ב-1 בינואר 2003. ליישום תקן חשבונאות מספר 143 לא הייתה השפעה מהותית על דוחותיה הכספיים של החברה.

באור 3 - כללי דיווח ומדיניות חשבונאית (המשך)**כא. שינויי מדיניות חשבונאית (המשך)**

בחודש אפריל 2002 פרסם המוסד לתקינה חשבונאית בארה"ב את תקן חשבונאות מספר 145, ביטול תקני חשבונאות מספר 4, 44 ו- 64, תיקון לתקן חשבונאות מספר 13 ואת קובץ התיקונים הטכניים. תקן חשבונאות מספר 145 שינה את ההנחיות שקדמו לו בנוגע לדיווח על רווחים והפסדים הנוגעים להחזר חוב, ושלל סיווג רווחים והפסדים אלו כפריטים מיוחדים. תקן חשבונאות מספר 145 גם שינה את הוראות תקן חשבונאות מספר 13 לגבי הטיפול החשבונאי במצבי חכירה בעלי מאפיינים כלכליים דומים לחכירה ומכירה חוזרת. ביטול תקן 4 חל בשנה הפיסקלית שהחלה ב-15 במאי 2002. הוראות תיקון תקן 13 חלות על עסקאות שנעשו לאחר ה- 15 במאי 2002. החברה אימצה את הוראות תקן חשבונאות מספר 145 ב-1 בינואר 2003. ליישום הוראות תקן חשבונאות מספר 145 לא הייתה השפעה מהותית על דוחותיה הכספיים של החברה.

בחודש יוני 2002 פרסם המוסד לתקינה חשבונאית בארה"ב את תקן חשבונאות מספר 146 "הטיפול החשבונאי בעלויות הקשורות בהפסקת פעילויות". תקן מספר 146 מתייחס לחשבונאות ודיווח כספי של עלויות הכרוכות ביציאה או בהפסקה של פעילויות ומבטל את EITF 94-3 "הכרה בהתחייבויות לסיום יחסי עובד-מעביד ועלויות אחרות הקשורות בהפסקת פעילויות". הוראות תקן זה חלות לגבי עלויות הכרוכות ביציאה או בהפסקה של פעילויות לאחר ה- 31 בדצמבר 2002. החברה מיישמת את הוראות תקן מספר 146 בדוחותיה הכספיים החל מ-1 בינואר 2003. ליישום התקן לא הייתה השפעה מהותית על דוחותיה הכספיים של החברה.

תקן חשבונאות מספר 150 "הטיפול החשבונאי במכשירים פיננסיים מסויימים בעלי מאפיינים של התחייבות והון יחדיו" פורסם בחודש מאי 2003. תקן זה קובע כללים לסיווג ומדידה של מכשירים פיננסיים מסויימים בעלי מאפיינים של התחייבות והון יחדיו. אין ברשותה של החברה כיום מכשירים פיננסיים הנמצאים בתחולת התקן.

בחודש דצמבר 2003, פרסם המוסד לתקינה חשבונאית בארה"ב את הבהרה (FIN) מספר 46 (שעודכנה בדצמבר 2003) "איחוד יישויות בעלות זכויות משתנות", שהתייחסה לאופן שבו על תאגיד לבחון האם הוא מחזיק באמצעי שליטה בישות אחרת שלא באמצעות זכויות הצבעה, ובהתאם, האם עליו לפעול לאיחוד דוחות עם אותה הישות. החברה נדרשת ליישם את הוראות הבהרה מספר 46 לגבי זכויות משתנות ביישויות שיש לגביהן זכויות משתנות שהוקמו לאחר 31 בדצמבר 2003. לגבי זכויות משתנות ביישויות שיש לגביהן זכויות משתנות שהוקמו לפני ה-1 בינואר 2004, ההבהרה תחול החל מה-1 בינואר 2005. לגבי יישויות שיש לגביהן זכויות משתנות אשר חובה לאחדן לפי הוראות FIN 46 אשר נוסדו לפני ה-1 בינואר 2004, הנכסים, ההתחייבויות והזכויות אשר אינן מקנות שליטה על יישויות אלו, ימדדו תחילה לפי ערכם השוטף, כשכל הפרש שבין הערך נטו מעל למאזן לבין הערך הקודם שהוכר בגין זכויות אלה, יוכר כהשפעה מצטברת בגין שינוי שיטה חשבונאית. במידה והערכת ערך שוטף זה אינה ישימה, ילקח הערך ההוגן של הנכסים, ההתחייבויות והאינטרסים כאמור, כפי שהיה זה במועד שבו יושם FIN 46R לראשונה. החברה בחנה את ההשפעה של יישום FIN 46R. ליישום דרישות הגילוי של ההבהרה לא הייתה השפעה על הדוחות המאוחדים.

באור 4 - לקוחות

הרכב:

2002	2003
אלפי דולר	אלפי דולר
40,838	61,213
(18,807)	(31,953)
22,031	29,260

לקוחות, ברוטו
בניכוי הפרשה לחובות מסופקים
לקוחות, נטו

באור 5 - רכוש קבוע, נטו

2002	2003	שיעור הפחת לשנה	
אלפי דולר	אלפי דולר	%	
			הרכב:
85,443	150,256	7.7	ציוד מיתוג
151,550	238,456	10.0	ציוד חיצוני
6,717	8,268	4.0	בניינים
819	988	20.0	כלי רכב
7,693	11,340	10.0	ריהוט וציוד
43,873	69,609	20.0	חומרה ותוכנה
3,817	9,918	10.0	ציוד אחר
-	6,963	50.0	הוצאות התקנת קווים
97,822	3,911		תשתית תקשורת בהקמה
397,734	499,709		בניכוי פחת נצבר והפחתות
46,876	104,361		רכוש קבוע, נטו
350,858	395,348		

מבנים בערך פנקסני של 5,846 אלפי דולר משועבדים להבטחת אשראי בנקאי לזמן קצר, ראה ביאור 6.

ההוצאות הבאות הונו:

2002	2003	
אלפי דולר	אלפי דולר	
3,441	1,885	ריבית
4,409	4,544	שכר עבודה והוצאות נלוות
-	6,610	הוצאות התקנת קווים

עלות רכוש קבוע כוללת ריבית שהוונה בסך של 13,852 אלפי דולר ו- 9,642 אלפי דולר, שכר עבודה בסך של 18,011 אלפי דולר ו- 10,718 אלפי דולר, וכן הוצאות התקנה בסך של 6,963 אלפי דולר ו- 0 דולר, נכון ל- 31 בדצמבר 2003 ו- 2002, בהתאמה.

באור 6 - אשראי מתאגידים בנקאיים

כולל אשראי לזמן קצר מבנקים שונים, הנקוב בריאל ברזילאי.

באור 7 - חכירות

החברה קשורה בהתחייבויות לחכירה הונית, בעיקר לגבי ציוד מחשוב, אשר מסתיימות במועדים שונים במהלך 3 השנים הקרובות. בנוסף, החברה קשורה בהתחייבויות לחכירה תפעולית בלתי-ניתנות לביטול (לתקופות מקוריות או יתרת תקופה של שנה אחת לפחות) של בניינים, עמודים וציוד מושכר לטובת אתרי רדיו, ארונות רחוב, קווים מושכרים ובעיקר שטחים במגדלי תקשורת.

באור 7 - חכירות (המשך)

תשלומי החכירה המינימליים בגין חכירות הוניות וחכירות תפעוליות בלתי-ניתנות לביטול, נכון ל- 31 לדצמבר 2003, הינן:

חכירה תפעולית אלפי דולר	חכירה הונית אלפי דולר	
		השנה המסתיימת ב- 31 לדצמבר:
12,085	10,262	2004
11,333	4,141	2005
10,794	440	2006
11,306	-	2007
43,312	-	2008 ואילך
<u>88,830</u>	<u>14,843</u>	סך תשלומי החכירה המינימליים
	(1,733)	בניכוי ריבית
	13,110	ערך נוכחי נקי של סך תשלומי חכירות הוניות, נטו
	(8,897)	בניכוי חלויות שוטפות של חכירות הוניות
	<u>4,213</u>	התחייבויות בגין חכירות הוניות, בניכוי חלויות שוטפות

סך הסכמים שנזקפו לדוח על רווח והפסד בשנת 2003 בגין חכירות תפעוליות היו 10,793 אלפי דולר (בשנת 2002 - 10,703 אלפי דולר).

באור 8 - עסקאות מכירה וחכירה חוזרת (הכנסה נדחית)

ב- 27 באפריל 2001, חתמה החברה על הסכם מכירה וחכירה חוזרת עם צד שלישי, לפיו החברה מכרה הלכה למעשה את כל 156 מגדלי התקשורת שברשותה תמורת 28,080 אלפי דולר. הערך הפונקסי של המגדלים היה בסך של 12,653 אלפי דולר.

הרווח מעסקה זו נפרש לאורך תקופת החכירה החוזרת למשך 15 שנה. כתוצאה מכך, 757 אלפי דולר ו- 819 אלפי דולר הוכרו כהכנסות לגבי השנים שנסתיימו ב- 31 בדצמבר 2003 ו- 2002, בהתאמה. נכון ל- 31 בדצמבר 2003 ו- 2002, 9,891 אלפי דולר ו- 8,744 אלפי דולר בהתאמה, נדחו למשך 148 החודשים הנותרים. הגידול בהכנסות הנדחות משנת 2002 לשנת 2003, נובע מתנודות בשער הריאל הברזילאי בהשוואה לדולר ארה"ב.

החברה חתמה על הסכם ל-15 שנה עם רוכש המגדלים לשכירת שטחים במגדלים אלו תמורת 2,380 דולר לחודש למגדל (תורגם מריאל ברזילאי במועד חתימת העסקה).

החברה התקשרה בהסכם "בנייה לפי הזמנה", לפיו רוכש המגדלים יבנה בעתיד עד 400 מגדלי תקשורת לפי אפיוניה של החברה. החברה תחכור שטחים על מגדלים אלו בתנאים דומים לאלו שנקבעו בהסכם המכירה והחכירה החוזרת. נכון ל- 31 בדצמבר 2003, 32 מגדלים נבנו והוחכרו.

באור 9 - מכשירים פיננסיים נגזרים

החברה משתמשת במכשירים פיננסיים נגזרים (עסקאות פרוורד) כדי לנהל סיכוני מטבע חוץ.

החברה התקשרה בעסקאות פרוורד (גיזור מטבע חוץ) במטרה להקטין את ההשפעה האפשרית של שינויים בשערי החליפין של הריאל הברזילאי ביחס לדולר ארה"ב לגבי ערכם של תשלומים קצרי-טווח הנקובים בדולר ארה"ב. נכון ל-31 בדצמבר 2003, החברה מהווה צד לחוזי פרוורד במטבע חוץ בסך כולל של 6,683 אלפי דולר ארה"ב (0 דולר ארה"ב ב-2002). סך ההפסד המצטבר לגבי התקופה מיום ההתקשרות בחוזים אלו, ב-19 בספטמבר 2003 ועד לתאריך המאזן הסתכם בסך 280 אלפי דולר.

באור 10 - הלוואות המירות לזמן ארוך

2002	2003	
אלפי דולר	אלפי דולר	
42,553	-	גילת רשתות לוויינים בע"מ
29,812	31,162	ECI טלקום
72,365	31,162	סך הכל
(72,365)	(31,162)	חלויות שוטפות של הלוואות המירות לזמן ארוך
-	-	הלוואות המירות, בניכוי חלויות שוטפות

א. ב-14 באפריל 2000 החברה הנפיקה הלוואה המירה לגילת בסך 40 מיליוני דולר של ארה"ב (להלן - "הלוואת גילת"). הקרן בתוספת ריבית שנתית בשיעור של 5%, עמדה לפירעון ב-14 באפריל 2002. ב-14 במאי 2002, החברה חתמה על תיקון להסכם הלוואה להארכת מועד הפירעון של הלוואה ל-27 בינואר 2003. פירעון הלוואה נדחה בינואר 2003 למרס 2003.

ב-12 ביוני 2003 החברה חתמה על הסכם עם גילת, לפיו לחברה ניתנה אופציה ("אופציית הרכש") עד ל-31 לדצמבר, 2003 לרכוש את הלוואה ההמירה מגילת כנגד (i) תשלום ע"י החברה של 4,300 אלפי דולר ("מחיר הרכישה") ו-(ii) הנפקה לגילת של מניות רגילות המייצגות כ-2% מהון המניות של החברה. ב-22 לדצמבר 2003 החברה מימשה את האופציה, שילמה לגילת את מחיר הרכישה והנפיקה לגילת 888,889 מניות בנות \$0.01 ערך נקוב. השווי ההוגן של מניות אלו הוערך ב-5,609 אלפי דולר במועד ההנפקה. ההפרש בין סכום הקרן והריבית שנצברה לבין מחיר הרכישה והשווי ההוגן של המניות שהונפקו הסתכם לסך של 34,812 אלפי דולר שגרשמו כרווח מהסדר ליישוב חוב בדוח רווח והפסד לשנת 2003.

ב. ב-30 לנובמבר, 2000 החברה הנפיקה הלוואה המירה ל-ECI (להלן "הלוואת ECI"), בסך 27 מיליון דולר. הקרן בתוספת ריבית שנתית בשיעור של 5% עמדה לפירעון ב-30 לנובמבר 2003. הסכום הכולל לתשלום ל-ECI, כולל ריבית, נכון ל-31 לדצמבר 2003 הסתכם לסך של 31,162 אלפי דולר. בחודש ינואר 2004, החברה חתמה על מסמך עקרונות עם ECI בדבר פירעון חלקי של הלוואה ופריסה מחדש כך שבמועד השלמת ההסכם המפורט הלוואת ECI תבוטל (ראה באור 18).

באור 11 - אגרות חוב להמרה לבעלי המניות

נכון ל- 1 ביולי, 2003 ("מועד ההנפקה") החברה איחדה והמירה את אגרות החוב להמרה שהנפיקה לבעלי מניותיה ב-2001, ב- 2002 וברבעון הראשון של 2003 בגיוס כולל בסך 167,870 אלפי דולר לאגרות חוב להמרה חדשות מ"סדרה F". אגרות חוב להמרה מסדרה F נושאות ריבית שנתית בשיעור 5.1%, ממועד ההנפקה ועד ליום 30 ביוני 2007 ("מועד הפירעון"), בכפוף לכך, שבמקרה של פירעון מוקדם, החברה תשלם סך כולל של 204,544 אלפי דולר, המהווה את הקרן בתוספת ריבית שהיתה נצברת עד למועד הפירעון. הסכום העומד לפירעון, כולל ריבית שנצברה, ליום 31 בדצמבר 2003 הסתכם לסך של 204,544 אלפי דולר, לפיכך, ההתחייבות תישאר ללא שינוי עד ליום 30 ביוני 2007.

בנוסף, במועד ההנפקה הנפיקה החברה אגרות חוב להמרה נוספות המסתכמות לסך של 22,000 אלפי דולר מ"סדרה G" בתנאים זהים לאגרות חוב להמרה מסדרה F. הסכום הכולל לפירעון אגרות החוב להמרה מסדרה G, כולל ריבית שנצברה, ליום 31 לדצמבר 2003 הסתכם לסך של 22,571 אלפי דולר.

ביום 15 לנובמבר 2003 החברה הנפיקה אגרות חוב להמרה נוספות בסך 9,700 אלפי דולר מ"סדרה H" בתנאים זהים לאגרות החוב להמרה מסדרה F ומסדרה G. הסכום הכולל לפירעון אגרות החוב להמרה מסדרה H, כולל ריבית שנצברה, ליום 31 לדצמבר 2003, הסתכם לסך של 9,788 אלפי דולר.

מחזיקי אגרות החוב להמרה יכולים להמיר את אגרות החוב מסדרות F, G ו- H למניות רגילות של החברה בכל עת. אגרות החוב להמרה יומרו אוטומטית למניות במקרה של ביצוע עסקאות מסוימות. נכון ליום 31 דצמבר 2003 הסכום הכולל של אגרות החוב להמרה שבידי בעלי המניות כולל ריבית שנצברה הסתכם לסך של 236,903 אלפי דולר.

באור 12 - התחייבויות לזמן קצר ולזמן ארוך

2002 אלפי דולר	2003 אלפי דולר	
382,746	383,421	הסדרי מימון לרכישת ציוד סכומים לתשלום לספקי ציוד
65,407	52,970	
448,153	436,391	סך הכל
(3,169)	(8,955)	סכומים לתשלום לספקי ציוד לזמן קצר חלויות שוטפות של התחייבויות לזמן ארוך
(26,695)	(59,200)	
(29,864)	(68,155)	
418,289	368,236	התחייבויות לזמן ארוך, בניכוי חלויות שוטפות

ההתחייבויות לזמן קצר כוללות סך של 52,167 אלפי דולר התחייבויות לספקים הממנים ול- HP בהתאם לתנאים המצויינים להלן ו- 15,988 אלפי דולר התחייבויות לספקים מקומיים ונושאות ריבית בשיעור ממוצע של 2% מעל ריבית בנקאית נקובה בריאל.

ההתחייבויות לזמן ארוך כוללות את הסכומים המפורטים להלן וכן התחייבויות לספקים בסך 39,047 אלפי דולר שמועד פירעונן טרם נקבע, 15,605 אלפי דולר בגין מסים לשלם ו- 9,401 אלפי דולר התחייבויות לספקים מקומיים שמועדי פירעונן יחולו ב- 2005 ו- 2006, נקובות בריאל ונושאות ריבית שנתית בשיעור ממוצע של 10%.

באור 12 - התחייבויות לזמן קצר ולזמן ארוך (המשך)

סה"כ אלפי דולר	חכירה אלפי דולר	לזמן ארוך אלפי דולר	לזמן קצר אלפי דולר	
46,603	8,994	17,316	20,293	HP
128,152	-	115,336	12,816	ECI
162,569	-	146,313	16,256	NNL
12,194	-	10,975	1,219	Harris
15,826	-	14,243	1,583	ADC
365,344	8,994	304,183	52,167	
		39,047	-	התחייבויות לספקים שטרם נקבע מועד פירעון
		15,605	-	מסים לשלם
		-	15,988	התחייבויות לספקים מקומיים לפירעון ב-2004
		9,401	-	התחייבויות לספקים מקומיים לפירעון ב-2005 ו-2006
		368,236	68,155	

מועדי הפירעון של ההתחייבויות לזמן ארוך לכל אחת מהשנים הקלנדריות הבאות נכון ליום 31 לדצמבר 2003 הינם כמפורט להלן: 2005, 121,940 אלפי דולר; 2006, 147,718 אלפי דולר; 2007, 95,490 אלפי דולר; ו- 2008, 3,088 אלפי דולר.

בחודש אפריל 2000, התקשרה ג'.י.טי. ברזיל בהסדר מימון לרכישת ציוד עם היולט פקארד ברזיל א.ס.א. וחברות קשורות שלה (HP) בסכום של עד 50 מיליון דולר למימון הסכם אספקה בין HP לג'.י.טי. ברזיל לרכישת חומרה, תוכנה ושירותים מ-HP (מוצרי HP) וכן מוצרים מסויימים שאינם מתוצרת HP, אשר אספקתם נעשית בהסכמי אספקה בין ספקים אחרים ו/או HP. נכון ליום 31 לדצמבר 2003 הסדר זה נוצל במלואו. סכום הקרן של כל משיכה מסולק לשיעורין ב-9 תשלומים חצי שנתיים המתחילים בחודש השניים עשר לאחר המשיכה, כמפורט להלן: תשלום 1 5.665%; תשלום 2 עד 3, 6.0%; תשלום 4 עד 6 10.0%; תשלום 7 16.0%; תשלום 8, 16.335%; ותשלום 9, 20%. הקרן עומדת לפירעון בכפוף להסדר המימון ונושאת ריבית בשיעור לייבור בתוספת 5.09%. הריבית משולמת בסוף החודש השישי אחרי כל משיכה ובכל מועד פירעון של קרן. הסדר המימון מובטח על ידי הציוד שנרכש במסגרת ההסדר ויובטח עד שהחלק בהסדר הקשור לתוכנה ושירותים ישולם במלואו. החלק בהתחייבות הקשור לתוכנה ושירותים מובטח על ידי חוזה אינטרקדיטורי המחלק באופן יחסי עם הספקים (כפי שמוגדר להלן) את נכסי ג'.י.טי. ברזיל. קרן החוב ל-HP ליום 31 לדצמבר 2003 הסתכמה לסך 46,603 אלפי דולר.

בחודש מאי 2000, התקשרה ג'.י.טי. ברזיל בחוזה אספקה עם ECI בסכום של עד 192 מיליון דולר בקשר עם בניית רשת טלפונית עם גישה אלחוטית קבועה. בנוסף לחוזה אספקה זה, ג'.י.טי. ברזיל והחברה, נכנסו להתקשרות מימונית עם ECI וחברות קשורות שלה למימון בסכום של עד 192 מיליון דולר. המסמכים הסופיים של מימון הספקים נחתמו ביום 31 באוקטובר 2000, לפיהם נדרשת עמידה באמות מידה פיננסיות ותפעוליות מסויימות (ראה להלן). הסכם המימון נבנה בשתי מסגרות (המסגרת הראשונה והמסגרת השנייה). במסגרת הראשונה לווה ג'.י.טי. ברזיל סכום של עד 165 מיליון דולר והיא חייבת להשתמש בכספים למימון התשלומים בהתאם לחוזי האספקה לרכישת ציוד שיוצר או שסופק במסגרת החוזה. במסגרת השנייה לווה החברה סכום של עד 27 מיליון דולר (ראה ביאור 10ב). סכום החוב בגין המסגרת הראשונה ליום 31 בדצמבר, 2003 הסתכם בסך 128,152 אלפי דולר.

בחודש יוני 2000, התקשרה ג'.י.טי. ברזיל בחוזה אספקה עם נורטל נטוורקס בע"מ (NNL) בסך של עד 240 מיליון דולר בקשר להקמת רשת טלפונית במתג קבוע. בקשר עם חוזה אספקה זה, השיגה ג'.י.טי. ברזיל התחייבות להלוואה מ-NNL או/ו נורטל נטוורקס בע"מ בסכום של עד 240 מיליון דולר במסגרת אשראי מובטח מדרגה ראשונה למימון רכישת ציוד תקשורת ושירותים קשורים המסופקים על ידי NNL או חברות קשורות שלה במסגרת חוזה האספקה.

במסגרת ההתחייבות, נדרשת ג'.י.טי. ברזיל לעמוד באמות מידה פיננסיות ותפעוליות מסויימות (ראה להלן). מסמכי ההלוואה הסופיים הושלמו ונחתמו במשא ומתן בין הצדדים ביום 31 באוקטובר 2000. קרן החוב ליום 31 בדצמבר 2003 ו-2002 הסתכמה לסך 162,569 אלפי דולר.

באור 12 - התחייבויות לזמן קצר ולזמן ארוך (המשך)

הריס קורפוריישן ("הריס") מספקת ציוד תקשורת בסכום של עד 26 מיליוני דולר במסגרת חוזה האספקה עם NNL. במסגרת חוזה אספקה זה, השיגה ג'.י.טי. ברזיל התחייבות להלוואה מהריס בסך 26 מיליון דולר (הופחתה ל- 16 מיליון דולר בחודש יולי 2002) במסגרת אשראי מובטח מדרגה ראשונה למימון רכישת ציוד תקשורת ושירותים קשורים שיופקו על ידי הריס במסגרת חוזה האספקה עם NNL. תנאי ההלוואה זהים לתנאי ההלוואה מ- NNL (ראה להלן). קרן החוב ליום 31 בדצמבר 2003 ו- 2002 הסתכמה לסך של 12,194 ו- 12,038 אלפי דולר, בהתאמה.

בחודש ספטמבר 2000 התקשרה ג'.י.טי. ברזיל בהסכם אספקה עם מטה טלקומוניקיישנס א.י.י. – חברה בקבוצת אי.די.טי. טלדטה (ADC) בסך 20 מיליון דולר בקשר עם בניית רשת טלפונית במתג קבוע. קרן החוב ליום 31 בדצמבר 2003 ו- 2002 הסתכמה לסך של 15,826 ו- 14,843 אלפי דולר, בהתאמה. במרס 2002 ADC הצטרפה להסכם המימון בין ג'.י.טי. לספקים, כמתואר לעיל.

להסכמי המימון הנזכרים לעיל (ECI, NNL, הריס, ADC - "הספקים") יש מספר תנאים משותפים והתחייבויות כמתואר להלן:

פירעון ותשלומים: הסכומים העומדים לפירעון ישולמו בשמונה תשלומים חצי שנתיים, החל מ- 30 באפריל 2004 ועד למועד הפירעון, ה-30 בנובמבר 2007. התשלום הראשון הינו בשיעור של 5% מסכום הקרן. לאחר מכן, כל תשלום עוקב הוא בשיעור מסכום הקרן העומד לתשלום כלהלן: 5%, 12.5%, 12.5%, 20%, 20%, 12.5% ו- 12.5%.

ריבית ועמלות: הסכומים ישאו ריבית לייבור בתוספת מרווח של 6.5%, לפירעון בסוף כל רבעון. המרווח יכול לרדת עד לשיעור של 4.5%, ותלוי ביחס החוב ל- EBITDA (רווח נקי מתואם מאוחד בתוספת הוצאות מימון נטו, מסים על ההכנסה, פחת והפחתות). במשך התקופה בה קיימת לספקים מחוייבות לממן אספקת ציוד (לא כולל המסגרת השנייה), ג'.י.טי. הולנד משלמת עמלה על החלק היומי הממוצע שטרם נוצל ממימון הספקים בשיעור שנתי של 1.25%.

בטחונות: ג'.י.טי. ברזיל שעבדה את מרבית נכסיה הקיימים והעתידיים, כולל רשיונות והיתרים, חשבונות בנקים, לקוחות, ציוד, מלאי ומקרקעין. החברה שעבדה את כל מנייתיה בהון של ג'.י.טי. הולנד. ג'.י.טי. הולנד שעבדה 100% מהחזקתה בג'.י.טי. ברזיל הולדינג וג'.י.טי. ברזיל הולדינג שעבדה את כל מנייתיה בג'.י.טי. ברזיל כבטחון לספקים.

הקבוצה נדרשת לעמוד באמות מידה פיננסיות, הכוללות, בין היתר:

- שמירה של הכנסות מינימליות ו- EBITDA שנתי מינימלי.
- שמירה על יחס חוב להון עצמי נפרע יחס חוב ל- EBITDA שנתי.
- שמירה על מקסימום הוצאות הוניות למנוי.
- הגבלות על שעבודים ולקיחת התחייבויות נוספות.

אירועים של הפרה כוללים, בין היתר:

- אי יכולת של הקבוצה לשלם קרן, ריבית או סכומים אחרים במועדי הפירעון.
 - הפרה של אמות מידה שנקבעו ושל עמידה בהתחייבויות.
- בכל מקרה של הפרה, הספקים רשאים לממש תרופות מסוימות כנגד הקבוצה, כולל הדרישה לתשלום מידי של הסכום במלואו ולנקוט בהליכים למימוש הביטחונות וביטול מחויבויותיהם. במהלך 2003 הספקים ביטלו את מחויבויותיהם לממן רכישת ציוד נוספת באשראי.

תשלומי חובה: ג'.י.טי. ברזיל נדרשת להקדים פירעון של סכומים עם התרחשות האירועים הבאים:

- השלמת הנפקה, ציבורית או פרטית, של הון או אגרות חוב על ידי ג'.י.טי. ברזיל, ג'.י.טי. ברזיל הולדינג, או ג'.י.טי. הולנד, בכפוף לתנאים מסוימים, בסכום הגבוה מ- 225 מיליון דולר.
- כניסה להתחייבות אחרת בנוסף להתחייבויות המותרות.

בחודש יולי 2002, החברה התקשרה בהסכם ויתור ותיקון כולל עם הספקים (ECI, NNL, הריס ו- ADC), שכלל מספר ויתורים ותיקונים להסכמי המימון עם הספקים בקשר לאמות מידה פיננסיות, מחויבויות הספקים ויעוד תמורות המימון.

באור 12 - התחייבויות לזמן קצר ולזמן ארוך (המשך)

מסמכי הזרמת ההון: בקשר עם עסקת המימון של הספקים המממנים, הסכימו בעלי המניות בחברה להתחייב בסכום כולל של עד 337 מיליון דולר. עד ליום 31 בדצמבר 2003, בעלי המניות השלימו את התחייבותם במלואה. עד ליום 31 בדצמבר 2003 ו- 2002, לוותה ג'.י.טי. ברזיל סכום כולל של 365,344 אלפי דולר ו- 364,206 אלפי דולר מהספקים, כולל HP, בהתאמה. ההלוואה נרשמה בבנק המרכזי של ברזיל כהלוואה מטעם צ'ייס מנהטן בנק, סוכן השעבוד עבור הספקים.

כתבי אופציות: לספקים הוענקו כתבי אופציה למימוש להון מניות. מחיר המימוש הינו \$0.01 למניה עבור 1.62% מהון המניות של החברה (בדילול מלא) נכון ליום המימוש. כתבי האופציה ניתנים למימוש בכל עת, אולם הם יפקעו ב- 30 בנובמבר 2015. כתבי האופציה יומרו אוטומטית למניות רגילות של החברה אם החברה תנפיק לראשונה מניות לציבור (IPO) העונה על מספר קריטריונים ובעקבות עסקאות מסוימות אחרות. כתבי האופציה ניתנים למימוש למניות רגילות של אחת מחברות הבנות של החברה בכפוף לתנאים מסוימים.

נכון ליום 31 בדצמבר 2003 ו- 2002 החברה לא עמדה באמות מידה פיננסיות ובהתחייבות לתשלומי הריבית. החברה, הספקים ו- HP נמצאים בתהליך משא ומתן מתקדם לשינוי התנאים המימוניים. כתוצאה ממשא ומתן זה נחתם מסמך העקרונות (ראה באור 18).

באור 13 - הון עצמי

הון מניות

ההון הרשום של החברה עד יוני 2000 היה 30,000 דולר, מחולק ל- 30,000 מניות בנות \$ 1 ע.ג. כל אחת, מהן הונפקו ושולמו במלואן 6,000. בחודש יוני 2000, פיצלה החברה כל מניה שהונפקה ל- 100 מניות בנות \$0.01 ע.ג. כל אחת, וכן הגדילה את ההון הרשום של החברה ל- 60,000,000 מניות בנות \$0.01 ע.ג. כל אחת. לאחר מכן, הנפיקה החברה לבעלי המניות הקיימים 19,400,000 מניות בנות \$0.01 ע.ג. כל אחת, לפי יחס החזקותיהם בחברה. סך הכל התמורה נטו, בגין הנפקה זו הסתכמה לסך 16,994 אלפי דולר.

בחודש יולי 2000, הנפיקה החברה 15,000,000 מניות נוספות בנות \$0.01 ע.ג. כל אחת, במחיר של \$4.00 למניה, בתמורה כוללת של 60,000 אלפי דולר. ביום 22 בדצמבר 2003, נרכשה ההלוואה מ"גילת" הניתנת להמרה, תמורת סכום של 4,300 אלפי דולר בתוספת הנפקה של 888,889 מניות, שהוערכו על פי שווי הנאות ב- 5,609 אלפי דולר. כתוצאה מהאמור לעיל, הסתכם ההון המונפק של החברה ליום 31 בדצמבר 2003, ב- 35,888,889 מניות בערך נקוב כולל של 359 אלפי דולר (2002 - 350 אלפי דולר).

תמורת המניות בסך של 6 אלפי דולר, 16,994 אלפי דולר, 60,000 אלפי דולר ו- 5,069 אלפי דולר, כמפורט לעיל, בתוספת פרמיה של 12,564 אלפי דולר ליום 31 בדצמבר 2003, ו- 12,472 אלפי דולר ליום 31 בדצמבר 2002, מהווה סכום כולל של הון מניות ופרמיה על מניות בסך 95,173 אלפי דולר ו- 89,472 אלפי דולר ליום 31 בדצמבר 2003 ו- 31 בדצמבר 2002, בהתאמה.

ההלוואה ההמירה לאי.סי.אי. טלקום בע"מ בסכום קרן של 27,000 אלפי דולר, ניתנת להמרה ל- 2,362,500 מניות רגילות של \$0.01 ע.ג. כל אחת. מספר המניות ניתן להתאמה בהתאם לתנאי חוזה ההלוואה (לפרטים נוספים, ראה באור 10).

כתבי אופציה

כחלק מההתחייבויות בקשר להסדר מימון ספקים שנחתמו ביום 31 באוקטובר 2000, הנפיקה החברה כתבי אופציה לספקים העיקריים שלה. ליום 31 בדצמבר 2003 הוענקו 567,000 כתבי אופציה.

כתבי האופציה האמורים, שהוערכו על פי מודל בלק אנד שולס להערכת מחיר אופציות, מהווים חלק מהתמורה בגין רשת הטלפוניה, ובהתאם, בשנת 2001 רשמה החברה סך של 2,262 אלפי דולר כחלק מהרכוש הקבוע של החברה כנגד פרמיה על מניות.

באור 13 - הון עצמי (המשך)

בנוסף, ביום 11 בדצמבר 2000, העניקה החברה 1,300,000 כתבי אופציה לבעלי מניות מסויימים לרכישת 1,300,000 מניות רגילות במחיר מימוש של \$3 בתמורה לערבויות שהעמידו אותם בעלי מניות בעניין הסדר מימון ספקים.

כתוצאה מכך, חושבה הוצאת רבית נדחית בסך 1,300 אלפי דולר בגין הסדר מימון ספקים, אשר תוכר בשיטת "קו ישר", על פני תקופת הסדר מימון הספקים. ליום 30 ביוני 2003, הוצאת רבית בסך 480 אלפי דולר נרשמה כנגד פרמיה על מניות (31 בדצמבר 2002 - 388 אלפי דולר).

ליום 1 ביולי 2003, מאחר והערבויות האמורות לא היו דרושות עוד, הסכימו המחזיקים בכתבי האופציה לבטל את 1,300,000 כתבי האופציה, ולכן לא תרשם הוצאת רבית נוספת.

תכניות אופציה לרכישת מניות לעובדים

לחברה שתי תכניות קיימות של אופציות לעובדיה ("התכנית"), האחת, שאומצה על ידי החברה ("התכנית"), והשניה, שאומצה על ידי החברה הבת, ג'י וי טי ברזיל ("תכנית ברזיל"), כמפורט להלן. החברה ו-ג'י וי טי ברזיל העניקו אופציות למניות לעובדיהן במספר ובמחירי מימוש בהתאם למעמדו ולתקופת העסקתו של כל עובד.

מאחר וקיימת אי וודאות לגבי זהותה של החברה אשר תנפיק לראשונה מניות לציבור (החברה עצמה או החברה הבת ג'י וי טי ברזיל), אושר מנגנון המרה אשר מאפשר לכל מחזיק באופציות לרכוש מניות של החברה או של ג'י וי טי ברזיל לפי יחס של 1:7 (7 אופציות של תכנית ברזיל ו-1 אופציה של התכנית). מימוש אופציות של התכנית האחת מבטל אוטומטית אופציות של התכנית השניה, כך שמחזיק באופציות אינו יכול לממש אופציות מקבילות בשתי התכניות. בנוסף, לחברות האמורות הזכות לבטל את תכנית האופציה שלהן בכל עת לפני מועד החסימה (vesting) כל עוד האופציות המקבילות שהוענקו על ידי החברה האחרת לא בוטלו קודם לכן, כך שמחזיק האופציות ישאר עם תכנית קיימת אחת בלבד.

החברה והחברה הבת רושמות בספריהן את תכניות האופציה הקבועות בהתאם לשיטה המבוססת על הערך הפנימי על פי התקן החשבונאי בארה"ב (APB 25) "רישום מניות המונפקות לעובדים" והפרשנות המתייחסת אליו. על פי שיטה זו נרשמת הוצאת תיגמול ביום הענקת האופציות רק אם מחיר השוק של המניות המתייחסות עולה על מחיר המימוש. תקן חשבונאות מספר 123 "רישום תיגמול מבוסס מניות" קובע שיטת רישום ודרישות גילוי בהתבסס על השווי הנאות של מניות הניתנות במסגרת תכנית לתיגמול עובדים. כפי שהתיר תקן חשבונאות מספר 123 בחרה החברה להמשיך בשיטת הרישום החשבונאי המבוססת על הערך הפנימי כנ"ל, ויישמה רק את דרישות הגילוי הנאות על פי תקן חשבונאות מספר 123.

תכנית אופציות לעובדים של ג'י וי טי (הולדינג) אן.וי.

בשנת 2000, החליטה החברה על תכנית אופציות לעובדים (התכנית) לפיה בסמכות הדירקטוריון להעניק אופציות לרכישת מניות לנושאי משרה ולבעלי תפקידי מפתח בחברה. התכנית הסמיכה הענקת אופציות לרכישה של עד 2,500,000 מניות. מספר זה הוגדל לאחר מכן, וליום 31 בדצמבר 2003 הוא עומד על 6,500,000 מניות. הענקת האופציות יכולה להעשות במחיר מימוש השווה למחיר השוק הנאות של המניה ביום הענקת האופציות, או הגדול ממחיר זה. מחירי המימוש נעים בין \$1.5 ועד \$14 למניה. כל האופציות מוענקות וניתנות למימוש במלואן לאחר שנתיים ועד ארבע שנים מיום הענקתן. ליום 31 בדצמבר 2003, 3,800,200 הוקצו לעובדים.

בהתבסס על מודל בלק אנד שולס לקביעת מחיר אופציות ללא תנודתיות ובהנחות הבאות: 2003 – תשואת דיבידנד צפויה 0%, שיעור רבית של 3% ומשך חיים של חמש שנים; 2002- תשואת דיבידנד צפויה 0%, שיעור רבית ללא סיכון של 3% ומשך חיים של חמש שנים, השווי הנאות לאופציות שהוענקו במשך שנת 2002 הוא \$0.67 ל-1,500,000 אופציות. ראה חישובי פרו-פורמה בביאור 3(יד'). השווי הנאות למניה של האופציות האחרות הינו זניח.

באור 13 - הון עצמי (המשך)

להלן התנועה באופציות בתקופות המצוינות:

ממוצע משוקלל של מחיר המימוש דולר	מספר המניות	
6.55	2,897,400	יתרה ליום 1 בינואר 2002
2.57	1,716,850	הוענקו
0.00	-	מומשו
8.98	(1,000,500)	חולטו
0.00	-	פקעו
3.99	3,613,750	יתרה ליום 31 בדצמבר 2002
9.81	189,450	הוענקו
0.00	-	מומשו
12.00	(3,000)	חולטו
0.00	-	פקעו
4.28	3,800,200	יתרה ליום 31 בדצמבר 2003

תכנית אופציות לעובדים של ג'י וי טי ברזיל

בשנת 2000 החליטה ג'י וי טי ברזיל על תכנית אופציות לעובדים (תכנית ברזיל) לפיה בסמכות הדירקטוריון של ג'י וי טי ברזיל להעניק אופציות לרכישת מניות לנושאי משרה ולעובדים בחברה. תכנית ברזיל הסמיכה הענקת אופציות לרכישה של עד 17,500,000 מניות. מספר זה הוגדל ביולי 2002 ל-31,500,000 מניות ולאחר מכן, בדצמבר 2003 ל-45,500,000 מניות. הענקת האופציות יכולה להיעשות במחיר מימוש השווה למחיר השוק הנאות של המניה ביום הענקת האופציות, או הגדול ממחיר זה. מחירי המימוש נעים בין \$0.21 ועד \$2 למניה. כל האופציות מוענקות וניתנות למימוש במלואן לאחר שנתיים ועד ארבע שנים מיום הענקתן.

בהתבסס על מודל בלק אנד שולס לקביעת מחיר אופציות ללא תנודתיות ובהנחות הבאות: 2003 – תשואת דיבידנד צפויה 0%, שיעור רבית של 3% ומשך חיים של חמש שנים; 2002 – תשואת דיבידנד צפויה 0%, שיעור רבית ללא סיכון של 3% ומשך חיים של חמש שנים, השווי הנאות לאופציות שהוענקו בשנים 2002 ו-2003 הינו זניח.

להלן התנועה באופציות בתקופות המצוינות:

ממוצע משוקלל של מחיר המימוש דולר	מספר המניות	
0.94	20,281,800	יתרה ליום 1 בינואר 2002
0.37	12,017,950	הוענקו
0.00	-	מומשו
1.28	(7,003,500)	חולטו
0.00	-	פקעו
0.57	25,296,250	יתרה ליום 31 בדצמבר 2002
1.40	1,326,150	הוענקו
0.00	-	מומשו
1.71	(21,000)	חולטו
0.00	-	פקעו
0.61	26,601,400	יתרה ליום 31 בדצמבר 2003

האופציות ניתנות להמרה לאופציות של החברה.

באור 14 - הכנסות (הוצאות) מימון

להלן פירוט הכנסות (הוצאות) מימון לשנים שנסתיימו ביום 31 בדצמבר 2003 ו- 2002:

2003	2002	
אלפי דולר	אלפי דולר	
1,490	6,858	הכנסות מריבית ומחוזי חילופין
(53,344)	(59,870)	הוצאות ריבית
(4,154)	(2,331)	הוצאות אחרות
81,409	(144,380)	רווחים (הפסדים) משינויים בשערי חליפין
25,401	(199,723)	

המרכיב העיקרי בהכנסות המימון בסך 25,401 אלפי דולר נובע מהשפעת הרווח משערי חליפין בסך 81,409 אלפי דולר. הרווח משינויים בשערי חליפין נובע מעלית ערך של 18% של הריאל הברזילאי לעומת הדולר מתחילת השנה ועד 31 בדצמבר 2003 (2002 - פיחות של 52%). כתוצאה מכך, חלה ירידה בהתחייבויות של החברה הבת בברזיל הצמודות לדולר ארה"ב.

באור 15 - מסים על ההכנסה

המסים על ההכנסה לשנים שנסתיימו ביום 31 בדצמבר 2003 ו- 2002 הם כדלקמן:

2003	2002	
אלפי דולר	אלפי דולר	
72,412	43,063	מסים נדחים לקבל
(72,412)	(43,063)	בניכוי הפרשה
-	-	

ליום 31 בדצמבר 2003 ו- 2002, המס הנדחה לקבל, המתייחס להפסדים להעברה לצורך מס, הסתכם בסך 72,412 אלפי דולר ו- 43,063 אלפי דולר, בהתאמה. נערכה הפרשה בגובה כל סכום המס הנדחה לקבל בתאריכים הנ"ל. בהערכת סבירות המימוש של המס הנדחה לקבל, לקחה ההנהלה בחשבון את הפסדי העבר בבואה לקבוע את גובה ההפרשה.

בשנת 2003, כללה החברה הוצאה בסך 68 אלפי דולר, בגין מס חברות לתשלום בקוראסאו.

באור 16 - התחייבויות תלויות והתקשרויות**א. התקשרויות תפעוליות**

החברה מערערת בבית המשפט על דמי רשיון תדרים (PPDUR) שנדרשו על ידי אנאטל. הסכומים שנדרשו בסך כולל של 5,994 אלפי דולר נכללים בסעיפים "רכוש קבוע" ו- "התחייבויות לזמן קצר".

החברה קבלה שומת מס זמנית משלטונות המס של מדינת ברזיליה לפיה היא נדרשת לשלם מס ערך מוסף בסך 2,001 אלפי דולר בגין ערך מוסף של שרותי טלקומוניקציה מסויימים. לדעת החברה, דרישה זו אינה בהתאם לחוק, והיא החלה תהליך הגנה כנגדה בבית המשפט. מאחר ונושא זה הינו עניין שבעקרון, יש לשער שדרישות דומות תגענה בעתיד גם משלטונות המס של מדינות אחרות. בדוח הכספי נכללה הפרשה בסך 311 אלפי דולר בגין תביעה זו ואילו לגבי היתרה בסך 1,690 אלפי דולר לא נכללה הפרשה כיון שההנהלה מאמינה כי האפשרות להפסד הינה קלושה.

באור 16 - התחייבויות תלויות והתקשרויות (המשך)

ב. ערבויות

החברה ערבה בסכום כולל של 394 אלפי דולר לגבי שכירות משרדים והטבות מס.

באור 17 - עסקאות ויתרות עם צדדים קשורים

להלן פירוט עסקאות ויתרות עם צדדים קשורים של הקבוצה בשנים 2003 ו-2002:

1. עסקאות עם צדדים קשורים מהוות שכר חברי דירקטוריון ודמי ניהול ששולמו לשני דירקטורים, בסכום כולל של 472 אלפי דולר ו- 600 אלפי דולר, בשנים 2003 ו- 2002, בהתאמה. סכומים אלה כלולים בסעיף "הוצאות הנהלה וכלליות".
2. לגבי עסקאות עם ספקים להם הוענקו כתבי אופציה לרכישת מניות ו/או המחזיקים באגרות חוב הניתנות להמרה במניות, ראה ביאורים 8 ו- 9 לעיל.
3. ראה ביאור 13 לגבי כתבי אופציה שהוענקו בהתאם לתכנית אופציות, לדירקטורים, עובדים וצדדים קשורים אחרים.

באור 18 - ארועים לאחר תאריך המאזן

בחודש ינואר 2004, חתמה החברה על מסמך עקרונות בלתי מחייב (להלן – "מסמך עקרונות") עם הנושים המובטחים שלה בכדי לשנות את התנאים ואת אמות המידה הפיננסיות בחוזי מימון ספקים שבתוקף כעת. המשא ומתן על הסכם מפורט טרם הושלם. עיקרי התנאים החדשים הם כדלקמן:

סכום הקרן והריבית שעל ג'.י.טי ברזיל לשלם עובר לתאריך השלמת ההסכם המפורט, יאורגן מחדש וישולם בתקופה שבין שנת 2005 ועד לשנת 2013. שיעורי הריבית ישתנו בין ליבור+1% ועד ליבור+9% בשנים המאוחרות יותר.

אמות מידה פיננסיות חדשות יחליפו את הקיימות, ואי עמידה באמות מידה מסויימות או בתשלומי הקרן והריבית במועד תגרור אחריה הנפקת כתבי אופציה לנושים המובטחים. בנוסף יונפקו בתאריך השלמת ההסכם המפורט, כתבי אופציה לנושים המובטחים.

לקבוצה נתונה הרשות לגייס מימון נוסף, אך גם אפשר יהיה לדרוש ממנה לפנות לשוקי הכספים לצורך גיוס הלוואות בתנאים מסויימים.

תסתיים התחייבותם של הנושים המובטחים לממן רכישת ציוד באשראי, ויוסכם על תנאים מסחריים חדשים.

בתאריך השלמת ההסכם המפורט, ההלוואה ההמירה של אי.סי.אי. תיפרע בחלקה ואילו חלק אחר יאורגן מחדש, כך שלאחר תאריך זה תבוטל ההלוואה ההמירה של אי.סי.אי.

בתאריך השלמת ההסכם המפורט יושבו כל המחלוקות המסחריות שבין ג'.י.טי ברזיל והספקים.

השפעת התנאים שפורטו לעיל תהיה סיווג מחדש של סכום של 121 מיליון דולר מהתחייבויות לזמן קצר להתחייבויות לזמן ארוך.

באור 19 - התאמה לכללי חשבונאות מקובלים בישראל

הדו"ח הכספי המאוחד של החברה נערך בהתאם לכללי חשבונאות מקובלים בארה"ב (US GAAP). אילו נערך הדו"ח הכספי המאוחד של החברה בהתאם לכללי חשבונאות מקובלים בישראל (ISRAELI GAAP) היתה ההשפעה על הדו"ח הכספי כדלקמן (באלפי דולר ארה"ב):

א. ההשפעה על דו"ח רווח והפסד לשנה שנסתיימה ביום 31 בדצמבר 2003:

Israeli GAAP	התאמות	US GAAP	
80,188	49,124	31,064	רווח נקי

ההשפעה על דו"ח רווח והפסד לשנה שנסתיימה ביום 31 בדצמבר 2002:

Israeli GAAP	התאמות	US GAAP	
(176,403)	75,744	(252,147)	הפסד

ההשפעה על דו"ח רווח והפסד לשנה שנסתיימה ביום 31 בדצמבר 2001:

Israeli GAAP	התאמות	*US GAAP	
(143,632)	2,580	(146,212)	הפסד

* כפי שהופיע בדוח הכספי המאוחד לשנת 2002.

ב. ההשפעה על המאזן:

ליום 31 בדצמבר 2003:

Israeli GAAP	התאמות	US GAAP	
538,309	82,538	455,771	סך הכל נכסים
(291,495)	126,542	(418,037)	עודפים
(257,246)	82,538	(339,784)	הון עצמי

ליום 31 בדצמבר 2002:

Israeli GAAP	התאמות	US GAAP	
438,541	40,745	397,796	סך הכל נכסים
(371,683)	77,418	(449,101)	עודפים
(317,477)	40,745	(358,222)	הון עצמי

באור 19 - התאמה לכללי חשבונאות מקובלים בישראל (המשך)

ב. ההשפעה על המאזן:

ליום 31 בדצמבר 2001:

Israeli GAAP	התאמות	*US GAAP	
496,716	4,862	491,854	סך הכל נכסים
(195,280)	1,674	(196,954)	עודפים
(120,141)	4,862	(125,003)	הון עצמי

* כפי שהופיע בדוח הכספי המאוחד לשנת 2002.

על פי כללי החשבונאות בישראל, כאשר שיעור האינפלציה עולה על 20% לשלוש שנים, יש לתאם את הדו"ח הכספי על פי השינויים בכח הקניה הכללי של המטבע המקומי. לפיכך, החברות בברזיל המהוות יחידות אוטונומיות תאמו את דוחותיהן הכספיים לאינפלציה בברזיל, בהתאם לגילוי דעת 36 של לשכת רואי חשבון בישראל והבהרה 8 המתייחסת אליו, על פי השינויים במדד המחירים לצרכן בברזיל. לפי כללי החשבונאות בארה"ב אין צורך בהתאמה זו.

לפי כללי החשבונאות בישראל, לאחר שנעשתה התאמה כנ"ל יש לתרגם את הדו"חות הכספיים מהמטבע המקומי לדולר של ארה"ב לפי שער החליפין בתאריך המאזן. לפי כללי החשבונאות בארה"ב יש לתרגם את הדו"חות הכספיים ללא התאמה לפי שערי חליפין ממוצעים, פרט למאזן המתורגם מהמטבע המקומי לדולר של ארה"ב לפי שער החליפין בתאריך המאזן.

Given Imaging Ltd.

**Consolidated Audited Financial Statements
As of December 31, 2003**

Given Imaging Ltd. and its Consolidated Subsidiaries

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Report of Independent Auditors to the Board of Directors and Shareholders of Given Imaging Ltd.

We have audited the accompanying consolidated balance sheets of Given Imaging Ltd. and its subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's Board of Directors and of its management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurances about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2003 and 2002, and the consolidated results of its operations, changes in shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Somekh Chaikin
Certified Public Accountants (Israel)
A member of KPMG International

February 10, 2004

Given Imaging Ltd. and its Consolidated Subsidiaries

Consolidated Balance Sheets
(In thousands except per share data)

	<u>Note</u>	<u>December 31</u>	
		<u>2002</u>	<u>2003</u>
Assets			
Current assets			
Cash and cash equivalents	1D; 2	\$ 35,792	\$ 25,367
Accounts receivable:			
Trade		6,865	6,945
Other	3	1,485	467
Inventories	1F; 4	10,659	8,485
Prepaid expenses	1G	<u>1,258</u>	<u>1,361</u>
Total current assets		56,059	42,625
Deposits		192	361
Assets held for severance benefits	1H; 9	674	1,008
Fixed assets, at cost, less accumulated depreciation	1I; 5	9,967	9,595
Other assets, at cost, less accumulated amortization	1J; 6	<u>1,836</u>	<u>1,980</u>
Total Assets		<u>\$ 68,728</u>	<u>\$ 55,569</u>

President and CEO

Vice President and CFO

February 10, 2004

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

Given Imaging Ltd. and its Consolidated Subsidiaries

Consolidated Balance Sheets
(In thousands except per share data)

	Note	December 31	
		2002	2003
Liabilities and shareholders' equity			
Current liabilities			
Current installments of obligation under capital lease	7B	\$ 56	\$ 27
Accounts payable:			
Trade		4,990	2,216
Other	8	6,279	4,462
Related parties		35	-
Deferred revenue	10	727	950
Total current liabilities		12,087	7,655
Long-term liabilities			
Obligation under capital lease, net	7B	47	4
Liability for employee severance benefits	9	835	1,188
Total long-term liabilities		882	1,192
Total liabilities		12,969	8,847
Commitments and contingencies	7		
Minority interest		2,182	1,924
Shareholders' equity			
Share capital:	11		
Ordinary Shares, NIS 0.05 par value each (60,000,000 shares authorized; 25,373,513 and 25,649,188 shares issued and fully paid at December 31, 2002 and 2003, respectively)		298	301
Additional paid-in capital		100,262	100,996
Capital reserve		2,166	2,166
Unearned compensation		(123)	(30)
Accumulated deficit		(49,026)	(58,635)
Total shareholders' equity		53,577	44,798
Total liabilities and shareholders' equity		\$ 68,728	\$ 55,569

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

Given Imaging Ltd. and its Consolidated Subsidiaries

Consolidated Statements Of Operations
(In thousands except per share data)

	Note	Year ended December 31,		
		2001	2002	2003
Revenues	1O; 12	\$ 4,733	\$ 28,904	\$ 40,539
Cost of revenues		2,476	11,907	13,551
Gross profit		2,257	16,997	26,988
Operating expenses				
Research and development, gross	1R	(6,156)	(8,609)	(7,037)
Royalty bearing participation	1P	44	-	1,303
Research and development, net		(6,112)	(8,609)	(5,734)
Sales and marketing		(12,902)	(22,681)	(26,804)
General and administrative		(2,664)	(4,749)	(5,312)
Total operating expenses		(21,678)	(36,039)	(37,850)
Operating loss		(19,421)	(19,042)	(10,862)
Financing income, net		764	1,469	995
Other expenses, net		-	(711)	-
Loss before taxes on income		(18,657)	(18,284)	(9,867)
Taxes on income	1Q; 13	-	-	-
Loss before minority share		(18,657)	(18,284)	(9,867)
Minority share in losses (profits) of subsidiary		-	(26)	258
Net loss		<u>\$ (18,657)</u>	<u>\$ (18,310)</u>	<u>\$ (9,609)</u>
Loss per share				
Basic and diluted loss per ordinary share	1L; 10	<u>\$ (1.60)</u>	<u>\$ (0.73)</u>	<u>\$ (0.38)</u>
Weighted average number of Ordinary Shares outstanding used in basic and diluted loss per Ordinary Share calculation	1L 10	<u>12,879,369</u>	<u>25,182,563</u>	<u>25,493,073</u>

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

Given Imaging Ltd. and its Consolidated Subsidiaries

Consolidated Statements Of Changes In Shareholders' Equity
(In thousands except per share data)

	Series A Preferred Shares		Ordinary shares		Additional Paid-In Capital	Capital Reserve	Unearned Compensation	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount					
Balance as at January 1, 2001	9,115,925	\$ 107	8,804,188	\$ 103	\$ 35,384	\$ -	\$ (460)	\$ (12,059)	\$ 23,075
Changes during the year 2001:									
Conversion of preferred shares into Ordinary Shares	(9,115,925)	(107)	9,115,925	107	-	-	-	-	-
Ordinary shares issued	-	-	7,184,800	86	64,101	-	-	-	64,187
Allocation of employees' stock options	-	-	-	-	251	-	(251)	-	-
Allocation of non-employees' stock options	-	-	-	-	367	-	-	-	367
Amortization of unearned compensation	-	-	-	-	-	-	361	-	361
Net loss	-	-	-	-	-	-	-	(18,657)	(18,657)
Balance as of December 31, 2001	-	\$ -	25,104,913	\$ 296	\$ 100,103	\$ -	\$ (350)	\$ (30,716)	\$ 69,333
Changes during the year 2002:									
Exercise of stock options	-	-	268,600	2	159	-	-	-	161
Amortization of unearned compensation	-	-	-	-	-	-	227	-	227
Capital reserve from issuance of shares in a newly formed subsidiary	-	-	-	-	-	2,166	-	-	2,166
Net loss	-	-	-	-	-	-	-	(18,310)	(18,310)
Balance as of December 31, 2002	-	\$ -	25,373,513	\$ 298	\$ 100,262	\$ 2,166	\$ (123)	\$ (49,026)	\$ 53,577
Changes during the year 2003:									
Exercise of stock options	-	-	275,675	3	722	-	-	-	725
Forfeiture of stock options	-	-	-	-	(78)	-	78	-	-
Acceleration of vesting	-	-	-	-	31	-	-	-	31
Allocation of non-employees' stock options	-	-	-	-	59	-	-	-	59
Amortization of unearned compensation	-	-	-	-	-	-	15	-	15
Net loss	-	-	-	-	-	-	-	(9,609)	(9,609)
Balance as of December 31, 2003	-	\$ -	25,649,188	\$ 301	\$ 100,996	\$ 2,166	\$ (30)	\$ (58,635)	\$ 44,798

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

Given Imaging Ltd. and its Consolidated Subsidiaries

Consolidated Statements Of Cash Flows
(In thousands)

	Year ended December 31,		
	2001	2002	2003
Cash flows from operating activities:			
Net loss	\$ (18,657)	\$ (18,310)	\$ (9,609)
Adjustments required to reconcile net loss to net cash used in operating activities:			
Minority share in profits (losses) of subsidiary	-	26	(258)
Depreciation and amortization	1,074	2,176	3,030
Employees' stock option compensation	361	227	46
Non-employees' stock option compensation	367	-	59
Other	41	97	9
Increase in accounts receivable - trade	(2,470)	(4,395)	(80)
Decrease (increase) in other accounts receivable	(534)	(633)	1,018
Increase in prepaid expenses	(984)	(109)	(103)
Decrease in advances to suppliers	259	-	-
Decrease (increase) in inventories	(2,638)	(7,402)	1,860
Increase (decrease) in accounts payable	3,775	5,537	(4,708)
Increase in deferred revenue	193	534	223
Increase (decrease) in payable to related parties	15	19	(35)
Net cash used in operating activities	\$ (19,198)	\$ (22,233)	\$ (8,548)
Cash flows from investing activities:			
Purchase of fixed assets and other assets	\$ (4,955)	\$ (7,472)	\$ (2,550)
Proceeds from sales of fixed assets	7	-	60
Deposits, net	(57)	(88)	(157)
Net cash used in investing activities	\$ (5,005)	\$ (7,560)	\$ (2,647)
Cash flows from financing activities:			
Principal payments on capital lease obligation	\$ (56)	\$ (64)	\$ (72)
Proceeds from the issuance of Ordinary Shares	64,187	161	725
Proceeds from issuance of shares by consolidated company	-	4,322	-
Net cash provided by financing activities	\$ 64,131	\$ 4,419	\$ 653
Effect of exchange rate changes on cash	\$ (58)	\$ (64)	\$ 117
Increase (decrease) in cash and cash equivalents	\$ 39,870	\$ (25,438)	\$ (10,425)
Cash and cash equivalents at beginning of year	21,360	61,230	35,792
Cash and cash equivalents at end of year	\$ 61,230	\$ 35,792	\$ 25,367
Supplementary cash flow information			
	Year ended December 31,		
	2001	2002	2003
Interest paid	\$ 12	\$ 7	\$ 3
Income taxes paid	\$ 75	\$ 79	\$ 68

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

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements (In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies

A. General

Given Imaging Ltd. (the "Company") was incorporated in Israel in January 1998. The Company has generated revenues from sales of its products commencing the third quarter of 2001. Due in large part to the significant expenditures required to develop and market its product, the Company has generated losses each year since its inception.

The Company has developed the Given System, a proprietary wireless imaging system that represents a new approach to visual examination of the gastrointestinal tract. The system uses a miniaturized video camera contained in a capsule that is ingested by the patient and delivers high quality color images in a painless and noninvasive manner.

The Given System consists of three principal components:

- a single-use, disposable M2A color-imaging capsule that is ingested by the patient;
- a portable data recorder and array of sensors that are worn by the patient; and
- a computer workstation with a proprietary RAPID software for downloading, processing and analyzing recorded data.

The Company has designed the Given System to be administered on an outpatient basis. After the patient swallows the M2A capsule, the capsule moves naturally through the digestive system without causing discomfort. During a typical seven-hour test the M2A capsule transmits 50,000 images to the portable data recorder while the patient continues normal daily activities. After the patient returns the data recorder to the physician at his or her convenience, the Company's proprietary RAPID software processes the images into a high quality video stream that a physician can review in about one hour.

On August 1, 2001, the U.S. Food and Drug Administration (the "FDA") cleared the marketing in the United States of the Company's swallowable video capsule.

The novel medical device industry in which the Company is involved is characterized by the risks of regulatory barriers and reimbursement issues. Penetration into the world market requires the investment of considerable resources and continuous development efforts. The Company's future success is dependent upon several factors including the technological quality, regulatory approvals and sufficient reimbursement for its products.

B. Basis of presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries in the USA, Germany, France, the Netherlands and Australia and its 51% owned subsidiary in Japan. The accounts of its subsidiaries are consolidated from the date of their inception. All significant intercompany balances and transactions have been eliminated in consolidation.

All the subsidiaries were established for the purpose of marketing and selling the Given System.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies (cont'd)

C. Functional and reporting currency

The accounting records of the Company are maintained in New Israeli Shekels ("NIS") and U.S. dollars. The Company's functional and reporting currency is the U.S. dollar.

Transactions denominated in foreign currencies other than the U.S. dollar are translated into the reporting currency using current exchange rates. Gains and losses from the translation of foreign currency balances are recorded in the statement of operations.

The Company currently has no plans to pay dividends and has not determined the currency in which any dividends would be paid.

D. Cash and cash equivalents

All highly-liquid investments with original maturity of three months or less from the date of deposit are considered to be cash equivalents.

E. Provision for doubtful debts

The provision for doubtful debts is calculated on the basis of specific identification of balances, the collection of which, in management's opinion, is doubtful. In determining the adequacy of the provision, management bases its opinion, inter alia, on the estimated risk, in reliance on available information with respect to the debtor's financial position and an evaluation of the collateral received.

F. Inventories

Inventories are stated at lower of cost or market. Cost is determined using the average cost method for raw materials and finished goods, and on the basis of actual manufacturing costs for work in progress and sub-contractors.

G. Prepaid expenses

Prepaid expenses are amortized using the straight-line method over the period during which such costs are recovered.

H. Assets held for severance benefits

Assets held for employee severance benefits represent contributions to severance pay funds and cash surrender life insurance policies that are recorded at their current redemption value.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies (cont'd)

I. Fixed assets

Fixed assets are stated at cost. Depreciation is computed by the straight-line method over the estimated useful lives of the assets at the following annual rates:

	<u>%</u>
Office furniture, leasehold improvements, laboratory equipment and other equipment	6 - 15
Computers, software and related equipment	20 - 33
Machinery and equipment	15
Motor vehicles	15

Motor vehicles purchased under capital lease arrangements are recorded at the present value of the minimum lease payments. Such assets and leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset.

J. Other assets

1. The Company develops proprietary software for its computer workstations that permits downloading and viewing recorded data from the portable data recorder. The costs of developing this software are capitalized in accordance with Statement of Financial Accounting Standards No. 86, "Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed" ("Statement 86"). As such, capitalization of software development costs begins upon the establishment of technological feasibility as defined in Statement 86 and continues up to the time the software is available for general release to customers, at which time capitalized software costs are amortized on a straight-line basis over the expected life of the related product which is generally three years.
2. Legal expenses related to patent and trademark registration have been capitalized and depreciated over the remaining life of the asset, which is generally eight years.
3. Technology and content costs are generally expensed as incurred, except for certain costs relating to the development of the Company's web site that are capitalized and depreciated over their estimated useful lives which are generally three years.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies (cont'd)

K. Stock compensation plans

Employees

The Company has adopted Financial Accounting Standards Board's Statement No. 123, "Accounting for Stock-Based Compensation" ("Statement 123") which permits entities to recognize as an expense over the vesting period, the fair value on the date of grant of all stock-based awards. Alternatively, Statement 123 allows entities to continue to apply the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees and related interpretations" ("APB Opinion No. 25") and provide pro forma net income and pro forma earnings per share disclosures for employee stock option grants as if the fair-value based method defined in Statement 123 had been applied. The Company has elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure provisions of Statement 123, as amended by SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of Statement No. 123" ("Statement 148").

The Company applies the intrinsic value-based method prescribed in APB Opinion No. 25 for its stock compensation to employees and directors. As such, the Company computes and records compensation expense for grants whose terms are fixed with respect to the number of shares and option price only if the market price on the date of grant exceeds the exercise price of the stock option. The compensation cost for the fixed plans is recorded over the period the employee performs the service to which the stock compensation relates.

Non-Employees

The Company applies the fair value-based method of accounting set forth in Statement 123 to account for stock based compensation to non-employees. Using the fair value method, the total compensation expense is computed based on the fair value of the options on the date the options are granted to the non-employees since the options are fully vested.

The following table shows the effect on net loss and loss per Ordinary Share if the Company had applied the fair value recognition provisions of Statement 123:

	Year ended December 31,		
	2001	2002	2003
Net loss as reported	\$ (18,657)	\$ (18,310)	\$ (9,609)
Deduct: Compensation expenses according to APB 25 included in the reported net loss	728	227	105
Add: Application of compensation expenses according to Statement 123	(1,198)	(4,324)	(7,012)
Pro forma net loss	<u>\$ (19,127)</u>	<u>\$ (22,407)</u>	<u>\$ (16,516)</u>
Basic and diluted loss per Ordinary Share:			
As reported	<u>\$ (1.60)</u>	<u>\$ (0.73)</u>	<u>\$ (0.38)</u>
Pro forma	<u>\$ (1.63)</u>	<u>\$ (0.89)</u>	<u>\$ (0.65)</u>

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies (cont'd)

L. Loss per Ordinary Share

Basic and diluted loss per Ordinary Share is presented in conformity with Statement of Financial Accounting Standard No. 128, "Earnings Per Share", for all years presented. Basic loss per Ordinary Share is calculated by dividing the net loss attributable to Ordinary Shares, by the weighted average number of Ordinary Shares outstanding. All the outstanding options have an anti-dilutive influence since the Company incurred losses since inception.

M. Use of estimates

Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Actual results could differ from these estimates.

N. Impairment of long-lived assets and certain intangibles

The Company accounts for long-lived assets and certain intangible assets in accordance with the provisions of Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment of or Disposal of Long-Lived Assets" ("Statement 144").

This Statement requires that long-lived assets and certain identifiable intangibles assets be reviewed for impairment 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 undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

The adoption of Statement 144 had no impact on the Company's financial position or results of operations.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies (cont'd)

O. Revenue recognition

The Company derives principally all of its revenues from sales of its gastrointestinal diagnostic system (Given System). The Given System consists principally of the disposable M2A color-imaging capsule, a portable data recorder with an array of sensors and a computer workstation equipped with the Company's proprietary RAPID software.

Revenues from sales of products are recognized in accordance with Staff Accounting Bulletin No. 101 "Revenue Recognition in Financial Statements" ("SAB No. 101"), that was amended in Staff Accounting Bulletin No. 104, upon delivery provided that the collection of the resulting receivable is probable, there is persuasive evidence of an arrangement, no significant obligations in respect of installation remain and the price is fixed or determinable.

For sale contracts which include a Post Contract Customer Support ("PCS") component, revenues from PCS are deferred and recognized ratably over the term of the support period, which is generally one year, according to EITF 00-21 "Revenue Arrangements with Multiple Deliverables".

The Company accrues estimated warranty costs at time of shipment based on contractual rights and historical experience. The Company's policy is not to grant return rights.

P. Government-Sponsored Research and Development

The Company records grants received from the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade (the "OCS") as a deduction of research and development expenses. Royalties payable to OCS are classified as cost of revenue.

Q. Income taxes

The Company accounts for income taxes under Statement of Financial Accounting Standards No. 109 "Accounting for Income Taxes" ("Statement 109").

Under Statement 109 deferred tax assets or liabilities are recognized in respect of temporary differences between the tax bases of assets and liabilities and their financial reporting amounts as well as in respect of tax losses and other deductions which may be deductible for tax purposes in future years, based on enacted statutory tax rates applicable to the periods in which such deferred taxes will be realized. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

R. Research and development costs

Research and development costs are expensed as incurred.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 1 - Organization and Summary of Significant Accounting Policies (cont'd)

S. Concentration of credit risk

Financial instruments that may subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents and trade accounts receivable.

Cash and cash equivalents are deposited with major financial institutions in Europe, the United States, Japan and Israel.

The Company performs ongoing credit evaluations of the financial condition of its customers. The risk of collection associated with trade receivables is reduced by the large number and geographical dispersion of the Company's customer base and the Company's policy of requiring collateral or security on sales to distributors.

T. Recent accounting pronouncements

The Company examined the recently issued accounting standards SFAS No. 149, SFAS No. 150, and FIN 46 and believes that the adoption of these standards will not have a significant impact on the Company's financial position or results of operations.

Note 2 - Cash and Cash Equivalents

	December 31	
	2002	2003
Denominated in U.S. dollars	\$ 29,807	\$ 17,364
Denominated in New Israeli Shekels	575	2,413
Denominated in Euro	772	1,321
Denominated in Australian dollars	147	485
Denominated in Japanese Yen	4,491	3,784
	<u>\$ 35,792</u>	<u>\$ 25,367</u>

Cash equivalents in Israeli currency include bank deposits bearing annual interest rates of 5% unlinked to the Israeli CPI. Cash equivalents in U.S. dollars include bank deposits bearing annual interest rates of 1%. Cash equivalents in Euros include bank deposits bearing annual interest rates of 1.5%. The original maturities of these cash equivalents did not exceed three months.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 3 - Accounts Receivable - Other

	December 31	
	2002	2003
Government institutions	\$ 1,192	\$ 443
Related party	206	-
Other	87	24
	<u>\$ 1,485</u>	<u>\$ 467</u>

Note 4 - Inventories

	December 31	
	2002	2003
Raw materials and components	\$ 3,838	\$ 4,248
Work in progress	2,342	1,011
Finished goods	4,479	3,226
	<u>\$ 10,659</u>	<u>\$ 8,485</u>

Note 5 - Fixed Assets, at Cost, Less Accumulated Depreciation

	December 31	
	2002	2003
Computers and software	\$ 3,352	\$ 3,648
Instruments and laboratory equipment	450	543
Leasehold improvements	1,069	1,120
Motor vehicles	267	144
Machinery and equipment	6,767	8,351
Communication equipment	296	328
Office furniture and equipment	756	813
	<u>12,957</u>	<u>14,947</u>
Fixed assets	12,957	14,947
Accumulated depreciation	(2,990)	(5,352)
	<u>\$ 9,967</u>	<u>\$ 9,595</u>

Depreciation expense for the years ended December 31, 2001, 2002 and 2003 are \$859, \$1,757 and \$ 2,475, respectively.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 6 - Other Assets, at Cost, Less Accumulated Amortization

	December 31	
	2002	2003
Software development costs	\$ 647	\$ 647
Patents and trademarks	1,242	1,714
Web site application and infrastructure	596	823
Other assets	2,485	3,184
Accumulated amortization	(649)	(1,204)
Other assets, net	\$ 1,836	\$ 1,980

Amortization expense for the years ended December 31, 2001, 2002 and 2003 are \$203, \$419 and \$ 555, respectively.

Note 7 - Commitments and Contingencies

A. Office of the Chief Scientist Grants

The Company's research and development efforts have been partially financed through grants from the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade (the "OCS"). In return for the OCS's participation, the Company is committed to pay royalties to the Israeli Government at a rate of 3% of the sales of its product, up to 100% of the amount of the grants received. The grants are deducted from research and development expenses. Grants received in advance of the corresponding expenditures incurred are recorded as a liability. The Company is entitled to the grants only upon incurring research and development expenditures. The Company is not obligated to repay any amount received from OCS if the research effort is unsuccessful or if no products are sold. There are no future performance obligations related to the grants received from the OCS. However, under certain limited circumstances, the OCS may withdraw its approval of a research program or amend the terms of its approval. Upon withdrawal of approval, the grant recipient may be required to refund the grant, in whole or in part, with or without interest, as the OCS determines. The Company received from the OCS office a total cumulative amount of \$2,500 of which it already repaid \$1,197. The total outstanding obligation for royalties, based on royalty-bearing government participation totaled approximately \$1,303 as of December 31, 2003. Royalties payable to the OCS are classified in cost of revenues.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 7 - Commitments and Contingencies (cont'd)

B. Leases

Capital leases for motor vehicles

The capital leases are to be repaid in five years and bear interest of LIBOR+ 1.35%. The vehicles are pledged as collateral.

Operating leases

The Company and its subsidiaries lease office space and manufacturing space for periods of up to ten years (including options to extend the lease terms). The Company and its subsidiaries furnished the lessors with bank guarantees - a total amount of \$ 531.

The Company and its subsidiaries signed several motor vehicles lease agreements. The companies deposited a total amount of \$ 177 to guarantee their performance under the terms of the lease agreements.

Future minimum capital lease payments and future minimum operating lease payments:

	December 31, 2003	
	Capital leases	Operating leases
2004	\$ 27	\$ 1,731
2005	4	1,449
2006	-	655
2007	-	142
2008 and thereafter	-	123
	<u>\$ 31</u>	<u>\$ 4,100</u>

Office and manufacturing rental expense under the lease agreements for the years ended December 31, 2001, 2002 and 2003 are \$516, \$950 and \$ 1,140, respectively.

C. Agreements with Pemstar Inc.

During 2002, the Company entered into a one year non-exclusive technical services agreement with Pemstar Inc., a U.S. electronics manufacturing service and equipment company (Pemstar), pursuant to which Pemstar will provide the Company with technical services relating to the manufacture of the M2A capsule and purchasing the components necessary for producing the M2A capsule, either through the Company or directly from the suppliers.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 7 - Commitments and Contingencies (cont'd)

C. Agreements with Pemstar Inc. (cont'd)

Pemstar built for the Company two semi-automated production lines. One is fully operated in the Company's facilities in Yoqneam and one serves as a back-up production line being stored outside of Israel and ready for operation on sixty days notice.

In consideration of providing these services to the Company, the Company pays Pemstar a monthly fixed amount for each functional M2A capsule that is delivered to the Company. This amount will decrease as the volume of M2A capsules produced increase.

D. Legal claims

1. On November 25, 2002, the Company filed a lawsuit and motion for preliminary injunction against a former employee, a company which he founded and a wholly-owned subsidiary thereof for which he is now working (together, the "Defendants") relating to certain patent applications filed by the former employee seeking a declaratory judgment that the above patent application are the sole property of the Company. The Defendants filed a defense and counterclaim against the Company and its CEO for abuse of legal proceedings and acting in bad-faith, damaging the Defendant's reputation and unfairly interfering with the Defendant's business.

On January 25, 2003, directors of the Company received correspondence from certain investors in the Defendants claiming that the directors are liable for the Company's conduct with respect to the lawsuit against the Defendants, and demanding that the Company withdraw its lawsuit.

The Company believes that its complaint against the Defendants has merit and that it should prevail, and accordingly, both the counterclaim and the correspondence received by the members of the Company's Board of Directors are both without merit and the Company intends to vigorously defend against them.

2. On November 14, 2002, the Company received correspondence from a U.S. Corporation proposing to grant the Company a license under reasonable terms for a U.S. patent for the technology utilized by the Company in its disposable imaging capsule. The Company believes that such a license is not warranted, however, several further letters have been exchanged between the parties and the Company is in communication with the U.S. Corporation to amicably resolve this matter.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 7 - Commitments and Contingencies (cont'd)

D. Legal claims (cont'd)

3. On December 30, 2003, a Japanese corporation filed a request for ex parte reexamination (hereinafter - "Reexamination Request") of some claims in one of the Company's U.S. patents (hereinafter - the "Patent") in the United States Patent and Trademark Office (hereinafter - the "USPTO"). The USPTO will decide by late March or early April 2004, whether or not to conduct the reexamination pursuant to the request.
The Company is not accused of infringing a third party's patent and its ability to sell its products is not contested.

Note 8 - Accounts Payable - Other

	<u>December 31</u>	
	<u>2002</u>	<u>2003</u>
Government institutions	\$ 559	\$ 439
Liabilities to employees	2,933	2,078
Advances from customers	214	40
Warranty	95	68
Chief Scientist Royalties	490	-
Commissions	346	884
Accrued expenses	1,642	953
	<u>\$ 6,279</u>	<u>\$ 4,462</u>

Note 9 - Liability in Respect of Employee Severance Benefits

Under Israeli law and labor agreements the Company is required to pay severance benefits to its dismissed employees and employees leaving its employment under certain circumstances. The Company's liability for severance benefits is covered mainly by deposits with insurance companies in the name of the employee and/or by purchase of insurance policies. The liability is calculated on the basis of the latest salary of the employee multiplied by the number of years of employment as of the balance sheet date. The provision for employee severance benefits included in the balance sheet represents the total liability for such severance benefits, while the assets held for severance benefits included in the balance sheet represents the Company's contributions to severance pay funds and to insurance policies. The Company may make withdrawals from the funds only upon complying with the Israeli severance pay law or labor agreements.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 9 - Liability in Respect of Employee Severance Benefits (cont'd)

The U.S. subsidiary has a defined contribution retirement plan for its employees. Employees are allowed to contribute a percentage of their salary in any one year, subject to a regulatory limit. The Company makes matching contributions of up to 3% of an employee's salary. Employees are immediately vested in the Company's contributions.

Expenses recorded in respect of severance pay for the years ended December 31, 2001, 2002 and 2003 are \$339 \$418, and \$ 489, respectively.

Note 10 - Loss Per Ordinary Share

The following table summarizes information related to the computation of basic and diluted loss per Ordinary Share for the years indicated.

	Year ended December 31,		
	2001	2002	2003
Net loss	\$ (18,657)	\$ (18,310)	\$ (9,609)
Interest accrued on Preferred Shares	(1,888)	-	-
Net loss attributable to Ordinary Shares	<u>\$ (20,545)</u>	<u>\$ (18,310)</u>	<u>\$ (9,609)</u>
Weighted average number of Ordinary Shares outstanding used in basic loss per Ordinary Share calculation	12,879,369	25,182,563	25,493,073
Add assumed exercise of outstanding dilutive potential Ordinary Shares	-	-	-
Weighted average number of Ordinary Shares outstanding used in diluted loss per Ordinary Share calculation	<u>12,879,369</u>	<u>25,182,563</u>	<u>25,493,073</u>
Basic loss per Ordinary Share	<u>\$ (1.60)</u>	<u>\$ (0.73)</u>	<u>\$ (0.38)</u>
Diluted loss per Ordinary Share	<u>\$ (1.60)</u>	<u>\$ (0.73)</u>	<u>\$ (0.38)</u>

The Company had 3,881,396 options outstanding as of December 31, 2003 that could potentially dilute basic loss per ordinary share in future periods but which were not included in diluted loss per Ordinary Share because their effect on the periods presented was antidilutive.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 11 - Share Capital

A. Ordinary shares

All of the issued and outstanding Ordinary Shares of the Company are duly authorized, validly issued, fully paid and non-assessable. The Ordinary Shares of the Company are not redeemable and have no preemptive rights. The ownership or voting of Ordinary Shares by non-residents of Israel is not restricted in any way by the Company's memorandum of association, its articles of association or the laws of the State of Israel, except that citizens of countries which are, or have been, in a state of war with Israel may not be recognized as owners of Ordinary Shares.

B. Employees' and non employees' stock options

In 1998, the Company adopted a stock option plan for employees and consultants involving up to 10% of the Company's share capital. Each option entitles the holder to purchase one Ordinary A Share (as of the IPO date - one Ordinary Share) of par value of NIS 0.05. The options vest over a period of four years and are exercisable for a period of ten years from the date of grant. The options are held in trust on behalf of the Israeli employees, in accordance with Section 102 of the Income Tax Ordinance in Israel and related regulations.

In 2000, the Company adopted the 2000 Stock Option Plan ("2000 Plan"), and in 2003, the Company adopted another Option Plan ("2003 Plan"). Under the 2000 Plan and the 2003 Plan, the Board of Directors (or a compensation committee appointed and upheld by the board) (the "Board") has the authority to grant options to employees of the Company and its subsidiaries, directors or consultants.

The purchase price of each share pursuant to the options granted under the 2003 Plan shall be the fair market value on the date the Board approves the grant of the option or as otherwise determined by the Board.

As of December 31, 2003, 4,303,788 Ordinary Shares of the Company, of a par value of NIS 0.05 each, are reserved for the exercise of options granted under the Plans.

According to the 2003 Plan, 25% of the options of an optionee, who received options under this option plan and who had already received options for the purchase of shares from the Company in the past, will vest and be exercisable as of the date of grant. Upon each of the first, second and third anniversaries of the date of grant and at any time thereafter, an additional 25% of the options shall vest.

Unless otherwise prescribed by the Board, an option is not exercisable before the second anniversary of the date of grant. As of the second anniversary of the date of grant and at any time thereafter, the option vests with respect to 50% of the option shares, and after the third and fourth anniversaries of the date of grant with respect to 25% of the option shares, respectively. The Board has the exclusive authority to accelerate the periods for exercising an option. However, no option is exercisable after the passing of ten years from the date of grant.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 11 - Share Capital (cont'd)

B. Employees' and non employees' stock options (cont'd)

Options granted to Israeli optionees are designated as Section 102 options or Section 3(i) options within the meaning of the Israeli Income Tax Ordinance and related regulations.
(See Note 13A(4)(b) regarding the Israel Tax Reform).

Options granted to non-Israeli optionees may or may not contain such terms as will qualify such options as Incentive Stock Options ("ISOs") within the meaning of Section 422(b) of the United States Internal Revenue Code of 1986, as amended (the "Code"). Options that do not contain terms that will qualify them as ISOs are referred to herein as Non-Qualified Stock Options. Each option agreement is required to state whether such option will or will not be treated as an ISO. No ISO is granted unless such option, when granted, qualifies as an "incentive stock option" under Section 422 of the Code.

Compensation expense related to options issued has been calculated based on the difference between the market price of the underlying shares and the option's exercise price. Prior to the IPO date (October 4, 2001), the market price of the underlying shares was estimated on the basis of the price that was paid by various third parties, as well as increases in value attributable to the achievement of milestones in the Company's business plan. The share price paid by third parties has been adjusted upwards between the dates of the various private offerings. Following the IPO date (October 4, 2001), the market price represents the underlying listed price on the Nasdaq National Market.

The Company applies APB Opinion No. 25 and recorded compensation expense of \$ 361, \$227 and \$ 46 in the years ended December 31, 2001, 2002 and 2003, respectively, according to the intrinsic value of the above options.

The Company applies Statement 123 in respect of options granted to consultants and recorded compensation expense of \$367, \$0 and \$ 59 in the years ended December 31, 2001, 2002 and 2003, respectively, related to the above options according to the Black-Scholes model.

The Company applies APB Opinion No. 25 and related interpretations in accounting for its stock compensation programs benefiting employees and directors.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 11 - Share Capital (cont'd)

B. Employees' and non employees' stock options (cont'd)

The following table illustrates the effect on net loss and loss per Ordinary Share if the Company had applied the fair value recognition provisions of Statement 123:

	Year ended December 31,		
	2001	2002	2003
Net loss as reported	\$ (18,657)	\$ (18,310)	\$ (9,609)
Deduct: Compensation expenses according to APB 25 included in the reported net loss	728	227	105
Add: Application of compensation expenses according to Statement 123	(1,198)	(4,324)	(7,012)
Pro forma net loss	\$ (19,127)	\$ (22,407)	\$ (16,516)
Basic and diluted loss per Ordinary Share:			
As reported	\$ (1.60)	\$ (0.73)	\$ (0.38)
Pro forma	\$ (1.63)	\$ (0.89)	\$ (0.65)

The fair value of each option granted is estimated on the date of grant, using the Black-Scholes model using the following assumptions:

1. Dividend yield of zero percent.
2. Risk-free interest rate of 2.00%, 2.00% and 1.50% for December 31, 2001, 2002 and 2003, respectively, which represents the risk free interest rates to dollar-linked financial instruments as published by the Israeli Stock Exchange.
3. Estimated expected lives of seven years as of the date of grant.
4. Expected average volatility of 55%, 100% and 81%, for December 31, 2001, 2002 and 2003, respectively which represents a weighted average standard deviation rate for the price of the Company's Ordinary Shares in the Nasdaq National Market.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 11 - Share Capital (cont'd)

B. Employees' and non employees' stock options (cont'd)

The following table summarizes information relating to stock options for Ordinary Shares outstanding as of the years indicated:

Exercise price	Number outstanding at December 31, 2003	Options outstanding Weighted average remaining contractual life (in years)	Options exercisable Number exercisable at December 31, 2003
NIS 0.05	403,036	4.8	403,036
\$1.00	33,000	5.1	33,000
\$1.250	12,000	6.8	12,000
\$1.268	139,350	5.9	133,350
\$2.628	282,375	6.5	241,782
\$3.505	563,732	6.8	434,999
\$4.667	189,270	7.3	95,010
\$8.030	40,000	9.2	-
\$8.180	53,000	9.4	500
\$8.700	32,000	8.7	-
\$8.860	321,625	9.1	76,250
\$9.260	21,000	9.0	21,000
\$11.00	32,000	9.7	-
\$11.70	84,900	7.6	54,600
\$12.00	475,000	8.2	187,500
\$12.15	336,800	8.5	37,800
\$12.35	4,500	9.7	3,750
\$12.45	15,000	8.2	-
\$12.60	2,500	9.8	2,500
\$12.68	100,000	9.5	25,000
\$12.95	10,000	8.1	-
\$13.00	26,808	8.1	5,308
\$13.09	8,000	9.6	-
\$13.85	41,500	8.3	-
\$14.30	2,000	7.9	1,000
\$16.40	2,000	7.9	1,000
\$17.76	650,000	9.9	68,750
	3,881,396		1,838,135

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 11 - Share Capital (cont'd)

B. Employees' and non employees' stock options (cont'd)

The option allotments are as follows:

	<u>Number of shares</u>	<u>Weighted average exercise price</u>	<u>Weighted average grant date fair value</u>
Balance at January 1, 2001	1,968,543		
Granted	721,140	9.16	9.57
Forfeited	(40,020)	2.77	3.46
Balance at December 31, 2001	<u>2,649,663</u>		
Granted	679,000	12.06	11.60
Forfeited	(82,600)	9.02	9.42
Exercised	(268,600)	0.60	1.91
Balance at December 31, 2002	<u>2,977,463</u>		
Granted	1,331,500	13.78	13.61
Forfeited	(151,892)	9.08	8.92
Exercised	(275,675)	2.63	3.34
Balance at December 31, 2003	<u><u>3,881,396</u></u>		

The following summarizes the departmental allocation of the stock-based compensation charge:

	<u>Year ended December 31,</u>		
	<u>2001</u>	<u>2002</u>	<u>2003</u>
Research and development costs	\$ 463	\$ 73	\$ (18)
Selling and marketing expenses	165	77	94
General and administrative expenses	100	77	29
	<u><u>\$ 728</u></u>	<u><u>\$ 227</u></u>	<u><u>\$ 105</u></u>

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 12 - Revenues

A. Revenues by activities

	Year ended December 31,		
	2001	2002	2003
Workstations and recorders	\$ 3,325	\$ 17,230	\$ 15,879
M2A capsule	1,362	10,889	22,865
Patency capsules and scanners	-	-	15
Service	46	785	1,780
	\$ 4,733	\$ 28,904	\$ 40,539

B. Revenues by geographic areas

	Year ended December 31,		
	2001	2002	2003
United States	\$ 2,252	\$ 15,648	\$ 26,162
Europe	1,972	8,334	11,838
Rest of the world	509	4,922	2,539
	\$ 4,733	\$ 28,904	\$ 40,539

Note 13 - Taxes on Income

A. Company

- (1) Israeli income tax is computed on the basis of the Company's results in nominal NIS determined for statutory purposes. The Company is assessed for tax purposes under the Income Tax Law (Inflationary Adjustments 1985), the purpose of which is to prevent taxation on inflationary profits.

Pursuant to the Israeli tax law, the Company was awarded "Approved Enterprise" status under the government alternative benefits track. The program is for investments in the development of infrastructure and for investments in locally produced and imported equipment. The main benefits to which the Company will be entitled, if it implements all the terms of an approved program, are the exemption from tax on income deriving from an approved enterprise, and reduced tax rates on dividends originating from this income. The income derived from an approved enterprise will be exempt from tax for a ten year period, commencing on the date that taxable income is first generated by the approved enterprise (limited to the earlier of a maximum period of 12 years from the year of commencement of operations or 14 years from the year the approval letter was received). As of December 31, 2003, the benefit term had not commenced.

On December 30, 2002, the Company received an approval from the Investment Center for the expansion of its production capacity during the next two years under the alternative benefits track. The investments are expected to amount to \$4.9 million and will be invested in its facilities in Yoqneam. The plan is subject to certain terms set forth in the approval letter.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 13 - Taxes on Income (cont'd)

A. Company (cont'd)

Dividend distributions originating from the income of the Approved Enterprise will be subject to tax at the rate of 15%, provided that the dividend is distributed during the period stipulated under Israeli law.

In the event of a dividend distribution (including withdrawals and charges that are deemed to be dividends) out of the income originating from the approved enterprise, and on which the Company received a tax exemption, income from which the dividend is distributed will be subject to corporate taxes at rates varying from 10% - 25% depending on the percentage of foreign investment holding in the Company as defined by the Law.

If the Company derives income from sources other than the approved enterprise during the relevant period of benefits, such income will be taxable at regular corporate tax rates (36%).

- (2) The Company has net operating loss carryforwards in Israel of approximately \$ 29.5 million as of December 31, 2003. These net operating loss carryforwards are linked to the Israeli Consumer Price Index and are available to offset future taxable income, if any, indefinitely.
- (3) The Company is exempt from tax for a ten-year period. Therefore, the Company has not recorded deferred tax assets and liabilities.
- (4) Israel Tax Reform

During the year 2002, tax reform legislation was enacted with effect from January 1, 2003, which significantly changed the taxation basis from a territorial basis to a worldwide basis. The main provisions of the tax reform that may affect the Company are as follows:

- (a) Transfer pricing of international transactions with related parties

The Income Tax Ordinance was amended to include provisions concerning transfer pricing between related parties, where one of the parties is situated abroad. Detailed provisions are to be included in Income Tax Regulations that have yet to be issued. Although the Company considers that its transfer pricing policy adopted with foreign affiliates is economically fair, an adjustment may be required following the issuance of the Regulations.

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 13 - Taxes on Income (cont'd)

A. Company (cont'd)

(4) Israel Tax Reform (continued)

(b) Employee stock incentive plans

The tax reform codified past practice and determined three alternative tracks for taxing employee stock option plans. Where a trustee arrangement is in place, the employer can either claim an expense for tax purposes while the employee will be fully taxed up to the maximum marginal tax rate of 50% or the Company can waive the tax expense and the employee will pay a reduced tax rate of 25%. Where there is no trustee arrangement, the employee is fully taxable and no expense is allowed to the Company. There are detailed provisions for implementing these tracks. The Company decided to waive the tax expense and the employees will pay a reduced tax rate of 25%.

(c) The seven year limit for carrying forward of capital losses has been removed with respect to capital losses arising from 1996 and thereafter.

B. Subsidiaries

Because of operating losses, the Company's subsidiaries, incurred no income tax expense for the period from inception through December 31, 2003. At December 31, 2003, the subsidiaries had local, federal and state net operating loss carryforwards of approximately \$ 23,886.

C. Deferred Taxes

The tax effects of significant items comprising the Company's deferred taxes as of December 31, 2003:

Net operating tax assets regarding carryforward losses of subsidiaries	\$ 8,730
Start up costs and other timing differences	526
Less valuation allowance	<u>(9,256)</u>
Net deferred tax assets	<u><u>\$ -</u></u>

Given Imaging Ltd. and its Consolidated Subsidiaries

Notes To The Consolidated Financial Statements
(In thousands except per share data)

Note 14 - Related Parties Transactions and Balances

- A.** The Company carried out transactions with companies considered to be "related parties". All of these transactions are carried out under normal business conditions.

B. Agreement with Rafael

On January 29, 1998, the Company entered into a technology purchase and license agreement (the "Technology Purchase Agreement") with Rafael Armament Development Authority ("Rafael") which is a division of the Israeli Ministry of Defense.

Rafael is a related party because it beneficially owns 47.8% of the outstanding shares of RDC Rafael Development Corporation, and they both held approximately 16.5% of the Company's shares.

Pursuant to the Technology Purchase Agreement, the Company purchased from Rafael for \$30 all of Rafael's rights to the technology associated with and the patent issued in connection with the prototype M2A capsule and system. Rafael and the Company each granted each other certain rights in connection with the know-how and technology associated with the M2A capsule and system, in the case of Rafael, solely for use in the military and security fields and, in the case of the Company, solely for commercial exploitation of the M2A capsule. In consideration for payment of royalties in an amount to be agreed upon, the Company and Rafael have agreed to grant to the other the exclusive right to use any improvements to the M2A capsule and system technology developed by the other party in these fields. None of the parties has exercised these certain rights to date.

Note 15 - Fair Value of Financial Instruments

The Company's financial instruments include cash and cash equivalents, accounts receivable, deposits, assets held for severance benefits and accounts payable. The carrying amounts of these financial instruments approximate fair value.