DIGITAL RIVER INC /DE
Form 10-K/A
March 09, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K/A

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2008

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number: 000-24643

DIGITAL RIVER, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	**41-1901640**
(State or other jurisdiction of Incorporation or organization)	*(I.R.S. Employer Identification No.)*

9625 WEST 76TH STREET
EDEN PRAIRIE, MINNESOTA 55344
(Address of principal executive offices)

(952) 253-1234
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
Name of each Exchange on which registered:
Common Stock $0.01 par value Nasdaq Global Select Market

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by checkmark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes þ No o

Indicated by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ

As of June 30, 2008, there were 36,959,613 shares of Digital River, Inc. common stock, issued and outstanding. As of such date, based on the closing sales price as quoted by The Nasdaq Global Select Market, 36,352,219 shares of common stock, having an aggregate market value of approximately $1,402,469,000 were held by non-affiliates. For purposes of the above statement only, all directors and executive officers of the registrant are assumed to be affiliates.

The number of shares of common stock outstanding at February 2, 2009 was 37,034,913 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Certain sections of the Registrant s definitive Proxy Statement for the 2009 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K to the extent stated herein.

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EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A amends the Company s Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Securities and Exchange Commission on February 19, 2009. We are amending Item 15 solely to correct a clerical error in the Consolidated Statement of Cash Flows.

In addition, as required by Rule 12b-15 under the Securities Exchange Act of 1934, as amended, new certifications by our principal executive officer and principal financial officer are filed as exhibits to this Form 10-K/A under Item 15 of Part IV hereof.

This Amendment No. 1 does not reflect events occurring after the original filing date of the 2008 10-K or otherwise modify or update the disclosures set forth in the 2008 10-K, including the financial statements and notes to financial statements set forth in the 2008 10-K.

DIGITAL RIVER, INC.
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PART IV

ITEM 15. ***EXHIBITS AND FINANCIAL STATEMENT SCHEDULES***

(a) The following documents are filed as part of this report:

(1) *Financial Statements.*

The consolidated financial statements required by this item are submitted in a separate section beginning on page 6 of this report.

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(2) *Financial Statement Schedules.*

All schedules for which provision is made in the applicable accounting regulations of the SEC have been omitted as not required or not applicable, or the information required has been included elsewhere by reference in the financial statements and related notes, except for Schedule II, which is included with this Form 10-K, as filed with the SEC.

(3) *Exhibits.*

Exhibit Number	Description of Document
3.1(2)	Amended and Restated Certificate of Incorporation of the Registrant, as currently in effect.
3.2(4)	Amended and Restated Bylaws of the Registrant, as currently in effect.
4.1(5)	Specimen Stock Certificate.
4.2(9)	Indenture dated as of June 1, 2004, between Digital River, Inc. and Wells Fargo Bank, N.A. as trustee, including therein the form of the Note.
10.1(5)	Form of Indemnity Agreement between Registrant and each of its directors and executive officers.
10.3(5)	Consent to Assignment and Assumption of Lease dated April 22, 1998, by and between CSM Investors, Inc., IntraNet Integration Group, Inc. and Registrant.
10.4(3)	Assignment of Lease dated April 21, 1998, by and between Intranet Integration Group, Inc. and Registrant.
10.5(3)	Lease Agreement dated January 18, 2000, between Property Reserve, Inc. and Registrant.
10.6(4)	First Amendment of Lease dated January 31, 2001, to that certain Lease dated April 24, 1996, between CSM Investors, Inc. and Registrant (as assignee of Intranet Integration Group, Inc.).
10.7(6)	1998 Stock Option Plan, as amended and superseded by Exhibit 10.18.*
10.8(7)	

	1999 Stock Option Plan, formerly known as the 1999 Non-Officer Stock Option Plan, as amended and superseded by Exhibit 10.18.*
10.9(6)	2000 Employee Stock Purchase Plan, as amended, and offering.*
10.11(8)	Second Amendment of Lease dated April 22, 2002, to that certain Lease dated April 24, 1996, between CSM Investors, Inc. and Registrant (as assignee of Intranet Integration Group, Inc.) as amended.
10.12(8)	Second Amendment of Lease dated April 28, 2003, to that certain Lease dated January 18, 2000, between Property Reserve Inc. and Registrant.
10.15(9)	Registration Rights Agreement dated as of June 1, 2004, between Digital River, Inc. and the initial purchasers of Senior Convertible Notes due January 1, 2024.

Exhibit Number	Description of Document
10.16(13)	Summary of Compensation Program for Non-Employee Directors.
10.17(14)	Second Amended and Restated Symantec Online Store Agreement, by and among Symantec Corporation, Symantec Limited, Digital River, Inc. and Digital River Ireland Limited effective April 1, 2006
10.18(10)	1998 Equity Incentive Plan (formerly known as 1998 Stock Option Plan).*
10.19(13)	Amended and Restated Employment Agreement for Joel A. Ronning.*
10.20(13)	Change of Control and Severance Agreement for Thomas M. Donnelly.*
10.21(11)	Form of Amendment to Non-Qualified Stock Option Agreement.*
10.22(12)	Inducement Equity Incentive Plan.*
10.23(15)	2007 Equity Incentive Plan.*
10.24(13)	Change of Control and Severance Agreement for Kevin L. Crudden.*
12.1(16)	Computation of Ratio of Earnings to Fixed Charges.
21.1(16)	Subsidiaries of Digital River, Inc.
23.1++	Consent of Independent Registered Public Accounting Firm, dated February 19, 2009.
24.1(16)	Power of Attorney, pursuant to which amendments to this Annual Report on Form 10-K may be filed, is included on the signature pages of this Annual Report on Form 10-K.
31.1++	Certification of Digital River, Inc. s Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2++	Certification of Digital River, Inc. s Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32++	Certification of Digital River, Inc. s Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

++ Filed herewith.

* Management contract or compensatory plan.

Confidential treatment has been requested for portions of this agreement, which portions have been filed separately with the SEC.

(1) Incorporated by reference from the Company s Current Report on Form 8-K filed on May 4, 2004.

(2) Incorporated by reference from the Company s Current Report on Form 8-K filed on June 1, 2006.

(3) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 1999, filed on March 30, 2000.

(4) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2000, filed on March 27, 2001.

(5) Incorporated by reference from the Company s Registration Statement on Form S-1 (File No. 333-56787), declared effective on August 11, 1998.

(6)

Incorporated by reference from the Company s Registration Statement on Form S-8 (File No. 333-105864) filed on June 5, 2003.

(7) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, filed on August 14, 2003.

(8) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003, filed on May 15, 2003.

(9) Incorporated by reference from the Company s Current Report on Form 8-K filed on July 13, 2004.

(10) Incorporated by reference from the Company s Current Report on Form 8-K filed on May 31, 2005.

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(11) Incorporated by reference from the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, filed on August 9, 2005.

(12) Incorporated by reference from the Company s Current Report on Form 8-K filed on December 20, 2005.

(13) Incorporated by reference from the Company s Current Report on Form 8-K filed on March 10, 2008.

(14) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2006, filed on March 1, 2007.

(15) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2007, filed on February 29, 2008.

(16) Incorporated by reference from the Company s Annual Report on Form 10-K for the year ended December 31, 2008, filed on February 19, 2009.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Digital River, Inc.

We have audited the accompanying consolidated balance sheets of Digital River, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2008. Our audits also included the financial statement schedule listed in Item 15(a)(2). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Digital River, Inc. and subsidiaries at December 31, 2008 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth herein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Digital River, Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 19, 2009 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Minneapolis, Minnesota
February 19, 2009

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DIGITAL RIVER, INC.

Consolidated Balance Sheets

	December 31, 2008	December 31, 2007
	(In thousands)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 490,335	$ 381,788
Short-term investments	10,000	315,636
Accounts receivable, net of allowance of $2,457 and $2,489	53,216	64,914
Deferred income taxes	7,613	7,899
Prepaid expenses and other	42,522	4,577
Total current assets	603,686	774,814
Property and equipment, net	41,733	31,102
Goodwill	273,788	261,885
Intangible assets, net of accumulated amortization of $66,345 and $59,493	32,222	32,382
Long-term investments	93,213	
Deferred income taxes	24,824	15,606
Other assets	786	11,955
TOTAL ASSETS	$ 1,070,252	$ 1,127,744
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Convertible senior notes	$ 186,195	$
Accounts payable	184,361	180,386
Accrued payroll	14,841	12,704
Deferred revenue	13,651	10,384
Accrued acquisition costs	3,278	399
Other accrued liabilities	41,336	41,229
Total current liabilities	443,662	245,102
NON-CURRENT LIABILITIES:		
Convertible senior notes	8,805	195,000
Other liabilities	15,712	11,362
Total non-current liabilities	24,517	206,362
TOTAL LIABILITIES	468,179	451,464
COMMITMENTS AND CONTINGENCIES		

STOCKHOLDERS EQUITY:		
Preferred Stock, $.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common Stock, $.01 par value; 120,000,000 shares authorized; 43,225,401 and 42,502,019 shares issued	432	425
Treasury stock at cost; 6,211,477 and 1,952,884 shares	(216,163)	(77,707)
Additional paid-in capital	623,778	597,128
Retained earnings	189,096	125,501
Accumulated other comprehensive income	4,930	30,933
Total stockholders equity	602,073	676,280
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,070,252	$ 1,127,744

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

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DIGITAL RIVER, INC.

Consolidated Statements of Income

	For the Years Ended December 31		
	2008	2007	2006
	(In thousands except per share data)		
Revenue	$ 394,226	$ 349,275	$ 307,632
Costs and expenses			
Direct cost of services	16,417	10,243	7,709
Network and infrastructure	41,040	32,309	29,250
Sales and marketing	150,118	134,401	113,462
Product research and development	51,184	39,179	32,341
General and administrative	39,525	38,937	34,158
Depreciation and amortization	15,980	12,706	10,983
Amortization of acquisition-related intangibles	8,391	7,586	12,134
Total costs and expenses	322,655	275,361	240,037
Income from operations	71,571	73,914	67,595
Interest Income	18,019	32,167	22,836
Other expense, net	(3,319)	(3,006)	(949)
Income before income tax expense	86,271	103,075	89,482
Income tax expense	22,676	32,261	28,672
Net income	$ 63,595	$ 70,814	$ 60,810
Net income per share basic	$ 1.72	$ 1.75	$ 1.58
Net income per share diluted	$ 1.55	$ 1.58	$ 1.40
Shares used in per-share calculation basic	37,016	40,444	38,593
Shares used in per-share calculation diluted	42,106	45,914	44,642

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

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DIGITAL RIVER, INC.

Consolidated Statements of Stockholders Equity

	Common Stock Shares	Common Stock Amount	Treasury Stock	Additional Paid-In Capital	Deferred Compensation	Accumulated Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total Stockholders Equity	Compre Inco (Lo
					(In thousands)				
NCE, December 31,	35,034	$ 355	$ (13,586)	$ 329,327	$ (1,990)	$ (2,431)	$ (6,123)	$ 305,552	$ 54
come							60,810	60,810	60
sification of deferred nsation balance upon on of SFAS 123(R)				(1,990)	1,990				
ized gain on ments						576		576	
n currency tion gain						13,463		13,463	13
f common stock	4,000	40		172,740				172,780	
Issued for sition	28		(12)	1,184				1,172	
se of stock options	1,220	12		21,106				21,118	
based compensation	113	1		13,903				13,904	
ithheld in restricted vesting	(8)		(426)					(426)	
nefit of stock-based nsation				12,700				12,700	
on stock issued the Employee Stock se Plan	71	1		2,110				2,111	
NCE, December 31,	40,458	$ 409	$ (14,024)	$ 551,080	$	$ 11,608	$ 54,687	$ 603,760	$ 74
come							70,814	70,814	70
ized gain on ments						1,006		1,006	1
n currency tion gain						18,319		18,319	18
chase of common	(1,372)		(62,968)					(62,968)	
Issued for sition	44	1	(189)	2,337				2,149	
se of stock options	1,220	12		13,498				13,510	

based compensation				13,742				13,742	
cted stock issued equity incentive net of forfeitures	135	2		(2)					
ithheld in restricted vesting	(11)		(526)					(526)	
nefit of stock-based nsation				13,990				13,990	
on stock issued the Employee Stock ase Plan	76	1		2,483				2,484	
NCE, December 31,	40,550	$ 425	$ (77,707)	$ 597,128	$	$ 30,933	$ 125,501	$ 676,280	$ 90
come							63,595	63,595	63
ized loss on ments						(10,822)		(10,822)	(10
n currency tion loss						(15,181)		(15,181)	(15
chase of common	(4,239)		(137,858)					(137,858)	
se of stock options	426	4		7,167				7,171	
based compensation				12,548				12,548	
cted stock issued equity incentive net of forfeitures	186	2		(2)					
ithheld in restricted vesting	(19)		(598)					(598)	
nefit of stock-based nsation				4,223				4,223	
on stock issued the Employee Stock ase Plan	112	1		2,714				2,715	
NCE, December 31,	37,016	$ 432	$ (216,163)	$ 623,778	$	$ 4,930	$ 189,096	$ 602,073	$ 37

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

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DIGITAL RIVER, INC.

Consolidated Statements of Cash Flows

	For the Years Ended December 31, 2008	2007	2006
	(In thousands)		
OPERATING ACTIVITIES:			
Net income	$ 63,595	$ 70,814	$ 60,810
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of acquisition-related intangibles	8,391	7,586	12,134
Change in accounts receivable allowance, net of acquisitions	434	(174)	1,215
Depreciation and amortization	15,980	12,706	10,983
Stock-based compensation expense related to stock-based compensation plans	12,548	13,742	13,904
Excess tax benefits from stock-based compensation	(4,390)	(12,030)	(8,980)
Deferred income taxes and other	4,971	27,522	19,583
Change in operating assets and liabilities (net of acquisitions):			
Accounts receivable	11,332	(6,863)	(14,678)
Prepaid and other assets	(26,505)	1,325	(1,293)
Accounts payable	6,531	32,181	3,701
Deferred revenue	3,235	3,046	811
Income tax payable	(5,366)	(7,076)	8,126
Accrued payroll and other accrued liabilities	4,478	3,609	11,190
Net cash provided by operating activities	95,234	146,388	117,506
INVESTING ACTIVITIES:			
Purchases of investments	(480,917)	(436,806)	(193,609)
Sales of investments	676,108	358,470	179,296
Cash paid for acquisitions, net of cash received	(23,465)	(31,625)	(37,800)
Purchases of equipment and capitalized software	(26,898)	(18,722)	(15,907)
Net cash provided by/(used for) investing activities	144,828	(128,683)	(68,020)
FINANCING ACTIVITIES:			
Proceeds from sales of common stock			172,780
Exercise of stock options	7,171	13,510	21,118
Sales of common stock under employee stock purchase plan	2,715	2,483	2,109
Repurchase of common stock	(137,858)	(62,968)	
Repurchase of restricted stock to satisfy tax withholding obligation	(598)	(528)	(426)
Excess tax benefits from stock-based compensation	4,390	12,030	8,980
Net cash (used for)/provided by financing activities	(124,180)	(35,473)	204,561
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(7,335)	9,313	4,426

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		108,547		(8,455)		258,473
CASH AND CASH EQUIVALENTS, beginning of year		381,788		390,243		131,770
CASH AND CASH EQUIVALENTS, end of year	$	490,335	$	381,788	$	390,243
SUPPLEMENTAL DISCLOSURES:						
Cash paid for interest on Convertible Senior Notes	$	2,438	$	2,438	$	2,438
Cash paid for income taxes	$	20,503	$	8,232	$	2,006
Noncash investing and financing activities:						
Common stock issued in acquisitions and earn-outs	$		$	2,150	$	1,172

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

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements
December 31, 2008 and 2007

1. Nature of Operations and Summary of Significant Accounting Policies

We provide outsourced e-commerce solutions globally to a wide variety of companies primarily in the software, consumer electronics, computer game and video game markets. We were incorporated in 1994 and began building and operating online stores for our clients in 1996. We generate revenue primarily based on the sales of products made in those stores, and in addition, offer services designed to increase traffic to our clients online stores and to improve the sales effectiveness of those stores.

Principles of Consolidation and Classification

The consolidated financial statements include the accounts of Digital River, Inc. and our wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with the United States 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. Actual results could differ from those estimates.

Foreign Currency Translation

Substantially all of our foreign subsidiaries use the local currency of their respective countries as their functional currency. Assets and liabilities are translated at exchange rates prevailing at the balance sheet dates. Revenues, costs and expenses are translated into U.S. dollars at average exchange rates for the period. Gains and losses resulting from translation are recorded as a component of equity. Gains and losses resulting from foreign currency transactions are recognized as other (expense), net.

We are exposed to market risk from changes in foreign currency exchange rates. Our primary risk is the effect of foreign currency exchange rate fluctuations on the U.S. dollar value of foreign currency denominated operating sales and expenses. At December 31, 2008, these exposures were mitigated through the use of foreign exchange forward contracts with maturities of approximately one week. The principal currency exposures being mitigated were the euro, British pound, Australian dollar, Swiss franc, Norwegian krone, Swedish krona and Canadian dollar. We also are exposed to foreign currency exchange risk as a result of changes in intercompany balance sheet accounts and other balance sheet items.

Our foreign currency forward contracts contain credit risk to the extent that our bank counterparties may be unable to meet the terms of the agreements. We minimize such risk by limiting our counterparties to major financial institutions of high credit quality.

Cash and Cash Equivalents

We consider all short-term, highly liquid investments, primarily high grade commercial paper and money market accounts, that are readily convertible into known amounts of cash and that have original or remaining maturities of

three months or less at the date of purchase to be cash equivalents. As of December 31, 2008 and 2007, cash balances of $0.0 million and $1.5 million, respectively, were held by banks or credit card processors to secure potential future credit card fees, fines and chargebacks or for other payments. In addition, at December 31, 2008 and 2007, $0.3 million and $0.4 million were restricted by letter of credit and agreements required by international tax jurisdictions as security for potential tax liabilities.

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

Short-Term Investments

Our short-term investments consist of debt securities that are classified as available-for-sale and are carried on our balance sheet at their market value with cumulative unrealized gains or losses recorded as a component of accumulated other comprehensive income within stockholders equity. We classify all of our available-for-sale securities as current assets, as these securities represent investments available for current corporate purposes.

Property and Equipment

Computer equipment, software and furniture are depreciated under the straight-line method using estimated useful lives of three to seven years and leasehold improvements are amortized over the shorter of the asset life or remaining length of the lease. Property and equipment at December 31 consisted of the following (in thousands):

	2008	2007
Computer hardware and software	$ 78,660	$ 60,977
Furniture, fixtures and leasehold improvements	15,475	13,077
Total property and equipment	$ 94,135	$ 74,054
Accumulated depreciation	(52,402)	(42,952)
Net property and equipment	$ 41,733	$ 31,102

Purchased Intangible Assets

Through both domestic and international acquisitions, we have continued to expand our global online businesses. Tangible net assets for our acquisitions were valued at their respective carrying amounts as we believe these amounts approximated their current fair values at the respective acquisition dates. The valuation of identifiable intangible assets acquired reflects management s estimates based on, among other factors, use of established valuation methods. Such assets consist of customer lists and user base, trademarks and trade names, developed technologies and other acquired intangible assets, including contractual agreements. Identifiable intangible assets are amortized using the straight-line method over the estimated useful lives, generally three to ten years. We believe the straight-line method of amortization best represents the distribution of the economic value of the identifiable intangible assets acquired to date. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. The purchase prices of the acquisitions described in Note 4 below exceeded the estimated fair value of the respective related identifiable intangible and tangible assets because we believe these acquisitions will assist with our strategy of establishing and expanding our global online marketplace.

Long-Lived Assets

We review all long-lived assets, including intangible assets with definite lives, for impairment in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived

Assets (SFAS 144). Under SFAS 144, impairment losses are recorded whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. For long-lived assets used in operations, impairment losses are only recorded if the asset s carrying amount is not recoverable through its undiscounted, probability-weighted cash flows. We measure the impairment loss based on the difference between the carrying amount and estimated fair value. An impairment loss is recognized when estimated undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset (if any) are less than the carrying value of the asset. As part of our evaluation, we consider certain non-financial data as indicators of impairment such as changes in the operating

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

environment and business strategy, competitive information, market trends and operating performance. When an impairment loss is identified, the carrying amount of the asset is reduced to its estimated fair value. There were no significant impairments of long-lived assets, including definite-lived intangible assets, recorded in 2008, 2007 or 2006.

Other Assets

The following table summarizes our other assets as of December 31 (in thousands):

	2008	2007
Unamortized debt financing costs	$ 224	$ 5,298
Cost of investment		6,000
Other	562	657
Total other assets	$ 786	$ 11,955

Unamortized debt financing costs, in the amount of about $5.1 million, related to the January 2, 2009 repurchase of our convertible senior notes, were reclassified to current as of December 31, 2008. In 2008, our cost of investment, which are preferred shares in a publicly traded company accounted for under the cost method of accounting, were reclassified to current assets due to their pending liquidation which occurred on January 20, 2009.

Other Accrued Liabilities

The following table summarizes our other accrued liabilities as of December 31 (in thousands):

	2008	2007
Accrued expenses	$ 24,148	$ 20,631
Sales, value-added and transaction taxes	19,788	20,598
Current income taxes	(2,600)	
Total other accrued liabilities	$ 41,336	$ 41,229

Comprehensive Income

Comprehensive income includes revenues, expenses, gains and losses that are excluded from net earnings under GAAP. Items of comprehensive income are unrealized gains and losses on short-term investments and foreign currency translation adjustments which are added to net income to compute comprehensive income. Comprehensive income is net of income tax benefits or expense.

In 2008, comprehensive income included $15.2 million recorded for unrealized foreign exchange losses on the revaluation of investments in foreign subsidiaries; $0.6 million net of $0.3 million tax benefit for unrealized investment losses; and $10.2 million net of $6.1 million tax benefit for the temporary impairment of auction rate securities. In 2007, comprehensive income included $18.3 million recorded for unrealized foreign exchange gains on the revaluation of investments in foreign subsidiaries, and $1.0 million net of $0.6 million tax expense for unrealized investment gains. In 2006, comprehensive income included $13.5 million recorded for unrealized foreign exchange gains on the revaluation of investments in foreign subsidiaries, and $0.6 million net of $0.2 million tax expense for unrealized investment gains

Revenue Recognition

We recognize revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition , from services rendered once all the following criteria for revenue recognition have been met: (1) persuasive

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

evidence of an agreement exists; (2) the services have been rendered; (3) the fee is fixed and determinable; and (4) collection of the amounts due is reasonably assured.

We evaluate the criteria outlined in Emerging Issues Task Force, (EITF) Issues No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, in determining whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned as net revenue. We act as the merchant of record on most of the transactions processed and have contractual relationships with our clients, which obligate us to pay to the client a specified percentage of each sale. We derive our revenue primarily from transaction fees based on a percentage of the products sale price and fees from services rendered associated with the e-commerce and other services provided to our clients and end customers. Our revenue is recorded as net as generally our clients are subject to inventory risks and control customers product choices. We sell both physical and digital products. Revenue is recognized upon fulfillment and based upon when products are shipped and title and significant risk of ownership passes to the customer.

We also provide customers with various proprietary software backup services. We recognize revenue for these backup services based upon historical usage within the contract period of the digital backup services when this information is available. Digital backup services are recognized straight-line over the life of the backup service when historical usage information is unavailable. Shipping revenues are recorded net of any associated costs.

We also, to a lesser extent, provide fee-based client services, which include website design, custom development and integration, analytical marketing, affiliate marketing and email marketing services. If we receive payments for fee-based services in advance of delivery, these amounts, if significant, are deferred and recognized over the service period.

Provisions for doubtful accounts and transaction losses and authorized credits are made at the time of revenue recognition based upon our historical experience. The provision for doubtful accounts and transaction losses are recorded as charges to operating expense, while the provision for authorized credits is recognized as a reduction of net revenues.

In June 2006, the EITF reached a consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation) (EIFT 06-3). EITF 06-3 provides that the presentation of taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer on either a gross basis (included in revenues and costs) or on a net basis (excluded from revenues) is an accounting policy decision that should be disclosed. The Company presents these taxes on a net basis.

Deferred Revenue

Deferred revenue is recorded when service payment is received in advance of performing our service obligation. Revenue is recognized over either the estimated usage period when usage information is available, or ratably over the service period when usage information is not available.

Advertising Costs

The costs of advertising are charged to sales and marketing expense as incurred. We incurred advertising expense of $0.7 million, $0.1 million and $1.5 million in 2008, 2007 and 2006, respectively.

Income Taxes

Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We record deferred tax assets for favorable tax attributes, including tax loss carryforwards. We currently have U.S. tax

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

loss carryforwards, consisting solely of acquired operating tax loss carryforwards, and a lesser amount of acquired foreign operating tax loss carryforwards. A portion of the benefit of the acquired tax loss carryforwards has been reserved by a valuation allowance pursuant to United States generally accepted accounting principles. These valuation allowances of the deferred tax asset will be reversed if and when it is more likely than not that the deferred tax asset will be realized. We evaluate the need for a valuation allowance of the deferred tax asset on a quarterly basis.

Interest Income

Our interest income line item is the total of interest income on our cash, cash equivalents, and investments. Interest income was $18.0 million, $32.2 million and $22.8 million in 2008, 2007 and 2006, respectively. The decrease in interest income from 2007 to 2008 was due to the use of $138 million in cash for our share repurchase program during the first quarter of 2008. Interest income also declined due to lower yields on our portfolio during 2008. The increase from 2006 to 2007 in interest income was primarily due to higher cash balances.

Other (Expense), Net

Our other (expense), net line item is the total of interest expense on our debt and foreign currency transaction gains and losses and disposals of asset gains and losses. Interest expense was $2.5 million in 2008 compared to $2.4 million in 2007 and 2006 and was related primarily to our Convertible Senior Notes. Our gain from foreign currency remeasurement was $0.3 million in 2008 compared to a loss of $0.6 million in 2007 and a gain of 1.5 million in 2006. The loss on disposals of assets was $1.1 million in 2008. Disposals of assets were immaterial in 2007 and 2006.

Research and Development and Software Development

Research and development expenses consist primarily of development personnel and non-employee contractor costs related to the development of new products and services, enhancement of existing products and services, quality assurance, and testing. We follow AICPA Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, in accounting for internally developed software. We capitalized $5.3 million related to software development during 2008, inclusive of amounts outside of Product Research and Development as recorded in our Consolidated Statement of Income. In 2007 and 2006, we capitalized $0.0 million and $0.1 million, respectively, of software development costs.

Stock-Based Compensation Expense

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payments made to employees and directors including stock options, restricted stock grants and employee stock purchases made through our Employee Stock Purchase Plan based on estimated fair values.

We have adopted SFAS 123(R) using the modified prospective transition method under which prior periods are not revised. Stock-based compensation expense recognized during the period is based on the value of the portion of share-based awards that are ultimately expected to vest during the period. The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option pricing model. The fair value of restricted stock is determined based on the number of shares granted and the closing price of our common stock on the date of grant.

Compensation expense for all share-based payment awards is recognized using the straight-line amortization method over the vesting period. Stock-based compensation expense of $12.5 million was charged to operating expenses during 2008.

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Notes to Consolidated Financial Statements (Continued)

As stock-based compensation expense recognized in our Consolidated Statement of Income for 2008 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

SFAS 123(R) also requires the benefits of tax deductions in excess of recognized stock-based compensation expense be reported as a financing cash flow, rather than an operating cash flow as required prior to adoption of SFAS 123(R) in our Consolidated Statement of Cash Flows.

See Note 5 for further information regarding the impact of our adoption of SFAS 123(R) and the assumptions we use to calculate the fair value of share-based compensation.

Recent Accounting Pronouncements

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FAS 133* (SFAS 161). SFAS 161 applies to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). The provisions of SFAS 161 require entities to provide greater transparency through additional disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, results of operations and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. We are currently evaluating the effects, if any, that SFAS 161 may have on our financial statements.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements* (SFAS 160). SFAS 160 requires entities to report non-controlling (minority) interests in subsidiaries as equity in the consolidated financial statements. SFAS 160 is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the effects, if any, that SFAS 160 may have on our financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations. This revised Statement, which we refer to as SFAS No. 141(R), is intended to simplify existing guidance and converge rulemaking under U.S. GAAP with international accounting rules. SFAS No. 141(R) will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, contingencies, acquisition costs and restructuring costs. Also under this Statement, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the effects, if any, that SFAS No. 141(R) may have on our financial statements.

2. Net Income per Share

Basic income per common share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share is calculated by dividing net income, adjusted to exclude interest expense and financing cost amortization related to potentially dilutive securities,

by the weighted average number of common shares related to potentially dilutive securities outstanding during the period, plus any additional common shares that would have been outstanding if potentially dilutive common shares had been issued during the period.

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Notes to Consolidated Financial Statements (Continued)

The following table summarizes the computation of basic and diluted earnings per share (in thousands, except per share data):

	For the Years Ended December 31, 2008	2007	2006
Earnings per share basic			
Net income basic	$ 63,595	$ 70,814	$ 60,810
Weighted average shares outstanding basic	37,016	40,444	38,593
Earnings per share basic	$ 1.72	$ 1.75	$ 1.58
Earnings per share diluted			
Net income basic	63,595	$ 70,814	$ 60,810
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	1,739	1,739	1,739
Net income diluted	$ 65,334	$ 72,553	$ 62,549
Weighted average shares outstanding basic	37,016	40,444	38,593
Dilutive impact of non-vested stock and options outstanding	665	1,045	1,624
Dilutive impact of convertible senior notes	4,425	4,425	4,425
Weighted average shares outstanding diluted	42,106	45,914	44,642
Earnings per share diluted	$ 1.55	$ 1.58	$ 1.40

In accordance with the Emerging Issues Task Force (EITF), Issue No. 04-8, the unissued shares underlying contingent convertible notes are treated as if such shares were issued and outstanding for the purposes of calculating GAAP diluted earnings per share beginning with the issuance of our 1.25% convertible senior notes on June 1, 2004.

3. Investments

As of December 31, 2008 and 2007, our available-for-sale securities consisted of the following (in thousands):

		Unrealized Gain/(Loss)			Maturities/Reset Dates	
	Cost	Less than 12 Months	Greater than 12 Months	Fair Value	Less than 12 Months	Greater than 12 Months
2008						

U.S. government sponsored entities	$ 9,900	$ 100	$	$ 10,000	$ 10,000	$
Student loan bonds	109,500	(16,287)		93,213		93,213
Total available-for-sale securities	$ 119,400	$ (16,187)	$	$ 103,213	$ 10,000	$ 93,213
2007						
U.S. government sponsored entities	$ 139,377	$ 94	$ 859	$ 140,330	$ 69,070	$ 71,260
Student loan bonds	119,750			119,750	119,750	
Other	55,556			55,556	55,556	
Total available-for-sale securities	$ 314,683	$ 94	$ 859	$ 315,636	$ 244,376	$ 71,260

Realized gains or losses on investments are recorded in our statement of income within other income (expense), net. Realized losses on sales of investments were immaterial in 2008, 2007 and 2006.

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

4. Business Combinations, Goodwill and Intangible Assets

The following table summarizes the purchase acquisitions completed during the three years in the period ended December 31, 2008 (in thousands):

Acquisition	Initial Shares Issued	Initial Purchase Consideration	Acquired Assets	Assumed Liabilities	Goodwill	Other Intangible Assets: Technology/ Tradename	Other Intangible Assets: Customer Relationships	Other Intangible Assets: Non-compete Agreements
2008								
Think Subscription, Inc.		$ 5,100	$ 644	$ (1,019)	$ 2,007	$ 1,209	$ 1,813	$
CustomCD, Inc.		7,000	764	(355)	3,136	2,059	1,468	
DigitalSwift Corporation		9,200	427	(459)	4,673	487	4,325	
Total		$ 21,300	$ 1,835	$ (1,833)	$ 9,816	$ 3,755	$ 7,606	$
2007								
Netgiro Systems AB		$ 27,386	$ 8,567	$ (7,477)	$ 9,742	$ 4,424	$ 12,372	$
Total		$ 27,386	$ 8,567	$ (7,477)	$ 9,742	$ 4,424	$ 12,372	$
2006								
Mindvision, Inc.		$ 24,975	$ 2,555	$ (8,036)	$ 18,859	$ 3,170	$ 4,490	$ 40
Direct Response Technologies, Inc.		14,876	1,573	(3,723)	11,343	2,465	3,620	
Total		$ 39,851	$ 4,128	$ (11,759)	$ 30,202	$ 5,635	$ 8,110	$ 40

Note: Balances as of acquisition date and do not reflect subsequent earn-outs, adjustments or currency translation.

Acquisitions completed in 2008

On September 1, 2008, we acquired all of the capital stock of THINK Subscription, Inc. (Think Subscription), a privately-held company based in Provo, Utah, for approximately $5.1 million in cash. Think Subscription provides subscription management and fulfillment software to content publishers, online service providers, media vendors and other subscription-based businesses. The agreement also provides Think Subscription shareholders with an earn-out opportunity based on Think Subscription achieving certain revenue and earnings targets during the first three years subsequent to the acquisition. Any future earn-out will result in additional goodwill.

On January 1, 2008, we acquired all of the capital stock of DigitalSwift Corporation (DigitalSwift), a privately-held company based in Madison, Georgia, for approximately $9.2 million in cash. DigitalSwift is a manufacturer and fulfiller of on-demand, dynamic and build-to-order CDs and DVDs to consumers. The agreement also provides

DigitalSwift shareholders with an earn-out opportunity based on DigitalSwift achieving certain revenue and earnings targets during the first year subsequent to the acquisition. In 2008, we paid earn-outs of $1.0 million and accrued $3.0 million for future earn-out payments. Earn-outs were recorded as goodwill in 2008 as they were considered incremental to the purchase price.

On January 1, 2008, we acquired the assets of IA Users Club d.b.a. CustomCD, Inc. (CustomCD), a privately held company based in Portland, Oregon and Krefeld, Germany, for approximately $7.0 million in cash. This acquisition involved an asset purchase of the US-based business and a stock purchase of the business located in Germany. CustomCD creates, sells and delivers to consumers custom CDs and DVDs containing software, games, and other licensed content. The agreement also provides CustomCD shareholders with an earn-out opportunity based on CustomCD achieving certain revenue and earnings targets during the

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

first two years subsequent to the acquisition. In 2008, we paid earn-outs of $1.3 million. Earn-outs were recorded as goodwill in 2008 as they were considered incremental to the purchase price. Any future earn-out will result in additional goodwill.

Acquisitions completed in 2007

On September 1, 2007, we acquired all of the capital stock of NetGiro Systems AB (NetGiro), a privately held company based in Stockholm, Sweden, for approximately $27.4 million in cash. NetGiro is an online payment service provider.

Acquisitions completed in 2006

In June 2006, we acquired all of the capital stock of MindVision, Inc., a privately held e-commerce company based in Lincoln, Nebraska, for approximately $25.0 million comprised of payments to stockholders of $21.2 million plus the assumption of certain liabilities totaling approximately $3.7 million. In November 2006, we recorded $0.2 million as acquisition cost related to a restructuring plan for employee severance to be paid out over a six month period.

In January 2006, we acquired all of the capital stock of Direct Response Technologies, Inc. (Direct Response), a privately held company based in Pittsburgh, Pennsylvania, for approximately $15.0 million in cash. Direct Response, a provider of tools for managing affiliate networks, is now named DR Marketing Solutions, Inc. The agreement also provided Direct Response shareholders with an earn-out opportunity based on DR Marketing Solutions, Inc. achieving certain revenue and earnings targets during the first three years subsequent to the acquisition. In 2006, we accrued $3.5 million for future earn-out payments. In 2007, pursuant to the January 2006 acquisition agreement, certain adjustments were made to the earn-out obligations under this agreement. Under the restructured earn-out agreement a final earn-out of $3.5 million was accrued and paid in 2007. These earn-outs have been recorded as goodwill in 2006 and 2007 as they were considered incremental to the purchase price.

Future Earn-outs

As of December 31, 2008, there were estimated future earn-outs of $3.0 million in accrued acquisition liabilities. Any of the estimated maximum potential future earn-out beyond the $3.0 million accrual will result in additional goodwill.

Pro Forma Operating Results (Unaudited)

The consolidated financial statements include the operating results of each business acquired from the date of acquisition. The following unaudited pro forma condensed results of operations for 2008, 2007 and 2006 have been prepared as if each of the acquisitions in 2008 had occurred on January 1, 2007, and as if each of the 2007 acquisitions had occurred on January 1, 2006 (in thousands except per share data):

	2008	2007	2006
Revenue	$ 395,698	$ 366,208	$ 322,296
Income from operations	70,373	70,590	68,260

Net income	62,400	67,494	61,338
Diluted income per share	$ 1.52	$ 1.51	$ 1.41

This pro forma financial information does not purport to represent results that would actually have been obtained if the transactions had been in effect on January 1, 2007 or 2006, as applicable, or any future results that may be realized.

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

Goodwill

We account for our goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 precludes the amortization of goodwill and intangible assets with indefinite lives, but these assets are reviewed annually (or more frequently if impairment indicators arise) for impairment.

We complete our annual impairment test using a two-step approach based in the fourth quarter of each fiscal year and reassess any intangible assets, including goodwill, recorded in connection with earlier acquisitions. Our assessment has indicated that there is no impairment of goodwill for the years ended December 31, 2008, 2007 and 2006.

The changes in the net carrying amount of goodwill for the years ended December 31, 2008 and 2007 are as follows (in thousands):

	Total
Balance as of December 31, 2006	$ 243,799
Goodwill from acquisitions and earn-outs	13,774
Adjustments(1)	4,312
Balance as of December 31, 2007	$ 261,885
Goodwill from acquisitions and earn-outs	14,955
Adjustments(1)	(3,052)
Balance as of December 31, 2008	$ 273,788

(1) Adjustments to goodwill during the year ended December 31, 2008 and December 31, 2007, resulted primarily from foreign currency translation and tax adjustments relating to goodwill associated with our current and prior period acquisitions.

Intangible Assets

Information regarding our other intangible assets is as follows (in thousands):

	As of December 31, 2008		
	Carrying Amount Gross	Accumulated Amortization	Carrying Amount Net
Customer relationships	$ 62,265	$ 37,931	$ 24,334
Non-compete agreements	5,312	5,301	11

Technology/tradename		30,991		23,114		7,877
Total	$	98,568	$	66,346	$	32,222

	As of December 31, 2007					
	Carrying Amount Gross		Accumulated Amortization		Carrying Amount Net	
Customer relationships	$	57,327	$	33,761	$	23,566
Non-compete agreements		5,351		5,328		23
Technology/tradename		29,197		20,404		8,793
Total	$	91,875	$	59,493	$	32,382

Amortization expense was $8.4 million, $7.6 million and $12.1 million, respectively for the years ended 2008, 2007 and 2006, respectively. The result of the allocation of the purchase price between amortizable costs

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

and goodwill could have an impact on our future operating results. The components of intangible assets acquired during the years ended December 31, 2008, 2007 and 2006, are as follows (in thousands). No significant residual value is estimated for these assets.

	2008		2007		2006	
	Amount	Weighted Average Life	Amount	Weighted Average Life	Amount	Weighted Average Life
Customer relationships	$ 7,606	6 years	$ 12,372	10 years	$ 8,110	8 years
Non-compete agreements					40	4 years
Technology/tradename	3,755	4 years	4,424	8 years	5,635	4 years
Total	$ 11,361	5 years	$ 16,796	10 years	$ 13,785	6 years

Estimated amortization expense for the remaining life of the intangible assets, based on intangible assets as of December 31, 2008, is as follows (in thousands):

Year	
2009	$ 7,378
2010	5,868
2011	4,706
2012	4,543
2013	2,617
Thereafter	7,110
Total	$ 32,222

Following is an allocation of the net assets acquired from the acquisitions consummated and amounts paid under earn-out arrangements in 2008 and 2007 (in thousands) which includes subsequent year activity for 2007 acquisitions:

	2008	2007
Tangible assets	$ 1,835	$ 8,567
Liabilities assumed	(1,833)	(7,477)
Customer relationships	7,606	12,372
Technology/tradename	3,755	4,424
Goodwill (year of acquisition)	9,816	9,742
Goodwill (subsequent to year of acquisition)		5,058

Net assets acquired	$ 21,179	$ 32,686

5. Stock-Based Compensation

Our stockholders approved the Digital River, Inc. 2007 Equity Incentive Plan (the 2007 Plan) at the Company s annual stockholder meeting held on May 31, 2007. The number of shares issuable under the 2007 Plan equals 2,000,000 shares of our common stock. In addition, shares not issued under the 1998 Plan shall become available for issuance under the 2007 Plan to the extent a stock option or other stock award under the 1998 Plan expires or terminates before shares of common stock are issued under the award. Under our 2007 Equity Incentive Plan we have the flexibility to grant incentive and non-statutory stock options, restricted stock awards, restricted stock unit awards and performance shares to our directors, employees, and consultants.

Our current plan is described more fully in Note 11.

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

Expense Information under SFAS 123(R)

On January 1, 2006, we adopted SFAS 123(R) which requires measurement and recognition of compensation expense for all stock-based payments made to employees and directors including stock options, restricted stock grants and employee stock purchases made through our Employee Stock Purchase Plan based on estimated fair values. The following table summarizes stock-based compensation expense, net of tax, related to our stock-based compensation plans recognized under SFAS 123(R):

	Year Ended December 31,	
	2008 (In thousands)	2007 (In thousands)
Costs and expenses		
Direct cost of services	$ 785	$ 807
Network and infrastructure	192	270
Sales and marketing	4,562	5,028
Product research and development	1,258	1,736
General and administrative	5,751	5,901
Stock-based compensation included in costs and expenses	12,548	13,742
Tax benefit	(2,802)	(3,737)
Stock-based compensation expense, net of tax	$ 9,746	$ 10,005

Valuation Information under SFAS 123(R)

During the twelve months ending ended December 31, 2008, 2007 and 2006 we used the Black-Scholes option pricing model with the following weighted average assumptions:

	2008	2007	2006
Risk-free interest rate	2.0%	4.5%	4.7%
Expected life (years)	3.37	3.46	4.08
Volatility factor	0.45	0.50	0.59
Expected dividends			
Weighted average fair value of options granted	$ 10.74	$ 23.11	$ 19.00

The risk-free interest rate assumption is based on observed interest rates appropriate for the term of our stock options. The expected life of stock options represents the weighted-average period the stock options are expected to remain outstanding and is based on historical exercise patterns. We used historical closing stock price volatility for a period

equal to the expected term of the options granted. The dividend yield assumption is based on our history and expectation of future dividend payouts.

As stock-based compensation expense recognized in the Consolidated Statement of Income for the twelve months ended December 31, 2008 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

At December 31, 2008, there was approximately $24.4 million of total unrecognized stock-based compensation expense, adjusted for estimated forfeitures, related to unvested share-based awards. Unrecognized stock-based compensation expense is expected to be recognized over the next 2.44 years on a weighted average basis and will be adjusted for any future changes in estimated forfeitures.

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Notes to Consolidated Financial Statements (Continued)

6. Income Taxes

The components of pretax income are as follows (in thousands):

	Year Ended December 31,		
	2008	2007	2006
United States	$ 46,988	$ 74,595	$ 65,171
International	39,283	28,480	24,311
Total	$ 86,271	$ 103,075	$ 89,482

The provision (benefit) for income taxes is composed of the following (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Current tax expense (benefit):			
United States federal	$ 18,792	$ 29,204	$ 34,362
State and local	1,223	1,842	2,160
International	6,858	5,939	2,915
Total current provision for income taxes	26,873	36,985	39,437
Deferred tax expense (benefit):			
United States federal	(3,926)	(3,896)	(10,136)
State and local	(255)	(227)	(637)
International	(16)	(601)	8
Total deferred provision (benefit) for income taxes	(4,197)	(4,724)	(10,765)
Provision for income taxes	$ 22,676	$ 32,261	$ 28,672

The following is a reconciliation of the difference between the actual provision for income taxes and the provision computed by applying the federal statutory rate of 35% to income before income taxes (in thousands):

	Year Ended December 31,		
	2008	2007	2006
Tax expense at statutory rate	$ 30,195	$ 36,076	$ 31,319

State taxes, net of federal benefit	968	1,615	1,469
International rate differential	(7,860)	(4,623)	(3,193)
Tax Credits	(955)	(671)	(1,909)
Nondeductible expense and other	328	(136)	986
Total	$ 22,676	$ 32,261	$ 28,672

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the bases for income tax purposes. Significant components of deferred income taxes are as follows (in thousands):

	2008	2007
Deferred tax assets:		
Net operating loss and credit carryforwards	$ 8,646	$ 12,412
Nondeductible reserves and accruals	21,075	9,144
Depreciation and amortization	4,777	3,339
Valuation allowance	(2,061)	(1,390)
Total deferred tax assets	32,437	23,505
Deferred tax liabilities:		
Depreciation	(1,191)	
Other intangibles	(11,016)	(5,054)
Total deferred tax liabilities	(12,207)	(5,054)
Net deferred tax assets	$ 20,230	$ 18,451

As of December 31, 2008, we had U.S. tax loss carryforwards of approximately $16.5 million and foreign tax loss carryforwards of $4.3 million. These tax loss carryforwards consist solely of acquired net operating losses. The U.S. tax loss carryforwards expire in the years 2021 through 2025. However, we anticipate most U.S. tax loss carryforwards will be utilized in the next few years.

There is uncertainty of future realization of the deferred tax assets resulting from acquired tax loss carryforwards due to anticipated limitations, including limitations under Section 382 of the Internal Revenue Code. Therefore, a valuation allowance was recorded against the tax effect of such tax loss carryforwards. At December 31, 2008, the Company has a valuation allowance on approximately $1.4 million of deferred tax assets related to acquired operating losses and other tax attributes as we believe it is more likely than not that these deferred tax assets will not be realized. Any future release of this valuation allowance will reduce expense.

On January 1, 2007, we adopted the provisions of Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109). As a result of the implementation of FIN 48, we recognized no material adjustment in the liability for unrecognized income tax benefits. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

Balance at January 1, 2007	$ 3,340

Increases for tax positions taken during current year	1,072
Decreases for tax positions taken during prior years	1,035
Balance at December 31, 2007	$ 5,447
Increases for tax positions taken during current year	2,957
Increases for tax positions taken during prior years	613
Decreases as a result of settlements with taxing authorities	(2,622)
Balance at December 31, 2008	$ 6,395

All of these unrecognized tax benefits would affect our effective tax rate if recognized. We recognize interest and penalties related to uncertain tax positions in income tax expense. We had approximately

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

$0.8 million and $0.1 million of accrued interest and penalties related to uncertain tax positions at December 31, 2008 and December 31, 2007, respectively.

The Company and its subsidiaries file income tax returns in U.S. federal and various state jurisdictions, and foreign jurisdictions. The tax years 2004-2008 remain open to examination by the major taxing jurisdictions to which we are subject. During 2008, the Internal Revenue Service (IRS) examined the Company s 2004 U.S. income tax return. The examination was substantially completed, resulting in only minor agreed upon adjustments. The Company expects the examination to be finalized in 2009. Several of the Company s international subsidiaries were also under examination during 2008 and the Company expects these examinations to be completed in 2009 as well. Due to the potential resolution of examinations currently being performed by taxing authorities, and the expiration of various statutes of limitation, it is reasonably possible that our gross unrecognized tax benefits balance may change within the next twelve months by a range of zero to $2.2 million.

No provision has been made for federal income taxes on approximately $81.3 million of our foreign subsidiaries undistributed earnings as of December 31, 2008 since we plan to indefinitely reinvest all such earnings. If these earnings were distributed to the U.S. in the form of dividends or otherwise, we would be subject to U.S. income taxes on such earnings. The amount of U.S. income taxes would be subject to adjustment for foreign tax credits and for the impact of the step-up in the basis of assets resulting from a Section 338 election made at the time of acquisition. If these earnings were to be distributed, the income tax liability would be approximately $17.5 million.

7. Commitments and Contigencies

Leases

We currently have 38 facility leases in addition to leasing certain computer equipment under non-cancelable operating leases. Total rent expense, including common area maintenance charges, recognized under all leases was $7.1 million, $5.7 million and $4.3 million for the years ended December 31, 2008, 2007 and 2006, respectively. The minimum annual rents under long-term leases at December 31, 2008, were as follows (in thousands):

Year ending December 31,		Lease Obligations
2009		5,048
2010		3,735
2011		2,312
2012		687
Thereafter		745
Total future minimum obligations	$	12,527

Litigation

We are subject to legal proceedings, claims and litigation arising in the ordinary course of business. While the final outcome of these matters is currently not determinable, we believe there is no litigation pending against us that is likely to have, individually or in the aggregate, a material adverse effect on our consolidated financial position, results of operation or cash flows. Because of the uncertainty inherent in litigation, it is possible that unfavorable resolutions of these lawsuits, proceedings and claims could exceed the amount we have currently reserved for these matters.

Third parties have from time-to-time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We have been notified of several potential patent disputes, and expect that we

DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

will increasingly be subject to patent infringement claims as our services expand in scope and complexity. We have in the past been forced to litigate such claims. We may also become more vulnerable to third-party claims as laws, such as the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are interpreted by the courts and as we expand geographically into jurisdictions where the underlying laws with respect to the potential liability of online intermediaries like ourselves are either unclear or less favorable. These claims, whether meritorious or not, could be time consuming and costly to resolve, cause service upgrade delays, require expensive changes in our methods of doing business, or could require us to enter into costly royalty or licensing agreements.

Indemnification Provisions

In the ordinary course of business we have included limited indemnification provisions in certain of our agreements with parties with whom we have commercial relations. Under these contracts, we generally indemnify, hold harmless and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by any third party with respect to our domain names, trademarks, logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In certain agreements, including both agreements under which we have developed technology for certain commercial parties and agreements with our clients, we have provided an indemnity for other types of third-party claims. To date, no significant costs have been incurred, either individually or collectively, in connection with our indemnification provisions.

In addition, we are required by our credit card processors to comply with credit card association operating rules, and we have agreed to indemnify our processors for any fines they are assessed by credit card associations as a result of processing payments for us. The credit card associations and their member banks set and interpret the credit card rules. Visa, MasterCard, American Express, or Discover could adopt new operating rules or re-interpret existing rules that we or our credit card processors might find difficult to follow. We have had payment processing agreements with certain of our payment processors terminated due to violations of their rules. We also could be subject to fines or increased fees from MasterCard and Visa.

8. Debt

In 2004 we sold and issued $195.0 million in aggregate principal amount of 1.25% convertible senior notes due January 1, 2024 (Notes), in a private, unregistered offering. The Notes were sold at 100% of their principal amount.

We are required to pay interest on the Notes on January 1 and July 1 of each year so long as the Notes are outstanding. The Notes bear interest at a rate of 1.25% and, if specified conditions are met, are convertible into our common stock at a conversion price of $44.063 per share. The Notes may be surrendered for conversion under certain circumstances, including the satisfaction of a market price condition, such that the price of our common stock reaches a specified threshold; the satisfaction of a trading price condition, such that the trading price of the Notes falls below a specified level; the redemption of the Notes by us, the occurrence of specified corporate transactions, as defined in the related indenture; and the occurrence of a fundamental change, as defined in the related indenture. The initial conversion price is equivalent to a conversion rate of approximately 22.6948 shares per $1,000 of principal amount of the Notes. We will adjust the conversion price if certain events occur, as specified in the related indenture, such as the issuance of our common stock as a dividend or distribution or the occurrence of a stock subdivision or combination. If a fundamental change, such as a change in our control, as defined in the related indenture, occurs on or before January 1, 2009, we may also be required to purchase the Notes for cash and pay an additional make whole premium

payable in our common stock upon the repurchase or conversion of the Notes in connection with the fundamental change.

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DIGITAL RIVER, INC.

Notes to Consolidated Financial Statements (Continued)

Holders of the Notes have the right to require us to repurchase their Notes prior to maturity on January 1, 2009, 2014 and 2019. We have the right to redeem the Notes at any time on or after January 1, 2009. On January 5, 2009, we announced that holders of 95.5% of the Notes exercised the option to require us to repurchase those Notes on January 2, 2009 at a purchase price of 100.25% of the principal amount of each tendered Note. Notes with an aggregate principal amount of $8,805,000 remain outstanding. In light of the right of holders to require us to redeem the Notes on January 1, 2009, on January 1, 2008, we reclassified the Notes as short-term debt. As such right has expired and the exercise of the next right to require us to redeem the Notes will not occur until January 1, 2014, we have reclassified the remaining Notes as long-term debt.

We incurred interest expense of $2.5 million in 2008 and made interest payments of $2.4 million. We incurred interest expense of $2.4 million D ALIGN=LEFT> 26,623 26,947 36,038 35,895 42,540 40,761 Operating income 4,279 483 10,286 10,929 18,263 18,370 19,922 19,065

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(1) Based on average exchange rates during the period.

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Our policy remains to reduce exposure to exchange rate fluctuations by entering into foreign currency forward transactions that qualify as hedging transactions under FAS No. 133, the results of which are reflected in our income statements as revenues. The result of these transactions, which are affected by fluctuations in exchange rates, could cause our revenues, gross profit and operating income to fluctuate.

In addition, due to increased fluctuations in the exchange rate of the US dollar vis-a-vis the Israeli Shekel in 2002, in December 2002 we commenced acquiring derivative financial instruments in order to convert currency fluctuation risks related to our US dollar denominated loans from the US dollar to other currencies which we thought would be more stable. We do not anticipate entering into such transactions in the future unless we incur significant debt in currencies that are different from the functional currency of the entity within our group incurring such debt, and any decision to enter into such transactions will require the approval of our Board of Directors and will only be made after consulting with our advisors. Gains or losses from such derivative financial instruments do not qualify for hedge accounting under FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and are reflected in financing expenses, net. As of June 2005, we have no more open positions on such derivative financial instruments and any remaining effects on our financial results from such derivative financial instruments are reflected in our financial results for the second quarter of 2005 and will not affect our results of operations for any subsequent period.

B. LIQUIDITY AND CAPITAL RESOURCES

Since our inception, we funded our operations primarily from cash generated from operations, borrowings under our credit facilities with banks, proceeds from the initial public offering of our ordinary shares in Israel and the proceeds received from other public or private sales of our equity and debt instruments. In 2004 and 2005, we had $4.6 million and $58.4 million in cash and marketable securities and $2.5 million and $61 million in working capital, respectively. In addition, in 2004 and 2005, we had $10.1 million and $3.5 million, respectively, of outstanding long-term borrowings from banks, of which $6.5 million and $3.1 million, respectively, were current, in 2004 and 2005, we also had $1.5 million and 1.1 million, respectively, available to us under existing lines of credit of which we were utilizing $0.1 million and $0.2 million, respectively. Our long-term loans are secured by liens on all of our assets and properties in Israel.

We believe that our cash flow from operations, availability under our lines of credit and cash and marketable securities will be adequate to fund our capital expenditures, contractual commitments and other demands and commitments for the foreseeable future as well as for the long-term. We believe that cash flow generated from operations and cash available to us from our credit facilities and the use of proceeds of the initial public offering of our shares in the USA, will be sufficient to cover future expansion of our various businesses into new geographical markets or new products, as currently contemplated and as we describe below. However, if existing cash and cash generated from operations are insufficient to satisfy our liquidity requirements, we may seek financing elsewhere by selling additional equity or debt securities or by obtaining additional credit facilities.

We had long-term liabilities in 2004 and 2005 of $4.3 million and $4.5 million, respectively, for employee pension costs for certain of our employees that become payable upon their retirement. Our Israeli employees are entitled to one month s salary, equal to the applicable monthly salary at the time of such employee s retirement, for each year of employment, or a portion thereof, upon retirement. This liability is partially funded by deposit balances maintained for these employee benefits in the amount of $2.9 million and $3.0 million in 2004 and 2005, respectively. The deposited funds include profits accumulated up to the balance sheet date and may be withdrawn upon the fulfillment of the obligation pursuant to Israeli severance pay laws or labor agreements.

As of December 31, 2005, we had outstanding capital notes. The holder of these capital notes and the Company are currently involved in legal proceedings over the terms of the notes. We believe that these notes may only be converted into approximately 2,802 of our ordinary shares (pre-split) and are not otherwise required to be repaid by us. The holder of these notes has made various alternative demands including the repayment in cash of the balance of the notes in the amount of approximately $6.2 million (plus accrued interest and expenses) and the payment of a cash amount equal to the amount obtained by multiplying 1,172,154 of our ordinary shares (pre-split) by the highest trading price of our ordinary shares between the maturity date and the date of a court decision, plus interest and expenses. Although we cannot predict the outcome of the litigation proceedings at this time, if the holder of these notes prevails, the award of damages could result in significant costs to us. See Item 8.A. Consolidated Statements and other Financial Information under the caption Legal Proceedings below.

On January 29, 2004, we adopted a dividend policy providing for an annual dividend distribution in an amount equal to 25% of our net profits, calculated based on our financial statements for the period ending on December 31 of the fiscal year with respect to which the relevant dividend is proposed to be paid. Pursuant to such policy, we distributed NIS 11.8 million (approximately, $2.7 million) on April 28, 2005 and NIS 17.6 million (approximately, $3.8 million), on April 4, 2006.

The following table sets forth the components of our historical cash flows for the periods indicated:

	Year ended December 31,		
	2005	**2004**	**2003**
	(In thousands)		
Net cash provided by operating activities	$ 17,758	$ 17,674	$ 15,787
Net cash used in investing activities	(4,893)	(2,910)	(2,214)
Net cash provided by (used in) financing activities	41,255	(14,142)	(11,090)
Effect of exchange rate changes on cash and cash equivalents	(295)	64	108
Net increase in cash and cash equivalents	$ 53,825	$ 686	$ 2,591

Years ended December 31, 2005, December 31, 2004 and December 31, 2003

Net cash provided by operating activities

Our operating activities provided cash of $15.8 million in 2003, $17.7 million in 2004 and $17.8 million in 2005. The increase in cash from operations in 2005 was primarily due to an increase in accounts receivable of $4.9 million in 2005, compared to an increase of $3 million in 2004, which is attributed to an increase in our revenues, decrease in deferred income taxes in the sum of $0.3 million in 2005 compared to a decrease of $1.2 million in 2004 resulting from an increase in the profit before tax in some of our subsidiaries, increase in accounts payable of $0.5 million in 2005 compared to $2.6 million in 2004 resulting from a material increase in inventories in 2004 due to our decision to increase the levels of inventories in light of increasing sales activity mainly in Brazil and Argentina in 2004, increase in deferred revenues of $0.3 million in 2005 compared to an increase of $1 million in 2004 resulting mainly from increased level of activity of providing services in Brazil to private subscribers paying a monthly service fee as opposed to some insurance companies paying subscription fees in advance.

The increase in cash from operations in 2005 was partially offset by an increase in inventory of $0.3 million in 2005 compared to an increase in inventories of $1.3 million in 2004 which was due our decision to increase the levels of inventories in light of expected growth of sales of our products in Brazil and Argentina and an increase in other current liabilities of $3.2 million in 2005 compared to an increase of $1.9 million in 2004, resulting mainly from an increase in tax liabilities.

The increase in cash from operations in 2004 was primarily due to an increase in net income of $5.4 million, an increase in accounts payable of $2.6 million, compared to a decrease of $0.8 million in 2003, resulting from our decision to increase our inventories due to increasing levels of sales, an increase in other current liabilities of $1.9 million, compared to an increase of $2.0 million in 2003, resulting from tax liabilities, and an increase in exchange differences on principal of deposits and loans of $0.4 million, compared to a decrease of $0.8 million in 2003. This increase in cash from operations was partially offset by an increase in inventories of $1.3 million, compared to a decrease of $3.6 million in 2003, resulting from expected growth in the sale of our products in Brazil and Argentina and an increase in accounts receivable of $3.0 million, compared to an increase of $0.6 million in 2003, resulting from the sale of our RFID products to Derech Eretz and an increase in the sale of our AVL products in Brazil.

Net cash used in investing activities

Our investing activities used cash of $4.9 million in 2005 primarily due to the purchase of property and equipment and purchase of intangible assets and minority interest for $4.3 million and an increase in funds with respect to employee rights upon retirement of $0.3 million. Our investing activities used cash of $2.9 million in 2004 primarily due to the purchase of property and equipment for $2.4 million and an increase in funds with respect to employee rights upon retirement of $0.4 million. Our investing activities used cash of $2.2 million in 2003, primarily due to the purchase of property and equipment for $2.3 million and proceeds from the sale of property and equipment for $0.1 million.

Net cash provided by (used in) financing activities

Our financing activities provided cash of $41.3 million in 2005 primarily from issuance of capital shares of $50 million which was partially offset by repayment of our short-term and long-term loans totaling $6.1 million and a dividend payment of $2.7 million paid during such period. Our financing activities used cash of $14.1 million in 2004 primarily for repayment of our short-term and long-term loans totaling $23.6 million and a dividend payment of $1.3 million paid during such period which was partially offset by the incurrence of new loans totaling $9.4 million. Our financing activities in 2003 used cash of $11.1 million primarily for repayment of our short-term and long-term loans totaling $16.2 million, which was partially offset by the incurrence of new long-term loans totaling $5.1 million.

C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

All of our research and development activities take place in Israel. Our Research and Design department is currently working on expanding our AMR product lines to include fixed area network systems and to adapt the Dialog 3G product lines for the electrical power and natural gas meter industry. Expenditures for research and development activities engaged by us were approximately US$ 2.8 million in 2005, US$ 2.0 million in 2004 and US$1.7 million in 2003.

D. TREND INFORMATION

Please see Item 4.A. History and Development of the Company and Item 4.B. Business Overview above for trend information.

E. OFF-BALANCE SHEET ARRANGEMENTS

We do not have off-balance sheet arrangements (as such term is defined in Item E(2) of the Form 20-F) that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial conditions, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

F. TABULAR DISCLOSRE OF CONTRACTUAL OBLIGATIONS

Contractual obligations and commercial commitments

The following table summarizes our material contractual obligations as of December 31, 2005:

	Payments due by period				
Contractual obligations[1]	**Total**	**Less than 1 year**	**1-3 years**	**4-5 years**	**After 5 years**
	(In thousands)				
Operating leases	3,511	947	1,273	794	497
Long-term loans	3,454	3,119	335	--	--
Total	6,965	4,066	1,608	794	497

(1) We may have to commence paying royalties at the rate of 3% with respect to revenues derived from services provided and products sold in Brazil and Argentina pursuant to the terms of royalty provisions in some of our license agreements with Teletrac if we elect to retain our exclusive rights in these countries.

G. SAFE HARBOR

The safe harbor provided in Section 27A of the Securities Act and Sections 21E of the Exchange Act shall apply to forward looking information provided in Items 5.E and F.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

The following persons are our directors, senior management and employees upon whose work we are dependent:

Name(1)	Age	Position
Izzy Sheratzky	60	Chairman of the Board of Directors
Yehuda Kahane	62	Director
Ron Benjamin[(1)]	74	Director
Avner Kurz	53	Director
Amos Kurz	50	Director
Yigal Shani	62	Director
Eyal Sheratzky	38	Co-Chief Executive Officer and Director
Nir Sheratzky	34	Co-Chief Executive Officer and Director
Gil Sheratzky	29	Director
Yoav Kahane	32	Director
Orna Ophir[(1)]	56	Director
Israel Baron[(1)]	53	Director
Eli Kamer	40	Executive Vice President, Finance; Chief Financial Officer
Guy Aharonov	41	General Counsel
Eddy Kafry	54	President & Chief Executive Officer of Telematics Wireless

(1) Member of our audit committee and an independent director under the Nasdaq National Market listing requirements.

Izzy Sheratzky is a co-founder of our company and has served as the Chairman of our Board of Directors, which in our company constitutes both an officer and director position, ever since our company was acquired from Tadiran in 1995. Until 2003, Mr. Sheratzky also served as our Chief Executive Officer. Mr. Sheratzky also serves as the Chairman of the Board of Directors of Telematics Wireless, Moked (1973) Investigations Company Ltd., Moked Services, Information and Investments Ltd., and Moked Ituran. He also serves as a director in Tikal Document Collection Ltd. Mr. Sheratzky is the father of Eyal, Nir and Gil Sheratzky.

Yehuda Kahane is a co-founder of our company and has served as a director since its acquisition from Tadiran in 1995. Professor Kahane is a full-time professor at the Faculty of Management, Tel Aviv University. Professor Kahane founded and served as the first Dean of the Israeli Academic School of Insurance until 2000. In addition, he was the co-founder and co-owner of the managing firm of the first balanced pension fund in Israel, Teshura, a co-owner of the technological incubators Weizman, Ofakim and Katzrin, and is involved in the formation, seed investment and management of start-up companies. Professor Kahane serves as an actuarial consultant to various companies and organizations. and has been providing financial consulting services to our company since 1998. Professor Kahane also serves as a director of Telematics Wireless and of Moked Ituran. He is a director in Tachlit Investment House Ltd. and Capital Point Ltd. and in a large number of private technological companies unrelated to us. He is the chairman of an association for the visually impaired of Hertzelia and Sharon District and a board member of the umbrella organization for the visually impaired in Israel. Professor Kahane holds a BA degree in Economics and Statistics, an MA degree in Business Administration and a PhD in Finance from the Hebrew University of Jerusalem. He is the father of Yoav Kahane.

Ron Benjamin has served as a director of our company since its acquisition in 1995 and serves as a member of our audit committee. Mr. Benjamin also serves as Co-Chief Executive Officer and director of Moked (1973) Investigations Company and Moked Services, Information Management and Investments and as a director of Moked Ituran and of Tikal Document Collection.

Avner Kurz has served as a director of our company since its acquisition in 1995. Mr. Kurz is the Chairman and director of F.K. Generators & Equipment Ltd. and serves as a Chief Executive Officer of Teleran Holding, our subsidiary in Brazil. Mr. Kurz also serves as a director of Telematics Wireless, El-Ram, Moked Ituran, Totam Plus, Expandis and several other private companies abroad. Mr. Kurz is the brother of Amos Kurz.

Amos Kurz has served as a director of our company since its acquisition in 1995. Mr. Kurz also serves as a director of Telematics Wireless, and as Chief Executive Officer and director of F.K. Generators & Equipment. Mr. Kurz is the brother of Avner Kurz.

Yigal Shani has served as a director of our company since its acquisition in 1995. Mr. Shani is an insurance agent and a partner in the insurance agency Tzivtit Insurance Agency (1998), Ltd., which provides insurance services to our company. Mr. Shani also serves as a director of Gir Magen.

Eyal Sheratzky has served as a director of our company since its acquisition in 1995 and as a Co-Chief Executive Officer since 2003. Prior to such date, he served as an alternate Chief Executive Officer of our company in 2002 and as Vice President of Business Development during the years 1999 through 2002. Mr. Sheratzky also serves as a director of Moked Ituran and certain of our other subsidiaries, including Telematics Wireless, Ituran Network and Ituran Cellular Communication. From 1994 to 1999, he served as the Chief Executive Officer of Moked Services, Information and Investments and as legal advisor to several of our affiliated companies. Mr. Sheratzky holds LLB and LLM degrees from Tel Aviv University School of Law and an Executive MBA degree from Kellogg University. Mr. Sheratzky is the son of Izzy Sheratzky, the brother of Nir and Gil Sheratzky.

Nir Sheratzky has served as a director of our company since its acquisition in 1995 and as a Co-Chief Executive Officer since 2003. Prior to such date, Mr. Sheratzky served as alternate Chief Executive Officer of our company from 1995 to 2003. Mr. Sheratzky is also a director of Telematics Wireless and of Moked Ituran. He holds BA and MA degrees in Economics from Tel Aviv University. Nir is the son of Izzy Sheratzky, the brother of Eyal and Gil Sheratzky.

Gil Sheratzky has served as a director of our company and as our advertising officer since 2003. Prior to such date, he worked in our control center during the years 2000 and 2001, and during the years 2001 and 2002, he worked in an advertising agency. Mr. Sheratzky holds a BA degree in Business Management from the Interdisciplinary Center, Herzlya. Mr. Sheratzky is the son of Izzy Sheratzky, the brother of Eyal and Nir Sheratzky.

Yoav Kahane has served as director of our company since 1998 and also serves as a director of Telematics Wireless. Since January 2006, Mr. Kahane serves as SBU Manager of Enzymotec Ltd. a biotechnology company. Prior to that, during the years 2004-2005, Mr. Kahane served as Vice President of Sales and Marketing in Elbit Vision Systems Ltd. Prior to that date, during the years 2001 and 2002, he served as Manager of Business Development in Denver Holdings and Investments Ltd. In 2000, Mr. Kahane established Ituran Florida Corp. and served as its Chief Executive Officer until 2001. Mr. Kahane has been providing consulting services to our company since 2004. Mr. Kahane holds BSc degree in Life Sciences form Tel-Aviv University, a BA degree in Insurance and an MBA degree from the University of Haifa. Yoav Kahane is the son of Professor Kahane.

Orna Ophir has been serving as an external director of our company since 2003 and is a member of our audit committee. Dr Ophir has been serving as Medical Director of Assuta hospitals in Israel since November 2004 and as Chief Executive Officer of the Golden Tower Hospital (Bat Yam, Israel) since 2001. Prior to such date, Dr Ophir served as Executive Vice President of Assuta Hospital (Tel Aviv, Israel) during the years 1997 to 2000. In addition, Dr Ophir is a director of Macabi Health Services, one of the principal health providers in Israel. Dr Ophir holds MD and MBA degrees from Tel Aviv University.

Israel Baron has been serving as an external director of our company since 2003 and is a member of our audit committee. Mr. Baron has been serving as Chief Executive Officer of several public sector employee retirement and saving plans since 2003. Prior to such date, Mr. Baron managed an organizational consulting firm, served as an investment manager in the Isaac Tshuva group during the years 1999 to 2001 and as Chief Executive Officer of Gmulot Investment Company Ltd. Mr. Baron serves as director of Quality Baron Management Services Ltd. and until 2004 he served as a director of Brill Shoe Industries Ltd. Mr. Baron is a certified CPA and holds a BA degree in Economics and Accounting.

Eli Kamer has served as Executive Vice President, Finance and Chief Financial Officer of our company since 1999, after serving as its Finance Department Manager since 1997. Prior such date, Mr. Kamer worked as an accountant in Fahn Kanne & Co., our independent auditors. Mr. Kamer is a CPA and holds a BA degree in Business Administration from the Israel College of Management and an MBA degree in business administration from Bar Ilan University.

Guy Aharonov has served as our in-house legal counsel since 1999. Prior to joining our company, he has worked as an attorney in Cohen Lahat & Co. Mr. Aharonov holds LLB and LLM degrees from Tel Aviv University.

*Eddy Kafr*y is President and Chief Executive Officer of Telematics Wireless. Mr. Kafry worked for Tadiran Ltd. until 1989 in the development of various weapon systems. He then spent five years with Kollsman leading the development and engineering of the Night Targeting System for the USMC AH-1W Cobra Attack Helicopter. In 1995 Mr. Kafry founded Telematics Wireless within Tadiran. He has served as President and Chief Executive Officer since then. He holds a BSc degree from the Israel Institute of Technology.

Our articles of association provide for staggered three-year terms for all of our directors. The directors on our Board (excluding the external directors) are divided into three classes, and each class of directors will serve for a term of three years. Our independent directors who also qualify as external directors under the Israeli Companies Law, Orna Ophir and Israel Baron, are serving three-year terms in accordance with Israeli law. In April 2006 our general meeting of shareholders approved the extension of term of office of our external directors, for an additional term of three years (until June 3, 2009) under the same terms of the initial term of office.

B. COMPENSATION

The aggregate direct compensation we paid to our directors who are not officers for their services as directors as a group for the year ended December 31, 2005 was approximately $15,000. Directors are reimbursed for expenses incurred in connection with their attendance of board or committee meetings.

The aggregate compensation paid to our Co-Chief Executive Officers in 2005 was $702,000. Our four highest paid officers in 2004, other than our Co-Chief Executive Officers, were the active Chairman of our Board of Directors, who was paid $1,275,000 in 2005, and our Vice President, Finance, IT and Systems Operation, our Purchase and Logistics Manager, who were paid $145,000, $132,000 and $120,000, respectively. The aggregate compensation paid to all Ituran officers as a group during 2005 was $2,899,000. In 2005, we also paid an aggregate amount of $40,000 to a director for services provided to us and employment compensation in an aggregate amount of $153,000 to three directors who are our employees but are not Ituran officers. These compensation amounts include amounts attributable to automobiles made available to our officers and other fringe benefits commonly reimbursed or paid by companies in Israel. Employee directors do not receive additional fees for their services as directors. During 2005, we set aside $198,000 for the benefit of our officers for pension, retirement or similar benefits. We do not set aside any funds for the benefit of our directors who are not employees for any pension, retirement or similar benefits. All numbers in this paragraph are rounded to the nearest thousand.

Messrs. Izzy Sheratzky, Eyal Sheratzky and Nir Sheratzky provide their services as Chairman of our Board of Directors and Co-Chief Executive Officers, respectively, as independent contractors pursuant to services agreements between the company and A. Sheratzky Holdings Ltd., a company controlled by Izzy Sheratzky. See Item 7.B. Related Parties Transactions under the caption Transactions with Related Parties below.

The compensation paid to Mr. Izzy Sheratzky included a bonus in an amount equal to 5% of our profits before tax (including the share of affiliated companies net and minority interests in (income) loss of subsidiaries), on a consolidated basis, based on our audited consolidated financial statements for the relevant year, to which Mr. Izzy Sheratzky is entitled pursuant to his services agreement with the company. The compensation paid to each of our Co-Chief Executive Officers, Eyal Sheratzky and Nir Sheratzky, includes a bonus in an amount equal to 1% of our profits before tax, on a consolidated basis, based on our audited consolidated financial statements for the relevant year, granted pursuant to a resolution of our Board of Directors from January 2004. See Item 7 Related Parties Transactions under the caption Transactions with our directors and principal officers below.

As of the date of this report, our executive officers and directors held options to purchase an aggregate of 230,889 of our ordinary shares. The exercise price of each option is NIS 1 and each option is fully vested and exercisable into three ordinary shares, par value of NIS $0.33^{1}/_{3}$ each.

We do not have any agreements with directors providing for benefits upon termination of their respective employment.

Shareholders Agreement and Articles of Association of Moked Ituran

On May 18, 1998, a shareholders agreement was entered into between Moked Ituran Ltd. and each of Moked s shareholders, Moked Services, Information, Management and Investments Ltd. (38%), F.K. Generators and Equipment Ltd. (26%), Yehuda Kahane Ltd. (26%), Gideon Ezra, Ltd. (2.5%), T.S.D. Holdings Ltd. (3.75%) and G.N.S. Holdings Ltd. (3.75%). On May 18, 1998, Moked s articles of association were amended to incorporate some of the provisions of the shareholders agreement as well as other provisions governing the relationship of its shareholders. The Moked articles were amended again on September 6, 2005 to correspond to an amendment to the shareholders agreement that was entered into on such date.

Gideon Ezra, Ltd. is a company controlled by Gideon and Hanna Ezra with each owing 50% of the capital stock of such company. Moked Services, Information, Management and Investments is a company owned by A. Sheratzky Holdings Ltd. (a company controlled by Izzy Sheratzky) (66.6%) and Benjamin Ron (2003) Ltd. (a company controlled by Ron Benjamin) (33.3%). F.K. Generators and Equipment is a company controlled by Perfect Quality Trading Ltd. (51%), a company owned by Avner Kurz and Amos Kurz in equal parts. Yehuda Kahane Ltd. is a company owned by Professor Kahane and Rivka Kahane. T.S.D. Holdings is a company controlled by Efraim Sheratzky. G.N.S. Holdings is a company controlled by Yigal Shani.

The shareholders agreement (as amended) and Moked s amended articles of association provide as follows:

- Prior to the time a shareholders meeting of our company takes place, a separate meeting of the shareholders of Moked will be convened.
- At the Moked shareholders meeting, all matters included in our meeting s agenda will be discussed and voted on.
- The required quorum in the Moked meeting will be any number of the shareholders actually present. The resolutions will be adopted by a majority of the votes present and voting is based on the relative shareholdings in Moked, with the exception of Moked Services, Information, Management and Investments, which is entitled to 41.5% of the voting rights, thereby decreasing the voting rights of F.K. Generators and Equipment to 22.5% on the vote of any matter other than issues in which Izzy Sheratzky has a direct or indirect interest.

- With respect to director elections, every Moked shareholder holding at least 3.5% of Moked s shares is entitled to designate one director in our annual shareholders meeting. Each Moked shareholder holding over 10% of Moked s shares may nominate an additional director for every additional 10% of Moked shares held by him or her in excess of the initial 10%. For the purpose of nominating additional directors, shareholdings may be aggregated.

- As discussed in Board of Directors in Item 6.C Board Practices below, our directors (excluding the external directors) are divided into three classes as follows: class A Amos Kurz, Yoav Kahane, Eyal Sheratzky and Yigal Shani (with their term of office expiring in 2007), class B Yehuda Kahane, Avner Kurz and Nir Shertazky (with their term of office expiring in 2008); and class C Gil Sheratzky, Ron Benjamin and Izzy Sheratzky (with their term of office expiring in 2009).

- Upon the expiration of the term of office of our class A directors, each of Moked Services, Information and Investment, provided it holds at least 40% of the voting rights (together with the 3.5% of the voting rights held by F.K. Generators and Equipment), Yehuda Kahane Ltd., provided it holds at least 20% of the voting rights, F.K. Generators and Equipment, provided it holds at least 20% of the voting rights, and Yigal Shani or G.N.S. Holdings, provided either of them holds at least 3.5% of the voting rights, shall be entitled to require Moked to appoint one director to class A. Upon the expiration of the term of office of the directors in class B, each of Moked Services, Information and Investment, provided it holds at least 40% of the voting rights (together with the 3.5% of the voting rights held by F.K. Generators and Equipment), and Yehuda Kahane, provided it holds at least 20% of the voting rights, and F.K. Generators and Equipment, provided it holds at least 20% of the voting rights, shall be entitled to require Moked to appoint one director to class B. Upon the expiration of the term of office of the directors in class C, (i) Moked Services, Information and Investment, provided it holds at least 36.5% of the voting rights shall be entitled to require Moked to appoint two directors and (ii) Efraim Sheratzky or T.S.D. Holdings, provided either of them holds at least 3.5% of the voting rights, shall be entitled to require Moked to appoint one director to class C.

- Moked has agreed to vote all of its shares at our shareholders meetings in accordance with the resolutions adopted at the Moked shareholders meeting or, with regard to director elections, as described above. In the event of a tie with respect to a certain issue, Moked has agreed to vote its shares against the relevant resolution at our shareholders meeting.

- Moked s shareholders have a right of first refusal on any sale of our shares by Moked. This right does not apply to open market sales by Moked of up to 2% of the issued share capital of our company in any given calendar year.

- According to Moked s articles of association, each of the shareholders of Moked may direct Moked to dispose of a portion of Moked s holdings in our company that corresponds to such shareholders proportional holdings in Moked and to distribute the proceeds of such disposition to such directing shareholders.

This shareholders agreement is in effect only for as long as Moked holds at least 20% of our issued and outstanding share capital. We expect Moked to continue to hold at least 20% of our issued and outstanding share capital following the consummation of this offering.

C. BOARD PRACTICES

Board of Directors

Currently, pursuant to our articles of association as presently in effect, our Board of Directors consists of twelve directors, including two external directors in accordance with Israeli law and three independent directors in accordance with the listing requirements of the Nasdaq National Market. Pursuant to our articles of association, other than the external directors, for whom special election requirements apply (see External directors below), our directors are elected and may in certain circumstances be removed by the majority of our shareholders. Our articles of association provide for staggered three-year terms for all of our directors. The directors on our Board (excluding the external directors) are divided into three classes, and each class of directors will serve for a term of three years. The term of office of the directors assigned to class A will expire at our annual meeting of shareholders to be held in 2007, and at each third succeeding annual meeting thereafter. The term of office of the directors assigned to class B will expire at the annual meeting of shareholders to be held in 2008, and at each third succeeding annual meeting thereafter. The term of office of the directors assigned to class C will expire at the annual meeting of shareholders to be held in 2009, and at each third succeeding annual meeting thereafter. This classification of the Board of Directors may delay or prevent a change of control of our company or in our management. The external directors, under Israeli law, serve a three-year term which may be extended for an additional term of three years. Our directors may at any time and from time to time appoint any other person as a director to fill a vacancy until the general meeting of shareholders in which the term of service of the replaced director was scheduled to expire. External directors may be removed from office pursuant to the terms of the Israeli Companies Law, 5759 1999, which we refer to as the Israeli Companies Law. See External directors below.

Pursuant to the Israeli Companies Law, our chairman convenes and presides over the meetings of the Board. In addition, any two directors may convene a meeting of the Board of Directors. A quorum consists of a majority of the members of the Board, and decisions are taken by a vote of the majority of the members present. Our articles of association provide that such quorum will in no event be less than two directors.

The Israeli Companies Law provides that an Israeli company may, under certain circumstances, exculpate an office holder from liability with respect to a breach of fiduciary duties.

We are incorporated in Israel and in addition to being listed on the Nasdaq National Market, we are also listed on the Tel Aviv Stock Exchange, and therefore subject to various corporate governance requirements pursuant to Israeli law relating to external directors, our audit committee and our internal auditor.

External directors

Under Israeli law, the board of directors of companies whose shares are publicly traded are required to include at least two members who qualify as external directors. External directors must be elected by the vote of a majority of the shares present and voting at a shareholders meeting provided that either:

- such majority includes at least one-third of the shares held by all non-controlling shareholders present and voting at such meeting; or
- the total number of shares voted against the election of the external director and held by shareholders other than controlling shareholders must not exceed 1.0% of the shares whose holders are entitled to vote at any meeting of shareholders.

External directors are elected to serve an initial term of three years and may be reelected to serve in that capacity for an additional three years. External directors may be removed from office by the same percentage of shareholders required for their election or by a court, in each case, only under limited circumstances, including ceasing to meet the statutory qualification for their appointment or violating the duty of loyalty to the company. If all directors are of the same sex, the next external director elected must be of the other sex. Each committee of the board of directors must include at least one external director, except that the audit committee must include all external directors then serving on the board of directors. Israeli law regulating the compensation of external directors prohibits external directors from receiving, directly or indirectly, any compensation other than for services as an external director pursuant to the provisions and limitations set forth in the regulations promulgated

under the Israeli Companies Law.

Israeli law provides that a person is not qualified to serve as an external director if, at any time during the two years preceding his or her appointment, that person, a relative, partner or employer of that person, or any entity under that person s control has had any affiliation or business relationship with the company, any entity controlling the company or an entity that, as of the date of appointment, or at any time during the two years preceding that date, is controlled by the company or by any entity controlling the company. In addition, no person may serve as an external director if that person s professional activities create, or may create, a conflict of interest with that person s responsibilities as a director or otherwise interfere with that person s ability to serve as a director. Until the lapse of two years after termination of an external director s membership on a board of directors, such company may not engage an external director to serve as an executive officer or director and cannot employ or retain that person to provide paid professional services, whether directly or indirectly.

Dr. Ophir and Mr. Baron have been elected as our external directors through 2006, and were re-elected by our shareholders for one additional three-year term expiring June 2009.

Audit committee

Under Israeli law, the board of directors of a public company must appoint an audit committee. The audit committee must comprise of at least three directors, including all of the external directors. The audit committee may not include the chairman of the board, any director who is employed by the company or regularly provides services to the company (other than as a board member), a controlling shareholder or any relative of such person.

Our Board of Directors has formed an audit committee that is empowered to exercise the powers of the Board of Directors for our accounting, reporting and financial control practices. The members of the audit committee are Dr. Orna Ophir and Messrs. Israel Baron and Ron Benjamin. Our Board of Directors has determined that Mr. Israel Baron is the committee s financial expert, as such term is defined by the rules of the Nasdaq National Market and the Securities and Exchange Commission.

Compensation committee

Our Board of Directors has appointed a Compensation Committee, pursuant to the listing requirements of the Nasdaq National Market. The members of the Compensation Committee are Orna Ophir, Israel Baron and Ron Benjamin. The Compensation Committee of our Board of Directors recommends the review and oversees the salaries, benefits and stock option plans for our employees, consultants, directors and other individuals whom we compensate. The Compensation Committee also administers our compensation plans. Our Board of Directors has determined that each member of the Compensation Committee is independent.

Internal auditor

The board of directors of an Israeli public company must appoint an internal auditor nominated by the audit committee. An internal auditor may not be:

- a person (or a relative of a person) who holds more than 5% of the company's shares;
- a person (or a relative of a person) who has the power to appoint a director or the general manager of the company;
- an executive officer, director or other affiliate of the company; or
- a member of the company's independent accounting firm.

The role of the internal auditor is to examine, among other things, the compliance of the company s conduct with applicable law and orderly business procedures. Our internal auditor is Simon Yarel, CPA.

The Sarbanes-Oxley Act of 2002 and the Nasdaq National Market listing standards

The Sarbanes-Oxley Act of 2002, as well as related new rules subsequently implemented by the Securities and Exchange Commission, requires foreign private issuers, such as us, to comply with various corporate governance practices. In addition, Nasdaq has recently adopted amendments to its requirements for companies that are listed on the Nasdaq National Market. Nasdaq Marketplace Rule 4350 was amended to permit foreign private issuers, such as us, to follow certain home country corporate governance practices without the need to seek an individual exemption from Nasdaq.

In reliance upon Nasdaq Marketplace Rule 4350(a)(1), as a foreign private issuer, we have elected to follow our home country practices, absent home country rules requiring otherwise, in lieu of certain Nasdaq Marketplace Rules. Specifically, in Israel, it is not required that a public company have (i) a majority of its board of directors be independent, as defined in Marketplace Rule 4350(c), (ii) an audit committee comprised solely of members who are able to read and understand fundamental financial statements as required by Nasdaq Marketplace Rule 4350(d)(2) or (iii) a nominating committee as required by Nasdaq Marketplace Rule 4350(c)(4). As a result, we have elected to follow Isreali law regarding independence requirements of our Board of Directors and the composition of our Board of Directors will remain as is. See External directors above. Similarly, we have elected to follow Israeli law with regard to the composition of our existing audit committee, which has three independent (as defined in Marketplace Rule 4350(c)) members, two of whom are external directors under the Israeli Companies Law and meet the requirements of Nasdaq Marketplace Rule 4350(d)(2) and at least one of which meets the requirement of the Directive of the Israel Securities Authority that one non-employee member has financial and accounting skills to, among other things, understand, on a high level, matters relating to business, accounting, internal auditing and financial statements. See also Audit Committees above. In addition, our Board of Directors will not appoint a nominating committee as required by Nasdaq Marketplace Rule 4350(c)(4) and, instead, elects to follow Israeli law, which provides that a company may determine its method of nominating its directors. In our case, Board of Director members (other than the External Directors) are nominated by our Board of Directors, as is the custom in Israel. By law, shareholders holding at least 1% of a company s voting rights may nominate directors and our company complies with this law. External Directors are nominated by the board of directors and must be elected at the shareholders general meeting that must approve them by a majority and in addition, either (i) one third of the non-controlling shareholders participating in such vote have voted for such External Directors; or (ii) the shareholders opposing such nomination that are not controlling shareholders must not represent in excess of 1% of the total voting rights in the company.

D. EMPLOYEES

The following table sets forth the total number of our subsidiaries employees at the end of each of the past three years, and a breakdown of persons employed by main category of activity and geographic location:

	Year Ended December 31,		
	2005	**2004**	**2003**
By area of activity:			
Control Center	195	206	193
Research and Development	36	28	23
Sales and Marketing	62	47	36
Technical support and IT	100	102	77
Finance, Administration and Management	259	148	130
Private enforcement and operations	130	120	66
Total	**782**	**651**	**525**
By geographic location (out of total):			
Israel	397	387	359
Brazil	222	125	86
Argentina	138	115	55
United States	25	24	25
Total:	**782**	**651**	**525**

We consider our relations with our employees to be satisfactory and have no ongoing major labor disputes or material labor-related litigation. Our employees are subject to local labor laws and regulations, which in some countries are more stringent than others. Some of our

senior executives also have employment agreements that may grant them rights in excess of those provided by the applicable laws.

Israel

Our employees in Israel are subject to Israeli labor laws and regulations and employment customs. The applicable labor laws and regulations principally concern matters such as paid annual vacation, paid sick days, length of the workday, payment for overtime and severance pay. Israeli law generally requires severance pay equal to one month s salary for each year of employment upon retirement or death of an employee or termination of employment without cause. Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Since January 1, 1995, these amounts also include payments for national health insurance.

In addition, the provisions of a special collective agreement between our subsidiary, Telematics Wireless, the Histadrut (the General Federation of Labor in Israel) and the workers representatives are applicable to some of the employees of Telematics Wireless. This agreement includes the following provisions:

- Telematics Wireless is obligated to share its profits with its employees each year, based on a formula that takes into consideration Telematics Wireless profits and the employee s salary for the applicable year.

- Telematics Wireless agreed that in the event that its shares are registered in a public offering, it will offer employees subject to this collective bargaining agreement the option to purchase no less than 2% of its shares on the same basis and based on the same criteria as its shares are offered to employees who joined Telematics Wireless after July 2000 (the date of the collective bargaining agreement) and who are not party to this collective bargaining agreement.

In addition, by order of the Israeli Ministry of Labor and Welfare, the provisions of several collective bargaining agreements between Telematics Wireless, the Histadrut and the Industrialists Association in Israel may be applicable to a segment of our employees other than managerial, finance and administrative, and marketing and sales personnel. However, we believe we provide our employees with benefits and working conditions that are at least as favorable as the conditions specified in these collective bargaining agreements.

Brazil

Our employees in Brazil are subject to Brazilian labor laws and regulations and employment customs. The laws and regulations in Brazil govern all aspects of labor relations and designate a general employment contract with which all employees and employers must comply. This general employment contract adopts by reference the provisions of the Labor Law which principally relates to matters such as paid annual vacation, paid sick days, the length of the workday, payment for overtime and severance pay. Brazilian law generally requires severance pay equal to 50% of the sum the dismissed worker accumulated in its pension fund during the period of employment upon the retirement or death of an employee or termination of employment without cause. Brazilian employers are also required to purchase health insurance for employees, cover employees food and travel costs, and allocate sums to the employees pension fund. Furthermore, Brazilian employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Our payments to the National Insurance Institute amount to 34.5% to 37.8% of the wages paid, depending on the amount of the wages, of which the employee contributes 7.7% to 11% and we contribute a fixed amount equal to 26.8%.

All of our employees in Brazil, excluding the chief executive officer, are members of a labor union and the employee member fees to the union are paid by us.

Argentina

Our employees in Argentina are subject to Argentine labor laws and regulations and other special practices and employment customs. The laws and regulations in Argentina control all aspects of labor relations and designate a general Employment Contract with which all employees and employers must comply. This general Employment Contract adopts by reference the provisions of the Labor Law which principally concerns matters such as paid annual vacation, paid sick days, the length of the workday, and payment for overtime and severance pay. Argentinean law generally requires severance pay equal to one month per year of service upon the termination of employment without a justified cause. Argentine employers are also required to contribute for health insurance for employees and allocate sums to the employee s pension fund. Our payments for pension funds is 17.5% and healthcare amount to 6% of each gross salary.

Our employees in Argentina, excluding the chief executive officer and a number of other employees, are members of a labor union and the employee member fees are paid by them.

United States

We have no collective bargaining agreements with any of our employees in the United States and none of our employees are members of a union.

E. SHARE OWNERSHIP

The following sets forth, as of June 21, 2006, the share ownership of our directors and executive officers. All of the information with respect to beneficial ownership by our directors and executive officers has been furnished by the respective director or executive officer, as the case may be.

Name of Director/Officer(1)	Number of Ordinary Shares Beneficially Owned (2)	Percentage of beneficial ownership
Izzy Sheratzky (3)	6,349,579	27.32%
Professor Yehuda Kahane (4)	2,278,539	9.80%
Ron Binyamin (5)	334,282	1.44%
Avner Kurz (6)	1,737,532	7.48%
Amos Kurz (7)	1,445,205	6.22%
Yigal Shani (8)	392,985	1.69%
Eyal Sheratzky (9)	*	*
Nir Sheratzky (10)	*	*
Gil Sheratzky	-	-
Yoav Kahane	*	*
Orna Ophir	-	-
Israel Baron	-	-
Eli Kamer	-	-
Guy Aharonov	*	*
Eddy Kafry	*	*

* owns less than one per cent of our outstanding share capital.

(1) This table includes only current directors and officers that beneficially hold our shares.

(2) Percentages in this column are based on 23,244,542 ordinary shares outstanding as of June 21, 2006. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission (as defined in Rule 13d 3 under the Securities Exchange Act of 1934) and shares deemed beneficially owned by virtue of the right of any person or group to acquire such ordinary shares within 60 days are treated as outstanding only for the purposes of determining the percent owned by such person or group. To our knowledge, the persons and entities named in the table above are believed to have sole voting and investment power with respect to all ordinary shares shown as owned by them, except as described below.

(3) Shares beneficially owned include: (a) 611,738 shares directly owned by Mr. Sheratzky, of which 5,427 shares are jointly owned with his wife, Maddie Sheratzky and of which 502,000 are owned by A. Sheratzky Holdings Ltd., a wholly owned company of Mr. Sheratzky (in May 2006, 76,965 ordinary shares were issued to Mr. Sheratzky pursuant to his exercise of options granted to

him as part the company s share incentive plan); (b) an option for the purchase of 230,889 ordinary shares granted to Mr. Sheratzky pursuant to the company s share incentive plan, which is currently exercisable within 60 days of the date hereof; and (c) 5,506,952 shares owned by Moked Ituran Ltd., which Mr. Sheratzky beneficially owns due to his shared voting and investment power over such shares in accordance with a certain shareholders agreement, dated May 18, 1998, among Moked Ituran and its shareholders, which we refer to as the Moked Shareholders Agreement. For further information concerning the Moked Shareholders Agreement see the discussion under Item 6.B. Compensation under the caption Shareholders agreement and articles of association of Moked Ituran above.

(4) Shares beneficially owned include: (a) 697,782 shares directly owned by Professor Kahane, of which 579,576 shares are jointly owned with his wife, Rivka Kahane, (b) 148,950 shares owned by Yehuda Kahane Ltd., which Professor Kahane may be considered to beneficially own by virtue of his shared voting and investment control of the company through his 50% shareholdings thereof, the other 50% being owned by his wife, Rivka Kahane; and (c) 1,431,807 shares owned by Moked Ituran, which Professor Kahane may be considered to beneficially own by virtue of his right to direct the disposition of such shares in accordance with Moked s articles of association. Professor Kahane has shared voting and investment control over Yehuda Kahane Ltd., a holder of 26% of the shares of Moked Ituran.

(5) Shares beneficially owned include (a) 28,101 shares directly and jointly owned by Ron Benjamin and his wife, Chaya Benjamin and (b) 306,181 shares owned by Benjamin Ron (2003) Ltd., which Ron Benjamin may be considered to beneficially own by virtue of his sole voting and investment control over such shares as described above.

(6) Shares beneficially owned include: (a) 292,326 shares directly owned by Avner Kurz, (b) 13,398 shares owned by F.K. Generators and Equipment, which Avner Kurz may be considered to beneficially own by virtue of his shared voting and investment power over such shares through his 50% ownership of Perfect Quality Trading Ltd., a majority shareholder of F.K with the other 50% ownership of Perfect Quality Trading Ltd. owned by Mr. Amos Kurz (Avner Kurz s brother), and (c) 1,431,807 shares owned by Moked Ituran that Avner Kurz may be considered to beneficially own through F.K. as described above, which F.K. is deemed to beneficially own by virtue of its right to direct the disposition of such shares in accordance with Moked s articles of association (due to its 26% ownership of Moked Ituran).

(7) Shares beneficially owned include: (a) 13,398 shares owned by F.K. Generators and Equipment, which Amos Kurz may be considered to beneficially own by virtue of his shared voting and investment power over such shares through his 50% ownership of Perfect Quality Trading Ltd., a majority shareholder of F.K., with the other 50% ownership of Perfect Quality Trading Ltd. owned by Mr. Avner Kurz (Amos Kurz s brother); (b) 1,431,807 shares owned by Moked Ituran that Amos Kurz may be considered to beneficially own as described above.

(8) Shares beneficially owned include: (a) 30,000 shares owned by G.N.S. Holdings Ltd. which Yigal Shani may be considered to beneficially own by virtue of his sole right to direct the disposition of such shares through his 100% ownership thereof, (b) 154,200 shares owned by Tzivtit Insurance Agency (1998) Ltd., which Yigal Shani may be considered to beneficially own by virtue of his shared voting and investment control over such shares through his 50% ownership thereof, the other 50% of the shares held by Efraim Sheratzky, and (c) 208,785 shares owned by Moked Ituran, which Mr. Shani may be considered to beneficially own by virtue of his right to direct the disposition of such shares in accordance with Moked s articles of association. Mr. Shani may be considered to beneficially own such shares by virtue of his sole voting and investment control over G.N.S. Holdings, the holder of 3.75% of Moked s shares, in which he owns 100% of the shares.

(9) In May 2006, 38,097 ordinary shares were issued to Eyal Sheratzky upon the exercise of options granted to him.

(10) In May 2006, 38,097 ordinary shares were issued to Nir Sheratzky upon the exercise of options granted to him.

Employee Share Option Plans

We adopted two option plans for managers and employees. The first option plan was adopted immediately prior to the time of our initial public offering on the Tel Aviv Stock Exchange in May 1998, pursuant to which we issued to our employees options to purchase 360,546 shares at a per-share exercise price of NIS $0.33^{1}/_{3}$, or $0.07, the par value of our ordinary shares. All options granted under the 1998 plan are fully vested and were exercised. Pursuant to our 2001 option plan, which was adopted on August 23, 2001, options to purchase an aggregate of 244,875 of our ordinary shares were granted to our employees, one of whom was also a director. All of these options were granted at a per-share

exercise price of NIS $0.33^1/_3$, or $0.07. The closing price of our ordinary shares on the TASE on the date these options were granted was NIS 12.20, or $2.67 per share. All of the options granted under the 2001 plan are fully vested and were exercised. In addition, on August 23, 2001, our Board of Directors resolved to grant options to purchase an aggregate of 601,857 ordinary shares to some of our directors and officers as follows: options to purchase 461,784 ordinary shares were granted to Mr. Izzy Sheratzky, our Chairman of the Board of Directors, options to purchase 50,796 ordinary shares were granted to each of Eyal Sheratzky and Nir Sheratzky, our Co-Chief Executive Officers and options to purchase 38,481 ordinary shares were granted to Mr. Yoav Kahane, our director. All such options were granted at a per-share exercise price of NIS $0.33^1/_3$ or $0.07 and are all fully vested and exercisable. Of these additional options, 217,809 ordinary shares were issued pursuant to exercise of options by Yoav Kahane, Izzy Sheratzky, Eyal Sheratzky and Nir Sheratzky and options for the purchase of 50,796 ordinary shares held by Eyal Sheratzky and Nir Sheratzky expired. On July 18, 2005, a special meeting of our shareholders approved the issuance of fully vested options to Eyal Sheratzky and Nir Sheratzky, in place of those options that expired. These options are exercisable for one year at a per-share exercise price of NIS $0.33^1/_3$ or $0.07, and were exercised in full by them in May 2006. As of the date of this report, options to purchase 230,889 of our ordinary shares are outstanding, all of which are fully vested and exercisable.

The following table sets forth information on stock options that have been granted and are outstanding as of the date of this report:

Name of grantee	No. of shares to be issued upon exercise of options	Weighted-average per-share exercise price	Expiration date[1]
Izzy Sheratzky	230,889	NIS $0.33^1/_3$	25% expire in September 2006 and 75% expire in September 2007
All directors and officers as a group	230,889	NIS $0.33^1/_3$	25% expire in September 2006 and 75% expire in September 2007
Other employees	-		
Total	230,889		

(1) All options are fully vested.

In January 2006, our remuneration committee adopted a resolution to pay our managers (not including managers who also serve as our directors) a quarterly bonus as of the first quarter of 2006 equal to 1.5% of our consolidated profit before tax and after equity and minority profits, which is divided between 13 of our managers in different proportions based on their seniority, level of global and domestic involvement in our operations and other criteria set by the committee.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS

The following table shows the number of our ordinary shares beneficially owned by (a) the only shareholders known to us as of June 21, 2006, to beneficially own more than 5% of our outstanding ordinary shares and (b) all of our directors and executive officers as a group. The number of ordinary shares used in calculating the percentage for each person listed below includes the shares underlying options or warrants held by such person that are exercisable within 60 days.

The shareholders listed below do not have any different or special voting rights from any other shareholders of our company. Except where otherwise indicated, we believe, based on information furnished by the owners, that the beneficial owners of the ordinary shares listed below have sole investment and voting power with respect to such shares. To our knowledge, none of our shareholders of record are US Holders, other than Yoav Kahane.

Shareholder	Number of Ordinary Shares Beneficially Owned (1)	Percentage of Outstanding Ordinary Shares(1)
Moked Ituran Ltd. (1)	5,506,952	23.69%
F.K. Generators and Equipment Ltd.(2)	1,445,205	6.22%
Gilder, Gagnon, Howe & Co. LLC (3)	1,323,020	5.69%
All directors and executive officers as a group	7,961,255	34.25%

(1) Moked s articles of association provides that each of Moked s shareholders shall have the right to direct Moked to dispose of such number of our shares corresponding to his or her relative shareholdings in Moked. For further information please see Item 6.B. Compensation under the caption Shareholders Agreement and Articles of Association of Moked Ituran above.

(2) Shares beneficially owned include 1,445,205 shares, of which (a) 13,398 shares are directly owned by F.K Generators & Equipment Ltd. (whereby Messrs. Avner Kurz and Amos Kurz are deemed to beneficially own said 13,398 shares owned by F.K. by virtue of their shared voting and investment power over such shares through their respective holdings of 50% each of ownership of Perfect Quality Trading Ltd., a majority shareholder of F.K.); and (b) 1,431,807 shares are owned by Moked Ituran Ltd., which F.K is deemed to beneficially own by virtue of its right to direct the disposition of such shares in accordance with a shareholders agreement dated May 28, 1998, as amended on September 6, 2005 (due to F.K. s 26% ownership of Moked Ituran).

(3) Information based on a Schedule 13G (Amendment No. 1), dated February 14, 2006, filed by Gilder, Gagnon, Howe & Co. LLC with the Securities and Exchange Commission.

None of our major shareholders have different voting rights than each other and/or than our other shareholders.

As of June 21, 2006, we had a total of 3* shareholders of record in the United States with registered with addresses in the United States. The number of record holders in the United States is not representative of the number of beneficial holders nor is it representative of where such beneficial holders are resident since many of these ordinary shares were held of record by brokers or other nominees

* Includes the Depository Trust Company.

B. RELATED PARTY TRANSACTIONS

Transactions with our directors and principal officers

We purchase our insurance policies, including our directors and officers insurance, through Tzivtit Insurance Agency (1998) Ltd., an insurance agency owned by Efraim Sheratzky, the brother of the Chairman of our Board of Directors and the uncle of both of our Co-Chief Executive Officers, and Yigal Shani, one of our directors. We pay an annual aggregate amount of NIS 948,500, or $211,400, for our basic insurance policies and NIS 1,366,200, or $304,500, for our directors and officers insurance policy. Tzivtit Insurance Agency is entitled to commissions in an aggregate amount of NIS 167,454, or $37,222 to be paid by the insurance company on account of these policies.

We have entered into indemnification agreements with each of our directors and officers and the officers and directors of our subsidiaries providing them with indemnification for liabilities or expenses incurred as a result of acts performed by them in their capacity as our directors and officers.

In February 2003, we entered into a two-year services agreement with A. Sheratzky Holdings, a company controlled by Izzy Sheratzky, and Izzy Sheratzky pursuant to which Mr. Sheratzky agreed to (i) cease to act as our Chief Executive Officer and (ii) to act as an independent

contractor that provides us full-time services as Chairman of the Board of Directors, under the same terms of his previous employment as Chief Executive Officer. Pursuant to the agreement, A. Sheratzky Holdings will receive compensation equal to NIS 85,500, or approximately $19,000, per month, adjusted for inflation, plus reimbursement of certain business expenses. In addition, Mr. Sheratzky will be entitled to participate in our profits in an amount equal to 5% of profits before tax, on a consolidated basis, based on our audited consolidated financial statements for the relevant year. This services agreement is automatically renewable for successive two-year periods until either party notifies the other of its intention to terminate the agreement, by providing a 180-day prior written notice.

On September 5, 2002, we entered into independent contractor agreements with A. Sheratzky Holdings and each of Eyal Sheratzky and Nir Sheratzky pursuant to which A. Sheratzky Holdings will provide management services to us through Eyal Sheratzky and Nir Sheratzky in consideration of monthly payments in the amount of NIS 48,892 and NIS 49,307, or $10,897 and $10,990, respectively, in addition to providing each of them a company car and reimbursement of certain business expenses. In January 2004, a change in the employment terms of the Chief Executive Officer was approved providing each of our Co-Chief Executive Officers, Eyal Sheratzky and Nir Sheratzky, an annual bonus in an amount equal to 1.0% of our profits before taxes, on a consolidated basis, based on our audited consolidated financial statements for the year for which the bonus is paid.

The aggregate amounts paid to A. Sheratzky Holdings in 2004 and 2005 were approximately $1,474,000 and $1,480,000, respectively (all numbers include value added tax).

On March 23, 1998, we entered into a financial services agreement with our director, Professor Kahane. Pursuant to this agreement, we are obligated to pay Professor Kahane a monthly consulting fee of NIS 4,000, or approximately $890, linked to the Israeli consumer price index. The initial term of the agreement was two years, automatically renewable for additional two-year terms, until terminated by either party by providing a 180-day prior notice. In May 2003, the monthly fee payable to Professor Kahane under the agreement was increased to NIS 15,000, or approximately $3300, linked to the consumer price index. The aggregate amounts paid to Professor Kahane in 2004 and 2005 were approximately $47,000 (all numbers include value added tax).

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On May 29, 2002, Telematics Wireless entered into an addendum to a lease agreement with Rinat Yogev Nadlan, Ltd., a company controlled by some of our and Telematics Wireless directors and executive officers. The addendum provides for the extension of the lease by Telematics Wireless for five automatically renewable two-year terms, up to a maximum period of 10 years, or until November 30, 2016. The property was originally leased to Telematics Wireless by Tadiran pursuant to a lease agreement dated September 13, 1998. In addition, pursuant to the original lease agreement, Telematics Wireless had a right of first refusal to purchase the property upon a proposed sale by Tadiran. In April 2002, Tadiran decided to sell the property and notified Telematics Wireless, which then transferred its right of first refusal, without consideration, to Rinat Yogev Nadlan. Rinat Yogev Nadlan exercised such right and purchased the property on April 18, 2002. Shortly following the purchase, Telematics Wireless entered into the addendum to the lease agreement with Rinat Yogev Nadlan. In addition to its agreement with Telematics Wireless, on May 29, 2002, Rinat Yogev Nadlan also entered into an agreement with our subsidiary Ituran Cellular Communication for the lease of the remainder of the property held by Rinat Yogev Nadlan under terms similar to those of the Telematics Wireless lease to expire on February 2012. The aggregate amounts paid to Rinat Yogev Nadlan in 2004 and 2005 were approximately $258,000 and $245,000, respectively (all numbers include value added tax). For further discussion regarding the terms of the lease agreements and the above-mentioned extension, see Item 4.D. Property, Plant and Equipment above.

Transactions with our affiliates and associates

On December 30, 2002, we entered into an agreement with Telematics Wireless and its three executive officers, Eddy Kafry, Avri Franco and Roman Sternberg, pursuant to which such executive officers agreed to exchange all of the equity of Telematics Wireless held by them for 457,095 of our ordinary shares. As part of the agreement, the term of employment of such executive officers was extended by five years, to December 31, 2007, during which time they will continue to serve as directors of Telematics Wireless. In addition, these officers are entitled to an annual bonus in an amount equal to 3.0% of the operating profits of Telematics Wireless. It was further agreed that for as long as they are employed by Telematics Wireless and for six months thereafter, upon an initial public offering of the shares of Telematics Wireless or any of its subsidiaries that uses Telematics Wireless intellectual property, these officers will be entitled to receive, for no cost, such number of shares or options of Telematics Wireless that will be equal to 7.5% of the post-offering issued and outstanding shares of Telematics Wireless in the event of an offering by Telematics Wireless, or 3.8% of the post-offering issued and outstanding shares of the relevant subsidiary in the event of an offering by a subsidiary, subject to the terms of the relevant underwriting arrangements.

C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable

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ITEM 8. FINANCIAL INFORMATION

A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

For the audited financial statements and audit reports required to be contained in this annual report, please see Item 18 below.

Legal proceedings

We are involved in litigation with Leonardo L.P., a US-based hedge fund, arising out of a financial transaction entered into between us and Leonardo in February 2000. Pursuant to the terms of this financial transaction, we received a cash investment of $12 million in exchange for certain notes that were convertible into our ordinary shares according to a pre-determined formula. Pursuant to the formula, the conversion price of the notes was the lower of NIS 67.3 ($14.7) or an average trading price of our shares for a defined period prior to conversion. The conversion price is used to determine the number of shares into which the notes may be converted by dividing the notional principal amount of the notes, initially $12 million, by the conversion price. On the date the notes were issued, March 2, 2000, the notes were convertible into approximately 720,000 of our ordinary shares. As part of the terms of this financial transaction, and, as required by the rules of the TASE where our ordinary shares are currently traded, we were required to seek the approval from the TASE for the issuance of the ordinary shares underlying the notes. The TASE approved the issuance of 2,250,000 of our ordinary shares as the number of registered shares that could be issued under the notes. We understood the terms of our financial transaction with Leonardo to provide that, except in certain limited circumstances, the amounts advanced to us, together with accrued interest on these advances at the annual rate of 3.5%, would be repaid and satisfied solely through the delivery of ordinary shares and that under no circumstance would we be required to deliver more than 2,250,000 of our ordinary shares. We believe that Leonardo also recognized that there was a limit on the number of shares issuable under the notes, and in fact at no time on or prior to the maturity date of the notes did Leonardo seek to convert the notes for more than 2,250,000 of our ordinary shares. Prior to the maturity date of the notes, Leonardo converted approximately $6.7 million of the notional principal amount of the notes into an aggregate of 2,241,594 of our ordinary shares. We believe that the holders of the notes are therefore only entitled to convert the balance of their notes into 8,406 shares, although in the pending litigation Leonardo has indicated that it does not believe that the notes were subject to any limit on the number of shares that could be issued to them on conversion and is seeking to recover damages based on this allegation.

The terms of the documents and agreements that comprise the financial arrangement with Leonardo contain provisions regarding the repayment and conversion of the notes which may be regarded as conflicting or subject to different interpretations. Accordingly, we believe that the matter may only be resolved through a litigation in which the parties present evidence as to the proper meaning and operation of the repayment and conversion provisions of documents and agreements comprising the financing transaction with Leonardo. The parties are currently in early stages of pleading the case before a district court in Israel and are in the process of undertaking discovery. In its pleadings, Leonardo is seeking alternative remedies and relief, including (a) the repayment in cash of the balance of the notes in the amount of approximately $6.2 million (plus accrued interest and expenses), (b) the delivery to Leonardo of the maximum number of our ordinary shares into which the notes could have been converted on the maturity date without regard to the 2,250,000 share limitation, or 3,516,462 ordinary shares, plus additional monetary damages, or (c) the payment of a cash amount equal to the amount obtained by multiplying the 3,516,462 shares mentioned in the preceding clause by the highest trading price of our ordinary shares between the maturity date and the date of the court s decision, plus interest or expenses. Although there can be no assurances as to the final outcome of this litigation, we believe that the maximum liability that we could have in this matter, assuming that a court rejects our interpretation of the agreements or determines that we have otherwise defaulted in the notes, is approximately $9.6 million. In addition, in June, 2006, Leonardo was permitted to amend its claim to add an additional cause of action, claiming that on January 29, 2002 we also breached the same agreement because Moked Ituran Ltd. distributed some of our shares to other parties, in violation of the covenant that entitles Leonardo the option to redeem the notes Moked Ituran to maintain at least 70% of the number of our shares that it held at the time we entered into the financial transaction with Leonardo. Based on such alleged breach, Leonardo is seeking an additional alternative remedy of $9.6 million, plus interest and expenses. We intend to appeal the decision allowing Leonardo to amend its claim on legal grounds and intend to vigorously defend ourselves in this litigation and we believe that we have meritorious defenses to the claims of Leonardo based on the language of the documents and agreements comprising the financial transaction and the additional evidence we have reflecting the intentions of the parties. While we cannot predict the outcome of this case, if Leonardo prevails, the award to Leonardo of damages, either in cash or by delivery of our ordinary shares, could result in significant costs to us, adversely affecting our results of operations. In addition, the issuance of our ordinary shares to Leonardo may impact the share price of our ordinary shares and would dilute our shareholders ownership percentage.

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On March 17, 2005, a suit was filed against us in an amount of NIS 4.7 million, or $1.0 million. The suit was filed by an attorney and the collection company managed by such attorney that acted on our behalf in collecting customer debts claiming that we owed him certain amounts in respect of unpaid fees and expenses. A significant portion of such attorney s claim is based on the allegation of damage to the plaintiffs reputation. We have filed a counter-claim to this claim. Recently, a settlement agreement was signed between the parties pursuant to which the attorney and the collection company repudiated their claim and accepted the position of the Company in full. Pursuant to the settlement agreement, which was approved by the Court, the claim against us was dismissed and our counterclaim against the plaintiff in the lawsuit was approved. Accordingly, the plaintiff was ordered to pay us the sum of approximately NIS 1.37 million (approximately, $300,000) including interest and linkage differentials from the date of filing the lawsuit and until actual date of payment. The Company is currently undergoing proceedings in order to recover payment of said amount.

On July 8, 2005, a class action was filed against our subsidiary, Ituran Florida Corporation, in the First Judicial District Court in Philadelphia, Pennsylvania. The lawsuit claims that Ituran Florida sent fax advertisements to the named plaintiff and the other members of the class allegedly in violation of the Telephone Consumer Protection Act of 1991. Ituran Florida filed a motion for judgment on the pleadings that such claims should not be heard as part of a class action. Such motion was denied by the court and the case is currently at the interrogatories and requests for production of information stage. The plaintiff agreed to limit the class action to Pennsylvania actions only and the maximum potential amount of damages that we estimate our subsidiary may be liable for pursuant to the provisions of the Telephone Consumer Protection Act if the plaintiffs prevail is approximately $1.5 million in the aggregate for all class plaintiffs, plus punitive damages and expenses. We do not believe that the plaintiffs will prevail and, even if they do prevail, we do not believe that the resolution of this claim will have a material effect on our revenues, operations or liquidity.

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On December 18, 2005, we were served with a statement of claim which has been filed against us in the Tel-Aviv District Court. The plaintiffs in said lawsuit are shareholders holding 50% in a company which has entered into an agreement with the Ituran, alleging breach of agreement causing damages estimated by the plaintiffs in the sum of approximately $3 million. A couple of months ago, the company that had entered into said agreement (together with another shareholder therein) filed a lawsuit against the Ituran alleging the same breach of agreement. Said lawsuit was dismissed by the Tel-Aviv District Court on August 15, 2005. In the lawsuit which Ituran filed against the party to the agreement and said shareholder, in the total sum of approximately $300,000, the court found for Ituran. Since the plaintiff did not deposit with the Court the court fees, the claim against us was stroked off (*in limine)*.

Dividend distribution policy

On January 29, 2004, we adopted a dividend policy providing for an annual dividend distribution in an amount equal to 25% of our net profits, calculated based on the financial statements for the period ending on December 31 of the fiscal year with respect to which the relevant dividend is paid.

According to our current dividend policy and Israeli law, an annual dividend will only be declared and paid if, in the discretion of the Board of Directors, there is no reasonable foreseeable concern that the distribution will prevent us from being able to meet the terms of our existing and contingent liabilities, as and when due. Our dividend policy may change from time to time at the discretion of our Board of Directors. Due to the foregoing restrictions on our dividend policy, and given our current financial condition and our current cash flows from operations, we do not believe that our dividend policy restricts our growth.

Dividends declared on our ordinary shares will be paid in NIS. Dividends paid to shareholders outside of Israel will be converted into dollars on the basis of the exchange rate prevailing on the date of the declaration of the relevant dividend and paid in dollars. The payment of dividends may be subject to Israeli withholding taxes. See Item 10.E. Taxation under the caption Israeli taxation withholding on dividends paid to non-residents of Israel below.

On January 29, 2004, upon adopting our current dividend policy, we declared a dividend in an amount equal to NIS 6.0 million, or $1.3 million. Such dividend was paid on April 1, 2004. On March 23, 2005, we declared a dividend in an amount equal to NIS 11.8 million, or $2.7 million. Such dividend was paid on April 28, 2005. On February 20, 2006, we declared a dividend in the amount equal to NIS 17.6 million, or $3.8 million. Such dividend was paid on April 4, 2006. We did not declare or pay any cash dividends to shareholders during the five-year period prior to January 29, 2004.

B. SIGNIFICANT CHANGES

Except for as stated in this annual report, there are no significant financial changes as of December 31, 2005.

ITEM 9. THE OFFER AND LISTING

A. OFFER AND LISTING DETAILS

Price History of Our Shares

Our ordinary shares have been trading on the Tel-Aviv Stock Exchange under the symbol ITRN since May 1998 and have been trading on the Nasdaq National Market under the symbol ITRN since September 2005.

The following table sets forth, for the periods indicated, the high and low market prices of our ordinary shares as reported by the Nasdaq National Market. Our shares commenced trading on the Nasdaq National Market on September 27, 2005. All per share prices for periods prior to or including May 2006 have been retroactively adjusted to reflect the three for one stock split effected on that date.

	High	Low
During the last six months		
May 2006	$ 16.98	$ 14.00
April 2006	$ 17.20	$ 15.53
March 2006	$ 17.01	$ 15.13
February 2006	$ 18.07	$ 14.97
January 2006	$ 18.59	$ 16.14
December 2005	$ 16.65	$ 14.44
During each fiscal quarter of 2005 and 2006		
First Quarter 2006	$ 18.59	$ 14.97
Fourth Quarter 2005	$ 16.65	$ 11.74

The following table shows, for the periods indicated, the high and low market prices of our ordinary shares as quoted on the Tel-Aviv Stock Exchange. U.S. dollars per ordinary share amounts are calculated using the applicable rate of exchange on the date the high or low market price occurred during the period shown. All per share prices prior to or including June 21, 2006 have been retroactively adjusted to reflect the three-for-one stock split effected on that date.

	Price per ordinary share (NIS)		Price per ordinary share ($)	
	High	Low	High	Low
Annual:				
2005	75.37	40.97	16.80	9.13
2004	41.57	25.42	9.78	5.60
2003	26.37	8.23	6.07	1.69
2002	13.90	7.50	3.10	1.54
2001	19.67	7.53	4.78	1.78
Quarterly:				
Fourth Quarter 2005	75.37	53.97	16.23	11.62
Third Quarter 2005	62.70	43.07	13.64	9.66
Second Quarter 2005	52.30	43.07	11.96	9.66
First Quarter 2005	52.47	40.97	12.14	9.32
Fourth Quarter 2004	41.30	29.77	9.47	6.67
Third Quarter 2004	31.72	25.42	7.10	5.60
Second Quarter 2004	32.10	28.13	7.09	6.12
First Quarter 2004	31.20	25.70	6.97	5.76

	Price per ordinary share (NIS)		Price per ordinary share ($)	
Fourth Quarter 2003	26.37	18.67	6.07	4.21
Third Quarter 2003	19.20	14.79	4.40	3.34
Second Quarter 2003	19.07	10.94	4.38	2.33
First Quarter 2003	11.01	8.23	2.35	1.69

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	Price per ordinary share (NIS)		Price per ordinary share ($)	
	High	Low	High	Low
Most recent six months:				
May 2006	76.09	64.11	17.00	14.33
April 2006	78.71	70.59	17.19	15.41
March 2006	80.09	73.21	17.08	15.61
February 2006	84.62	73.50	17.99	15.63
January 2006	85.29	73.03	18.46	15.81
December 2005	75.37	66.77	16.34	14.48

B. PLAN OF DISTRIBUTION

Not applicable

C. MARKETS

Our ordinary shares are quoted only on the Nasdaq National Market and the Tel-Aviv Stock Exchange under the symbol ITRN .

D. SELLING SHAREHOLDERS

Not applicable

E. DILUTION

Not applicable

F. EXPENSES OF THE ISSUE

Not applicable

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL

Not applicable

B. MEMORANDUM AND ARTICLES OF ASSOCIATION

Our number with the Israeli Registrar of Companies is 52-004381-1. Our purpose appears in our memorandum of association and includes engaging in any lawful business.

Articles of Association; Israeli Companies Law

Articles of Association

Pursuant to our articles of association our objectives are to engage in any lawful business and our purpose is to operate in accordance with business considerations to maximize our profits. We may take into consideration, inter alia, the interests of our creditors, employee and the public interest. Please also see a summarized description of our purposes and activities under the caption Overview in Item 4.A. above.

Our Corporate Practices Under The Israeli Companies Law

Approval of Transactions under Israeli Law

Directors and executive officers

Fiduciary duties

Israeli law codifies the fiduciary duties that directors and executive officers owe to a company. These fiduciary duties consist of a duty of care and a duty of loyalty. The duty of care requires a director or executive officer to act with the level of care with which a reasonable director or executive officer in the same position would have acted under the same circumstances. The duty of loyalty requires that a director or executive officer act in good faith and in the best interests of the company.

Personal interest

Israeli law requires that a director or executive officer promptly disclose to the board of directors any personal interest that he or she may have and all related material information known to him or her concerning any existing or proposed transaction with the company. A personal interest includes an interest in any company in which the person, his or her relative or any entity in which such person or relative has a personal interest, is a direct or indirect 5% or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager. Board approval is required for the transaction and no transaction that is adverse to the company s interest may be approved. Approval by the company s audit committee and board of directors is required for an extraordinary transaction, meaning any transaction that is not in the ordinary course of business, not on market terms or is likely to have a substantial effect on the company s profitability, assets or liabilities. If a majority of the board of directors has a personal interest in the transaction, shareholder approval is also required.

Compensation arrangements

Pursuant to the Israeli Companies Law, all compensation arrangements for executive officers who are not directors require approval of our board of directors. Extraordinary transactions with executive officers who are not directors require additional approvals. Compensation arrangements with directors require the approval of our audit committee, board of directors and shareholders, in that order. Transactions relating to exculpation, insurance or indemnification of (a) executive officers require audit committee approval and subsequent board of directors approval and (b) directors require audit committee approval, board of directors approval and subsequent shareholder approval.

Shareholders

Controlling shareholders

Pursuant to Israeli law, the disclosure requirements regarding personal interests that apply to directors and executive officers also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder who owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights. Currently Moked Ituran Ltd. is considered a controlling shareholder of our company under Israeli law and we expect it will continue to be a controlling shareholder following the consummation of this offering. Mr. Izzy Sheratzy beneficially owns the shareholdings of Moked Ituran due to his shared voting and investment power over such shares in accordance with a shareholders agreement, dated May 18, 1998, among Moked Ituran and its shareholders, as amended. In addition, all shareholders of Moked Ituran who are parties to such shareholders agreement, may also be considered controlling shareholders under Israeli law.

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Required approval

Extraordinary transactions with a controlling shareholder, or in which a controlling shareholder has a personal interest, including a private placement in which a controlling shareholder has a personal interest, and the terms of compensation or employment of a controlling shareholder or his or her relative who is a director, executive officer or employee, require the approval of the audit committee, the board of directors and the shareholders, in that order. This shareholder approval must include the majority of shares voted at the meeting. In addition, either:

- the majority must include at least one-third of the shares of disinterested shareholders voted at the meeting; or
- the total number of shares of disinterested shareholders who voted against the transaction must not exceed 1.0% of the aggregate voting rights in the company.

The approval of the board of directors and shareholders is required for a private placement of securities (or a series of related private placements during a 12-month period or that are part of one continuous transaction or transactions conditioned upon each other) that:

- represents at least 20% of a company s actual voting power prior to the issuance of such securities, and that would increase the relative holdings of a 5% shareholder or that would cause any person to become a 5% shareholder the consideration for which (or a portion thereof) is not cash or securities listed on a recognized stock exchange, or is not at fair market value; or
- results in a person becoming a controlling shareholder of the company.

For these purposes, a controlling shareholder is any shareholder that has the ability to direct actions of the company, including any shareholder holding 25% or more of the company s voting rights if no other shareholder owns more than 50% of such voting rights. Two or more shareholders with a personal interest in the approval of the same transaction are deemed to be one shareholder.

Shareholder duties

Pursuant to the Israeli Companies Law, a shareholder has a duty to act in good faith and in customary way toward the company and other shareholders and to refrain from abusing his or her power in the company, including, among other things, in voting at the general meeting of shareholders and class meetings with respect to the following matters:

- an amendment to the company's articles of association;
- an increase of the company's authorized share capital;
- a merger; or
- interested party transactions that require shareholder approval.

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In addition, specified shareholders have a duty of fairness toward the company. These shareholders include any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder vote and any shareholder who has the power to appoint or to prevent the appointment of an office holder of the company or other power towards the company. The Israeli Companies Law does not define the substance of this duty of fairness.

Anti take-over provisions; mergers and acquisitions under Israeli Law

Tender offer

A person wishing to acquire shares or any class of shares of a publicly traded Israeli company and who would, as a result, hold over 90% of the company s issued and outstanding share capital or of a class of shares that are listed, is required by the Israeli Companies Law to make a tender offer to all of the company s shareholders or all shareholders of such class of shares, as applicable, for the purchase of all of the issued and outstanding shares of the company or of that class of shares, as applicable. If the shareholders who do not respond to the offer hold less than 5% of the issued share capital of the company or of that class of shares, as applicable, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. However, the shareholders may petition the court to alter the consideration for the acquisition. If the dissenting shareholders hold more than 5% of the issued and outstanding share capital of the company or of such class of shares, as applicable, the acquirer may not acquire additional shares of the company or of such class of shares, as applicable, from shareholders who accepted the tender offer if following such acquisition the acquirer would then own over 90% of the company s issued and outstanding share capital or of the shares comprising such class, as applicable.

The Israeli Companies Law provides that an acquisition of shares of a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a holder of 25% or more of the voting rights of the company. This rule does not apply if there is already another holder of 25% or more of the voting rights of the company. Similarly, the Israeli Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a holder of more than 45% of the voting rights of the company, if there is no other holder of more than 45% of the voting rights of the company.

The foregoing provisions do not apply to:

- a private placement in which the company s shareholders approved such holder owning 25% or more of the voting rights of the company (provided that there is no other shareholder that holds 25% or more of the voting rights of the company); or more than 45% of the voting rights of the company (provided that there is no other shareholder that holds 45% or more of the voting rights of the company); or

- a purchase from an existing holder of 25% or more of the voting rights of the company that results in another person becoming a holder of 25% or more of the voting rights of the company or purchase from an existing holder of more than 45% of the voting rights of the company that results in another person becoming a holder of more than 45% of the voting rights of the company.

Merger

The Israeli Companies Law permits merger transactions if approved by each party s board of directors and shareholders. Pursuant to the Israeli Companies Law and our articles of association as currently in effect, merger transactions may be approved by holders of a simple majority of our shares present, in person or by proxy, at a general meeting and voting on the transaction. In determining whether the required majority has approved the merger in the event of cross ownership between the merging companies, namely, if our shares are held by the other party to the merger, or by any person holding at least 25% of the outstanding voting shares or 25% of the means of appointing directors of the other party to the merger, then a vote against the merger by holders of the majority of the shares present and voting, excluding shares held by the other party or by such person, or anyone acting on behalf of either of them, including any of their affiliates, is sufficient to reject the merger transaction. If the transaction would have been approved but for the exclusion of the votes of certain shareholders as provided above, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of a company, if the court holds that the merger is fair and reasonable, taking into account the value of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger. In addition, a merger may not be consummated unless at least 50 days have passed from the time that a proposal for approval of the merger has been filed with the Israeli Registrar of Companies and 30 days have passed from the date of the approval of the shareholders of the merging companies.

The Israeli Companies Law further provides that the foregoing approval requirements will not apply to shareholders of a wholly-owned subsidiary in a roll-up merger transaction, or to the shareholders of the acquirer if:

- the transaction is not accompanied by an amendment to the acquirer's memorandum or articles of association;
- the transaction does not contemplate the issuance of more than 20% of the voting rights of the acquirer that would result in any shareholder becoming a controlling shareholder; and
- there is no "cross-ownership" of shares of the merging companies, as described above.

For these purposes, controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder who owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights.

The Israeli Companies Law allows us to create and issue shares having rights different from those attached to our ordinary shares, including shares providing certain preferred or additional rights to voting, distributions or other matters and shares having preemptive rights. In the future, if we do create and issue a class of shares other than our ordinary shares, such class of shares, depending on the specific rights that may be attached to them, may delay or prevent a takeover or otherwise prevent our shareholders from realizing a potential premium over the market value of their ordinary shares. The authorization of a new class of shares will require an amendment to our articles of association. Shareholders voting at such a meeting will be subject to the restrictions under the Israeli Companies Law. See Voting rights above.

Dividend and Liquidation Rights. We may declare a dividend to be paid to the holders of our ordinary shares according to their rights and interests in our profits. If we dissolve, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of our ordinary shares in proportion to their shareholdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future. Our articles of association provide that shareholder approval would not be required for the declaration of dividends. Dividends may only be paid out of our retained earnings or profits accrued over a period of two years, as defined in the Israeli Companies Law, whichever is greater, according to the last reviewed or audited financial reports of the company, provided that the date of the financial reports is not more than six months before the date of distribution, and further provided that there is no reasonable concern that a payment of a dividend will prevent us from satisfying our existing and foreseeable obligations as they become due, as determined by our Board of Directors.

Voting, Shareholder Meetings and Resolutions. We are required to hold an annual general meeting of our shareholders once every calendar year, but no later than 15 months after the date of the previous annual general meeting. All meetings other than the annual general meeting of shareholders are referred to as special meetings. Our Board of Directors may call special meetings whenever it sees fit, at such time and place, within or outside of Israel, as it may determine. In addition, the Israeli Companies Law provides that the board of directors of a public company is required to convene a special meeting upon the request of (a) any two directors of the company or one quarter of its board of directors or (b) one or more shareholders holding, in the aggregate, (i) 5% of the outstanding shares of the company and 1% of the voting power in the company or (ii) 5% of the voting power in the company.

Pursuant to our articles of association, shareholders are entitled to participate and vote at general meetings and are the shareholders of record on a date to be decided by our Board of Directors, provided that such date is not more than 21 days, nor less than four days, prior to the date of the general meeting, except as otherwise permitted by the Israeli Companies Law. Furthermore, the Israeli Companies Law dictates that resolutions regarding the following matters must be passed at a general meeting of our shareholders:

- amendments to our articles of association;
- appointment or termination of our auditors;
- appointment and dismissal of external directors;
- approval of acts and transactions requiring general meeting approval pursuant to the Israeli Companies Law;
- increase or reduction of our authorized share capital;
- a merger; and

- n the exercise of the Board of Directors powers by a general meeting, if the Board of Directors is unable to exercise its powers and the exercise of any of its powers is required for our proper management.

The Israeli Companies Law and our articles of association require that a notice of any annual or special shareholders meeting will be provided 21 days prior to the meeting.

Pursuant to our articles of association, holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of the shareholders. These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that we may authorize in the future. The quorum required for our ordinary meetings of shareholders consists of at least two shareholders present in person or by proxy, who hold or represent between them at least one-third of the total outstanding voting rights. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or on a later date specified in the summons or notice of the meeting. At the reconvened meeting, any number of our shareholders present in person or by proxy shall constitute a lawful quorum.

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Our articles of association provide that, other than with respect to the amendment of the provisions of the articles of association with respect to the appointment of directors and a resolution for removal of a director, which action requires a majority vote of 75%, all resolutions of the shareholders require a simple majority.

Israeli law does not provide for public companies such as ours to have shareholder resolutions adopted by means of a written consent in lieu of a shareholders meeting. The Israeli Companies Law provides that a shareholder, in exercising his or her rights and performing his or her obligations toward the company and its other shareholders, must act in good faith and in an acceptable manner and avoid abusing his or her powers. This is required, among other things, when voting at general meetings on matters such as changes to the articles of association, increasing the company s registered capital, mergers and approval of related-party transactions. In addition, pursuant to the Israeli Companies Law, any controlling shareholder, any shareholder who knows that its vote can determine the outcome of a shareholder vote and any shareholder who, under the company s articles of association, can appoint or prevent the appointment of an office holder, is required to act with fairness towards the company. The Israeli Companies Law does not describe the substance of this duty and there is no binding case law that addresses this subject directly. Pursuant to Israeli Law, no voting agreement may circumvent these shareholder duties.

An ordinary resolution requires approval by the holders of a simple majority of the voting rights represented at the meeting, in person, by proxy or by written ballot, and voting on the resolution. Under the Israeli Companies Law, unless otherwise provided in the articles of association or applicable law, all resolutions of the shareholders require a simple majority. A resolution for the voluntary winding up of the company requires the approval of holders of 75% of the voting rights represented at the meeting, in person, by proxy or by written ballot and voting on the resolution. For information regarding the majority required for approval of related party transactions, see Approval of related party transactions under Israeli law above.

Transfer of Shares and Notice. Our ordinary shares that are fully paid are issued in registered form and may be freely transferred under our articles of association unless the transfer is restricted or prohibited by applicable law.

Election of Directors. Our ordinary shares do not have cumulative voting rights in the election of directors. As a result, the holders of a majority of the voting power represented at a shareholders meeting have the power to elect all of our directors, subject to the special approval requirements for external directors described under the caption External directors in Item 6.C. Board Practices above. Pursuant to the Israeli Companies Law, the procedures for the appointment and removal and the term of office of directors, other than external directors, may be contained in the articles of association of a company. Our articles of association provide for staggered terms for directors. This provision may be amended only by a vote of 75% of our shares voting at a meeting of shareholders.

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Insurance, Indemnification and Release. Pursuant to the Israeli Companies Law, an Israeli company may not exculpate a director or officer from liability for a breach of his or her duty of loyalty. A company may, however, approve an act performed in breach of the duty of loyalty provided that the director or officer acted in good faith, neither the act nor its approval harms the company, and the director or officer discloses the nature of his or her personal interest and all material facts and documents a reasonable time before discussion of the approval. A company may exculpate a director or officer in advance from liability to the company for a breach of his or her duty of care, but only if a provision

authorizing such exculpation is included in its articles of association and such breach does not relate to a dividend or other distribution by the company. Our articles of association do not include such a provision. A company may indemnify a director or officer in respect of certain liabilities either in advance of an event or following an event provided that a provision authorizing such indemnification is inserted in its articles of association. Our articles of association contain such a provision. An undertaking by a company to indemnify a director or officer for civil actions by third parties must be limited to foreseeable liabilities and reasonable amounts or criteria determined by the board of directors. A company may insure a director or officer against the following liabilities incurred for acts performed as a director or officer:

- a breach of duty of care to the company or to a third party;
- a breach of duty of loyalty to the company, provided the director or officer acted in good faith and had a reasonable basis to believe that the act would not prejudice the interests of the company; and
- monetary liabilities imposed for the benefit of a third party.

We have acquired directors and officers liability insurance covering our officers and directors and the officers and directors of our subsidiaries against certain claims. To date, no claims for liability have been filed under this policy. In addition, we have entered into indemnification agreements with each of our directors and officers and the officers and directors of our subsidiaries providing them with indemnification for liabilities or expenses incurred as a result of acts performed by them in their capacity as our directors and officers.

Change in Capital. Our articles of association enable us to increase or reduce our share capital. Any such changes are subject to the provisions of the Israeli Companies Law and must be approved by a resolution duly passed by our shareholders at a general meeting and voting on such change in the capital. In addition, transactions that have the effect of reducing capital, such as the declaration and payment of dividends in the absence of sufficient retained earnings and profits and an issuance of shares for less than their nominal value, require a resolution of the Board of Directors and court approval.

C. MATERIAL CONTRACTS

The Teletrac Agreements

Our AVL system is based on three main components: (i) an AVL end-unit that is installed in the vehicle, the components of which were originally developed by Tadiran and acquired and were improved by us, (ii) a network of base stations that relay information between the vehicle location units and the control center, certain components of which were developed by Teletrac and are currently licensed to us by Teletrac and (iii) a 24-hour manned control center consisting of software used to manage communications and the exchange of information among the hardware components of the AVL products, certain components of which were developed by Teletrac and licensed to us under exclusive and non-exclusive licenses.

The technology licensed to us by Teletrac, which we refer to as the Teletrac intellectual property, is licensed to us by virtue of a series of agreements pursuant to which we have secured the exclusive rights to use the Teletrac intellectual property in Israel, Brazil, Argentina, and certain cities in the United States. We have also secured certain exclusive rights to use the Teletrac intellectual property in other designated countries and non-exclusive rights to use the Teletrac intellectual property in every country outside of the United States and Europe, including China and South Korea where we have sublicensed the rights to third parties.

We are not required to pay any ongoing royalties for use of the Teletrac intellectual property in Israel, although we may be required in the future to pay a royalty up to 3% of sales of products and services utilizing the Teletrac intellectual property in countries where we wish to maintain our exclusive rights. We also have the right to use the Teletrac intellectual property in any country outside of Europe and the United States on a non-exclusive basis upon payment to Teletrac of a fee of $100,000 for each country in which the Teletrac intellectual property is so used or sold. Our license agreements with Teletrac are perpetual in term unless terminated by mutual agreement or for breach, including bankruptcy, dissolution or insolvency.

The Arad Technologies Agreements

Telematics Wireless has entered into a series of agreements with Arad Technologies for the manufacture and supply by Telematics Wireless of its transponders for incorporation in Arad Technologies AMR systems. The agreements provide for the joint development,

manufacturing and marketing of the AMR systems, as well as the provision of the Telematics Wireless transponders to Arad Technologies. Pursuant to these agreements, each party retains its intellectual property rights in the components of the AMR system that it develops. Since the execution of the original agreement in 2000, the parties have entered into a number of amendments, each of which consist of Arad Technologies order of additional transponders at varying prices per transponder. The agreements contain mutual exclusivity obligations, pursuant to which the parties agreed not to develop, manufacture, market and/or enter into an agreement with another provider in the radio frequency-based automatic meter reading field, subject to certain limited exceptions. Pursuant to the most recent amendment to the Arad agreements, the agreements will terminate on December 28, 2009. In the event that Arad ceases to market and sell AMR products, it may request Telematics Wireless to terminate the production of its transponders by giving Telematics Wireless four months prior written notice.

The Derech Eretz Agreement

In January 2000, Telematics Wireless entered into a Supply Agreement with Derech Eretz, the concessionaire of the cross-Israel highway project, pursuant to which Telematics Wireless was retained to develop, manufacture and supply the wireless transponders for the electronic toll and traffic management system in connection with the operation of the first, and currently only, toll road in Israel.

The intellectual property incorporated in our RFID products remains Telematics Wireless property, although we have agreed to grant Derech Eretz all requisite licenses for all intellectual property utilized in connection with the transponders. In addition, we agreed to grant the Israeli government a license to use our RFID products for the operation of the toll road upon termination of the Israeli government s agreement with Derech Eretz, as well as for its use in other transport projects in Israel.

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The China Agreement

On August 28, 2004, Telematics Wireless entered into an agreement with Golden Net Communication Technology, a Chinese company, and Digitrack Wireless (China) Group Co. Ltd., a Hong Kong company for the deployment of independently operated AVL systems in China, Hong Kong, Macao and Taiwan. Pursuant to the agreement, we are required to provide Golden Net with a turn-key project management, specific hardware and software, engineering and technical planning and design of the system, as well as training qualified personnel to operate the system. In addition, we agreed to supply to the applicable local operators established by Golden Net the base stations and hardware required for the construction and operation of the system. We have been informed by Golden Net that the Chinese government will hold a direct or indirect interest in these local operators and that it has a controlling interest in the operating company in Shanghai, Shanghai Golden Net Location & Measurement Co. Ltd.. As of the date of this report, we do not know what the scope of such interest will be or what control or influence the Chinese government will exercise over the other operating companies that will be formed. We expect to derive revenues from our contract with Golden Net. To the extent that any of the political, economic or regulatory conditions in China effect Golden Net and its operations, our revenues from this customer may be adversely affected. The AVL infrastructure is to be constructed in phases, beginning in Shanghai and Beijing, where separate operating company was established, controlled by Golden Net.

Pursuant to the agreement, Golden Net agreed to exclusively purchase required equipment from us. The agreement also provides that following the initial purchase of base stations and AVL end-units specified in the agreement, the base stations and AVL end-units will be manufactured, on our behalf, by a local manufacturer approved by the buyers and that, after the deployment of the first system in Shanghai, a research and development center will be set up in China for the future development of AVL systems in China.

The term of the agreement commences (per project deployed) from the advance payment date for the system until our fulfillment and Golden Net s final acceptance of our obligations under the agreement with respect to such project, including the satisfaction of any applicable warranty, spare parts, maintenance and option obligations. The agreement may be terminated by either party in the event of a material breach of the agreement by the other party. A separate agreement was executed by the parties in October 2005 governing the purchase of the AVL end-units. It contains the pricing and intellectual property rights terms, among others, set forth in the existing agreement. Under this end-user production agreement, an initial order of 18,000 end units was executed. Accordingly, we have commenced initial sales in Beijing in the second quarter of 2006 and expect to commence sales in Shanghai in the second half of 2006 and in Seoul in 2007.

The agreement became effective upon the payment of $732,000 as an advance for the Shanghai system and in May 2005 we received an additional advance of $400,000. The agreement provides for payments to us for deployment costs, system license fees and all provided equipment. In April 2006, we received a letter of credit in an amount of approximately $3.9 million (less the amount of the advances) that will guarantee the payment of expected obligations under the agreement for the deployment of the AVL system in Shanghai. In April 2005, Golden Net notified us that it intends to proceed with the deployment of the system in Beijing and since such date has advanced payments to us in an aggregate amount of approximately $600,000.

Although the agreement requires the initial deployment of the AVL system in Shanghai by November 1, 2005, due to delays in the organization and registration of Golden Net s local operating company in Shanghai, deployment of the first phase of the AVL system in Shanghai, consisting of the erection of ten base sites, was rescheduled and is now required to be completed by the end of the first half of 2006. The deployment of an additional 45 base sites is scheduled for no later than several months later. According to the agreement for the deployment in Beijing, the first ten base sites (the first phase) in Beijing are to be deployed by December 31, 2005 and this target was reached on time. Our ability to meet our scheduled deployment depends, in part, on Golden Net s ability to obtain necessary infrastructure components, such as standard equipment purchases, and satisfy their financial obligations. We believe that Golden Net has obtained to date all of the necessary local and regional governmental permits and approvals necessary to construct the AVL system in Shanghai and Beijing.

Currently, the total expected revenues from the agreement with Golden Net are $6 million, $4.3 million of which are attributable to the deployment of the AVL system in Shanghai and $1.7 million of which is attributable to the first phase of the deployment of the AVL system in Beijing. The revenues recorded in our financial statements for these contracts for the fiscal year ended December 31, 2005 are $2 million and $1.1 million, respectively. Following the development and deployment of the AVL system in Shanghai and Beijing, we expect to receive ongoing additional revenues from Golden Net from maintenance contracts, sales of spare parts for the base sites in each of the markets, further deployment contracts for additional cities (over ten deployments are currently contemplated), and sales of our AVL end-units (manufactured in Israel and later on manufactured locally) to Golden Net. We will not receive any revenues from the end-user subscriber fees collected by Golden Net for the provision of its SVR services.

Pursuant to the agreement, in the event payments made by Golden Net to us exceed $150.0 million on a cumulative basis, the title and ownership to all of our intellectual property rights in our AVL system will be transferred to Golden Net solely for use in China, Hong Kong, Macao and Taiwan. Currently, a portion of the technology used in connection with the implementation of our AVL system is subject to the terms of a grant Telematics Wireless received from the Israeli Office of Chief Scientist to partially fund the development of certain components of our AVL system, which terms state that the technology may not be transferred without the prior approval of the Israeli Office of the Chief Scientist. See Item 4.B. Business Overview under the caption Intellectual Property and Licenses above. The Golden Net agreement does not condition the transfer on the receipt of the consent of the Israeli Office of Chief Scientist. In the event that at the time Telematics Wireless would need to transfer technology pursuant to the agreement such technology will still include elements subject to the Israeli Office of Chief Scientist grant, Telematics Wireless would need to seek the consent of the Israeli Office of Chief Scientist to do so. The Israeli Office of Chief Scientist may not provide such consent or may, as is often done in such cases, condition its consent upon the payment of royalties, penalties, or other amounts.

The South Korea Agreement

On August 31, 2004, Telematics Wireless entered into a license and supply agreement with Vision Plant Inc., a South Korean corporation that, on June 15, 2005, assigned its rights and obligations under the agreement to Korean Location Information and Communications Company Ltd. The agreement provides for the construction and operation of a location-based system in South Korea. Pursuant to the agreement, Korean Location Information has received a sole and exclusive license to use our AVL infrastructure-related technologies in South Korea for the purpose of operating a location-based system. The agreement is in effect for 10 years, automatically renewable for an additional term of 10 years, after which the agreement will remain in effect indefinitely and shall be terminable by three years prior notice by either party or by the injured party in the event of a material breach by the other party. The agreement became effective in July, 2005, upon the procurement by Korean Location Information of all necessary governmental permits and approvals, the establishment of its local operating company, and the transfer to us of a down payment.

Pursuant to this agreement, Telematics Wireless undertook to provide services including the design, integration, update of software and hardware applicable to the system and the training of personnel and Korean Location Information undertook to purchase the equipment required for the construction and operation of the system exclusively from Telematics Wireless. During the construction stage, we are required to supply the base stations and oversee the deployment of the system in cooperation with Korean Location Information. In addition, Telematics Wireless will supply the subscriber equipment (vehicle location end-units, people and merchandise) to Korean Location Information. The consummation of the agreement is contingent upon Korean Location Information obtaining from the appropriate authorities the required permits and licenses.

Pursuant to the agreement, there are three phases of the development and construction of the complete AVL system in South Korea:

- Phase I relates to the Seoul metropolitan area and neighboring vicinities. This phase consists of 82 base sites to be deployed by September 2006 and is valued at $5.4 million, excluding the sale of our end-units following the establishment of the Phase I infrastructure.

- Phase II relates to five other major metropolitan areas in South Korea. This phase consists of an additional 124 base sites to be deployed at a date to be determined by Korean Location Information. We will commence providing deliveries for construction of the base sites five months following the placement of an order. Phase II is valued at $4.8 million, excluding the sale of our end-units following the establishment of the Phase II infrastructure.

- Phase III relates to coverage across South Korea. This phase consists of an additional 294 base sites to be deployed at a date to be determined by Korean Location Information. We will commence providing deliveries for construction of these base sites five months following Korean Location Information s placement of the order. Phase III is valued at $9.8 million, excluding the sale of our end-units following the establishment of the Phase III infrastructure.

In each phase, a local operating company established by Korean Location Information will deploy the AVL infrastructure, under our supervision. In the event that these three phases are completed and we supply the equipment as contemplated under the agreement, we will be paid up to $20.0 million (not including revenues from sales of our end-units following the establishment of the system).

The revenues recorded in our financial statements for this contract for the fiscal year ended December 31, 2005 are $2.6 million.

Following the development and deployment of the system, we expect to receive ongoing revenues from Korean Location Information from maintenance contracts, sales of spare parts for the base sites in each of the markets and sales of our end-units (manufactured in Israel and later on locally) to Korean Location Information. We will not receive any revenues from the end-user subscriber fees collected by Korean Location Information for provision of its location-based services. We expect that, initially, Korean Location Information will be providing primarily personal tracking services in South Korea.

A separate agreement will be executed by the parties at a later date governing the purchase of the end-units. It will contain the pricing, local manufacturing and intellectual property rights terms, among others, set forth in the existing agreement.

In addition to rights in South Korea, Korean Location Information was granted a right of first refusal for the development, construction and operation of our AVL system in all countries in the far east and south-east Asia, including Japan (but excluding China, Hong Kong and Taiwan, with some limitations for Malaysia, Thailand and Singapore), as long as the technology license and all related products, whether the components of the infrastructure or the end-units, are exclusively purchased from us. In the event this right is exercised by Korean Location Information, the agreement provides for payments to us for deployment costs, system license fees and all provided equipment. This right will terminate with respect to any country if within four years from the date of execution of the agreement there is no significant progress in constructing the system by Korean Location Information in the relevant country.

D. EXCHANGE CONTROLS

Under current Israeli regulations, any dividends or other distributions paid in respect of our ordinary shares purchased by nonresidents of Israel with certain non-Israeli currencies (including dollars) and any amounts payable upon the dissolution, liquidation or winding up of our affairs, as well as the proceeds of any sale in Israel of our securities to an Israeli resident, may be paid in non-Israeli currencies (including US dollars) or, if paid in NIS, may be converted into freely repatriable currencies at the rate of exchange prevailing at the time of conversion pursuant to the general permit issued under the Israeli Currency Control Law, 1978, provided that Israeli income tax has been paid on (or withheld from) such payments. Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, U.S. shareholders will be subject to any such currency fluctuation during the period from when such dividend is declared through the date payment is made in U.S. dollars. Investments outside Israel by the Company no longer require specific approval from the Controller of Foreign Currency at the Bank of Israel.

E. TAXATION

The following describes certain income tax issues relating to us and also certain income tax consequences arising from the purchase, ownership and disposition of our ordinary shares. **This discussion is for general information only and is not intended, and should not be construed, as legal or professional tax advice and does not cover all possible tax considerations**. To the extent that the discussion is based on legislation yet to be judicially or administratively interpreted, there can be no assurance that the views expressed herein will accord with any

such interpretation in the future. Accordingly, holders of our ordinary shares should consult their own tax advisor as to the particular tax consequences arising from your purchase, ownership and disposition of ordinary shares, including the effects of applicable Israeli, United States and other laws and possible changes in the tax laws.

The following discussion represents a summary of the material United States & Israeli tax laws affecting us and our shareholders.

United States Tax Considerations

The following discussion is a description of the material United States, or US, federal income tax considerations applicable to the acquisition, ownership and disposition of our ordinary shares by holders who acquire their shares pursuant to this offering and who hold such ordinary shares as capital assets . As used in this section, the term US Holder means a beneficial owner of an ordinary share who is:

- a citizen or resident of the United States;

- a corporation or partnership created or organized in or under the laws of the United States or of any state of the United States or the District of Columbia (other than a partnership that is not treated as a US person under any applicable Treasury regulations);
- an estate, the income of which is subject to United States federal income taxation regardless of its source; or
- a trust if the trust has elected validly to be treated as a US person for United States federal income tax purposes or if a US court is able to exercise primary supervision over the trust s administration and one or more US persons have the authority to control all of the trust s substantial decisions.

The term Non-US Holder means a beneficial owner of an ordinary share who is not a US Holder. The tax consequences to a Non-US Holder may differ substantially from the tax consequences to a US Holder. Certain aspects of US federal income tax relevant to a Non-US Holder are discussed below.

This description is based on provisions of the United States Internal Revenue Code of 1986, as amended, which we refer to as the Code, existing, proposed and temporary US Treasury regulations and administrative and judicial interpretations thereof, each as available and in effect as of the date of this report. These sources may change, possibly with retroactive effect, and are open to differing interpretations. This description does not discuss all aspects of US federal income taxation that may be applicable to investors in light of their particular circumstances or to investors who are subject to special treatment under US federal income tax law, including:

- insurance companies;
- dealers or traders in stocks, securities or currencies;
- financial institutions and financial services entities;
- real estate investment trusts;
- regulated investment companies;
- grantor trusts;
- persons that receive ordinary shares as compensation for the performance of services;
- tax-exempt organizations;
- persons that hold ordinary shares as a position in a straddle or as part of a hedging, conversion or other integrated instrument;

- individual retirement and other tax-deferred accounts;
- expatriates of the United States;
- persons having a functional currency that is not the dollar; or
- direct, indirect or constructive owners of 10% or more, by voting power or value, of our ordinary shares.

This description also does not consider the US federal gift or estate tax or alternative minimum tax consequences of the acquisition, ownership and disposition of our ordinary shares.

If a partnership (or any other entity treated as a partnership for US federal income tax purposes) holds our ordinary shares, the tax treatment of a partner in such partnership will generally depend on the status of the partner and the activities of the partnership. Such a partner should consult its tax advisor as to its tax consequences.

We urge our shareholders to consult with your own tax advisor regarding the tax consequences of acquiring, owning or disposing of our ordinary shares, including the effects of US federal, state, local and foreign and other tax laws. This summary does not constitute, and should not be construed as, legal or tax advice to holders of our shares.

Distribution Paid on the Ordinary Shares

On January 29, 2004, we adopted a dividend policy providing for an annual dividend distribution in an amount equal to 25% of our net profits, which is calculated based on the financial statements for the period ending on December 31 of the fiscal year for which the dividend is paid.

Subject to the discussion below under Passive Foreign Investment Company Considerations , US Holders, for US federal income tax purposes, will generally will be required to include in their gross income as ordinary dividend income the amount of any distributions made to them in cash or property (other than certain distributions, if any, of our ordinary shares distributed pro rata to all our shareholders), with respect to their ordinary shares, before reduction for any Israeli taxes withheld (without regard to whether any portion of such tax may be refunded to them by the Israeli tax authorities), to the extent that those distributions are paid out of our current or accumulated earnings and profits as determined for US federal income tax purposes. Subject to the discussion below under Passive Foreign Investment Company Considerations , distributions in excess of our current and accumulated earnings and profits as determined under US federal income tax principles will be applied first against, and will reduce their tax basis in, your ordinary shares and, to the extent they exceed that tax basis, will then be treated as capital gain. We do not maintain calculations of our earnings and profits under US federal income tax principles. Our dividends will not qualify for the dividends-received deduction generally available to corporate US Holders.

For shareholders who are qualified as US Holder, if we pay a dividend in NIS, any such dividend, including the amount of any Israeli taxes withheld, will be includible in such US Holders income in a US dollar amount calculated by reference to the currency exchange rate in effect on the day the distribution is includible in your income, regardless of whether the NIS are converted into dollars. Any gain or loss resulting from currency exchange fluctuations during the period from the date the dividend is includible in such US Holders income to the date that payment is converted into dollars generally will be treated as ordinary income or loss.

A non-corporate US Holder s qualified dividend income currently is subject to tax at reduced rates not exceeding 15%. This reduced rate applicable to qualified dividend income does not apply to tax years beginning after December 31, 2008. For purposes of determining whether US Holders will have qualified dividend income, qualified dividend income generally includes dividends paid by a foreign corporation if either:

- the stock of that corporation with respect to which the dividends are paid is readily tradable on an established securities market in the US, or
- that corporation is eligible for benefits of a comprehensive income tax treaty with the US that includes an information exchange program and is determined to be satisfactory by the US Secretary of the Treasury. The Internal Revenue Service has determined that the US-Israel Tax Treaty is satisfactory for this purpose.

In addition, under current law, a shareholder of our shares who is a US Holder, must generally hold his ordinary shares for more than 60 days during the 120-day period beginning 60 days prior to the ex-dividend date in order for the dividend to qualify as qualified dividend income.

Dividends paid by a foreign corporation will not be treated as qualified dividend income , however, if such corporation is treated, for the tax year in which the dividend is paid or the preceding tax year, as a passive foreign investment company for US federal income tax purposes. We do not believe that we will be classified as a passive foreign investment company for US federal income tax purposes for our current taxable year. However, see the discussion under Passive foreign investment company considerations below.

Subject to the discussion below under Information reporting and back-up withholding , a Non-US Holder generally will not be subject to US federal income or withholding tax on dividends received on ordinary shares unless that income is effectively connected with the conduct by that Non-US Holder of a trade or business in the US.

Foreign Tax Credit

If a holder of our shares is a US Holder, any dividends paid by us to such shareholder with respect to our ordinary shares generally will be treated as foreign source passive income for US foreign tax credit purposes. Subject to the foreign tax credit limitations, if a holder of our shares is a US Holder such holder may elect to credit any Israeli income taxes withheld from dividends paid on our ordinary shares against such shareholder s US federal income tax liability (provided, *inter alia*, such shareholder satisfies certain holding requirements with respect to our ordinary shares). Amounts withheld in excess of the Treaty tax rate, however, will not be creditable against such shareholder s US federal income tax liability. As an alternative to claiming a foreign tax credit, such shareholder may instead claim a deduction for any withheld Israeli income taxes, but only for a year in which such shareholder elects to do so with respect to all foreign income taxes. The amount of foreign income taxes that may be claimed as a credit in any year is subject to complex limitations and restrictions, which must be determined on an individual basis by each shareholder. Accordingly, our shareholders should consult their own tax advisor to determine whether their income with respect to their ordinary shares would be foreign source income and whether and to what extent they would be entitled to the credit.

Disposition of Ordinary Shares

Upon the sale or other disposition of ordinary shares, subject to the discussion below under Passive foreign investment company considerations , if a holder of our shares is a US Holder, such shareholder generally will recognize capital gain or loss equal to the difference between the amount realized on the disposition and such shareholder s adjusted tax basis in the ordinary shares, which is usually the cost of such shares, in dollars. US Holders should consult their own advisors with respect to the tax consequences of the receipt of a currency other than dollars upon such sale or other disposition.

Gain or loss upon the disposition of the ordinary shares will be treated as long-term if, at the time of the disposition, the ordinary shares were held for more than one year. Long-term capital gains realized by non-corporate US Holders generally are subject to a lower maximum marginal US federal income tax rate than the maximum marginal US federal income tax rate applicable to ordinary income, other than qualified dividend income, as defined above. The deductibility of capital losses by a US Holder is subject to limitations. In general, any gain or loss recognized by a US Holder on the sale or other disposition of ordinary shares will be US source income or loss for US foreign tax credit purposes. US Holders should consult their own tax advisors concerning the source of income for US foreign tax credit purposes and the effect of the US-Israel Tax Treaty on the source of income.

If any of our shareholders are Non-US Holder, subject to the discussion below under Information Reporting and Back-up Withholding , such shareholders generally will not be subject to US federal income or withholding tax on any gain realized on the sale or exchange of ordinary shares unless:

- such gain is effectively connected with such shareholder's conduct of a trade or business in the US, or
- if such shareholder is an individual, such shareholder has been present in the US for 183 days or more in the taxable year of the sale or exchange, and certain other conditions are met.

Passive Foreign Investment Company Considerations

Special US federal income tax rules apply to US Holders owning shares of a passive foreign investment company , or a PFIC, for US federal income tax purposes. A non-US corporation will be considered a PFIC for any taxable year in which, after applying look-through rules, either

- 75% or more of its gross income consists of specified types of passive income, or
- 50% or more of the average value of its assets consists of passive assets, which generally means assets that generate, or are held for the production of, passive income.
- Passive income for this purpose generally includes dividends, interest, royalties, rents and gains from commodities and securities transactions and includes amounts derived by reason of the temporary investment of funds. If we were classified as a PFIC, and you are a US Holder, you could be subject to increased tax liability upon the sale or other disposition of ordinary shares or upon the receipt of amounts treated as excess distributions (generally, your ratable portion of distributions in any year which are greater than 125% of the average annual distribution received by you either in the shorter of the three preceding years or your holding period). Under these rules, the excess distribution and any gain would be allocated ratably over our shareholders holding period for the ordinary shares, and the amount allocated to the current taxable year and any taxable year prior to the first taxable year in which we were a PFIC would be taxed as ordinary income. The amount allocated to each of the other taxable years would be subject to tax at the highest marginal rate in effect for the applicable class of taxpayer for that year, and an interest charge for the deemed deferral benefit would be imposed on the resulting tax allocated to such other taxable years. In addition, holders of stock in a PFIC may not receive a step-up in basis on shares acquired from a decedent. If any of our shareholders are US Holders who hold ordinary shares during a period when we are a PFIC, such shareholders be subject to the foregoing rules even if we cease to be a PFIC.

We believe that we will not be classified as a PFIC for US federal income tax purposes for our current taxable year and we anticipate that we will not become a PFIC in any future taxable year based on our financial statements, our current expectations regarding the value and nature of our assets, and the sources and nature of our income. This conclusion, however, is a factual determination that must be made annually based on income and assets for the entire taxable year and thus may be subject to change. It is not possible to determine whether we will be a PFIC for the current taxable year until after the close of the year and our status in future years depends on our income, assets and activities in those years. In addition, because the market price of our ordinary shares is likely to fluctuate after this offering and the market price of the shares of technology companies has been especially volatilte, and because that market price may affect the determination of whether we will be considered a PFIC, we cannot assure that we will not be considered a PFIC for any taxable year.

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If we were a PFIC, our shareholders could avoid certain tax consequences referred to above by making an election to treat us as a qualified electing fund or by electing to mark the ordinary shares to market. A US Holder may make a qualified electing fund election only if we furnish the US Holder with certain tax information and we do not presently intend to prepare or provide this information. Alternatively, a US Holder of PFIC stock that is publicly traded may elect to mark the stock to market annually and recognize as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the PFIC stock and the US Holder s adjusted tax basis in the PFIC stock. Losses would be allowed only to the extent of net mark-to-market gain previously included by the US Holder under the election for prior taxable years. This election is available for as long as our ordinary shares constitute marketable stock, which includes stock that is regularly traded on a qualified exchange or other market. We believe that the Nasdaq National Market will constitute a qualified exchange or other market for this purpose. However, no assurances can be provided that our ordinary shares will continue to trade on the Nasdaq National Market or that the shares will be regularly traded for this purpose.

The rules applicable to owning shares of a PFIC are complex, and our shareholders should consult with their own tax advisor regarding the tax consequences that would arise if we were treated as a PFIC.

Information Reporting and Back-up Withholding

Dividend payments with respect to ordinary shares and proceeds from the sale or disposition of ordinary shares made within the United States or by a US payor or US middleman may be subject to information reporting to the Internal Revenue Service and possible US backup withholding at a current rate of 28%. Certain exempt recipients (such as corporations) are not subject to these information reporting requirements. Backup withholding also will not apply to a US Holder who furnishes a correct taxpayer identification number and makes any other required certification or otherwise is exempt from US backup withholding requirements. US Holders who are required to establish their exempt status must provide such certification on Internal Revenue Service Form W-9. US Holders should consult their tax advisors regarding

the application of the US information reporting and backup withholding rules.

Non-US Holders generally are not subject to information reporting or back-up withholding with respect to dividends paid on, or upon the disposition of, ordinary shares, provided that such non-US Holder certifies to its foreign status, or otherwise establishes an exemption.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a US Holder s US federal income tax liability and a US Holder may obtain a refund of any excess amounts withheld by filing the appropriate claim for refund with the Internal Revenue Service and furnishing any required information in a timely manner.

The above description is not intended to constitute a complete analysis of all tax consequences relating to acquisition, ownership and disposition of our ordinary shares. Our shareholders are urged to consult their own tax advisor concerning the tax consequences of their particular situation.

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Israeli Tax Considerations

The following is a summary of the current material Israeli tax laws applicable to companies in Israel with special reference to its effect on us. This section also contains a discussion of certain Israeli government programs from which we may benefit and some Israeli tax consequences to persons acquiring ordinary shares in this offering. This summary does not discuss all the acts of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law. Examples of this kind of investor include residents of Israel, traders in securities or persons that own, directly or indirectly, 5% or more of our outstanding capital, all of whom are subject to special tax regimes not covered in this discussion. Some parts of this discussion are based on new tax legislation that has not been subject to judicial or administrative interpretation. Accordingly, we cannot assure you that the views expressed in the discussion will be accepted by the tax authorities in question. The discussion is not intended and should not be construed as legal or professional tax advice and does not cover all possible tax considerations.

Potential investors are urged to consult their own tax advisors as to the Israeli or other tax consequences of the purchase, ownership and disposition of our ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

General Corporate Tax Structure in Israel

Israeli companies are generally subject to corporate tax on their taxable income at a rate that is 31% for the 2006 tax year. This rate was 34% in the 2005 tax year and 35% in the 2004 tax year and will be 29% for the 2007 tax year, 27% for the 2008 tax year, 26% for the 2009 tax year and 25% thereafter. However, as discussed below, the rate is effectively reduced for income derived from an approved enterprise.

Special Provisions Relating to Taxation Under Inflationary Conditions

The Income Tax Law (Inflationary Adjustments), 1985, generally referred to as the Inflationary Adjustments Law, represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing rapid inflation. The Inflationary Adjustments Law is highly complex. The provisions that are material to us, are summarized as follows:

- Where a company s equity, as calculated under the Inflationary Adjustments Law, exceeds the depreciated cost of its fixed assets (as defined in the Inflationary Adjustments Law), a deduction from taxable income is permitted equal to the above excess multiplied by the applicable annual rate of inflation. The maximum deduction permitted in any single tax year is 70% of taxable income, with the unused portion permitted to be carried forward, linked to the Israeli consumer price index.
- Where a company s depreciated cost of fixed assets exceeds its equity, then the excess multiplied by the applicable annual rate of inflation is added to taxable income.
- Subject to specified limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the change in the consumer price index.

Under the Inflationary Adjustments Law, results for tax purposes are measured in real terms, in accordance with changes in the Israeli consumer price index. We are taxed under this law. The difference between the change in the Israeli consumer price index and the exchange rate of Israeli currency in relation to the dollar may in future periods cause significant differences between taxable income and the income measured

in dollars as reflected in our consolidated financial statements.

Law for the Encouragement of Capital Investments, 1959

The Law for Encouragement of Capital Investments, 1959, which we refer to as the Investment Law, provides certain incentives for capital investments in a production facility (or other eligible assets). Generally, an investment program that is implemented in accordance with the provisions of the Investment Law, referred to as an Approved Enterprise , is entitled to benefits, including cash grants from the Israeli government and tax benefits, based upon, among other things, the location of the facility into which the investment is made and/or the election of the grantee.

In April 2005, a comprehensive amendment to the Investment Law came into effect. Our current tax benefits are subject to the provisions of the Investment Law prior to its revision, while new benefits that will be received in the future, if any, will be subject to the provisions of the Investment Law, as amended. Accordingly, the following discussion is a summary of the Investment Law prior to its amendment as well as the relevant changes contained in the new legislation.

According to the Investment Law prior to its amendment, in order to obtain benefits, an approval from the Investment Center of the Israeli Ministry of Industry and Trade had to be obtained. Each certificate of approval for an Approved Enterprise relates to a specific investment program in the Approved Enterprise, delineated both by the financial scope of the investment and by the physical characteristics of the facility or the asset.

An Approved Enterprise may elect to forego any entitlement to the grants otherwise available under the Investment Law and, in lieu of the foregoing, participate in an alternative benefits program, under which the undistributed income from the Approved Enterprise is fully exempt from corporate tax for a defined period of time. The period of tax exemption ranges between two and 10 years, depending upon the location within Israel of the Approved Enterprise and the type of Approved Enterprise. Upon expiration of the exemption period, the Approved Enterprise would be eligible for the otherwise applicable reduced tax rates under the Investment Law for the remainder, if any, of the otherwise applicable benefits period. If a company has more than one Approved Enterprise program or if only a portion of its capital investments are approved, its effective tax rate is the result of a weighted combination of the applicable rates. The tax benefits from any certificate of approval relate only to taxable profits attributable to the specific Approved Enterprise. Income derived from activity that is not integral to the activity of the Approved Enterprise should not be divided between the different Approved Enterprises and would therefore not enjoy tax benefits.

Income derived from an Approved Enterprise is generally subject to a tax rate of 25% for a period of seven years. However, further reductions in tax rates depending on the percentage of the non-Israeli investment in a company s share capital (conferring rights to profits, voting and appointment of directors) and the percentage of its combined share and loan capital owned by non-Israeli residents, would apply. The tax rate is 20% if the non-Israeli investment level is 49% or more but less than 74%, 15% if the non-Israeli investment level is 74% or more but less than 90%, and 10% if the non-Israeli investment level is 90% or more. The lowest level of foreign investment during the year will be used to determine the relevant tax rate for that year. These tax benefits are granted for a limited period not exceeding seven years or 10 years with respect to a company whose foreign investment level exceeds 25% during the first year in which the Approved Enterprise has taxable income after utilizing its net operating losses. The period of benefits may in no event, however, exceed the lesser of (a) 12 years from the year in which the program was activated and (b) 14 years from the year of receipt of Approved Enterprise status.

Telematics Wireless facilities have been granted Approved Enterprise status. We have elected to participate in the alternative benefits program. Under the terms of our Approved Enterprise program, our income from that Approved Enterprise will be tax-exempt for a period of two years, commencing with the year in which we first generate taxable income from the relevant Approved Enterprise, and is subject to a reduced tax rate for an additional period of up to a total of five years from when the tax exemption began. We cannot assure you that the current benefit program will continue to be available or that we will continue to qualify for its benefits.

A company that has elected to participate in the alternative benefits program and that subsequently pays a dividend out of the income derived from the Approved Enterprise during the tax exemption period will be subject to corporate tax in respect of the amount distributed (including withholding tax thereon) at the rate that would have been applicable had the company not elected the alternative benefits program (generally 10% to 25%). The dividend recipient is taxed at the reduced withholding tax rate of 15%, applicable to dividends from the Approved Enterprises if the dividend is distributed within 12 years after the benefits period or other rate provided under a treaty. The withholding tax rate will be 25% after such period or a lower rate as provided by a relevant treaty. In the case of a company with a foreign investment level (as defined by the Investment Law) of 25% or more, the 12-year limitation on reduced withholding tax on dividends does not apply.

The Investment Law also provides that an Approved Enterprise is entitled to accelerated tax depreciation on property and equipment included in an approved investment program.

The benefits available to an Approved Enterprise are conditional upon our fulfilling certain conditions stipulated in the Investment Law and its regulations and the criteria set forth in the specific certificate of approval. If we were to violate those conditions, in whole or in part, we would be required to refund the amount of tax benefits, plus an amount linked to the Israeli consumer price index, plus interest and penalties. We believe that our Approved Enterprise operates in substantial compliance with all of these conditions and criteria.

Pursuant to the recent amendment to the Investment Law, only Approved Enterprises receiving cash grants require the approval of the Investment Center. Approved Enterprises that do not receive benefits in the form of governmental cash grants, such as benefits in the form of tax benefits, are no longer required to obtain this approval. In lieu of such approval, these Approved Enterprises are required to make certain investments as specified in the law. Such Approved Enterprises may, at their discretion, elect to apply for a pre-ruling from the Israeli tax authorities confirming that they are in compliance with the provisions of the law.

The amended Investment Law specifies certain conditions that an Approved Enterprise has to comply with in order to be entitled to benefits. These conditions include:

- that the Approved Enterprise's revenues from any single country not exceed 75% of the Approved Enterprise's total revenues; or
- that 25% of the Approved Enterprise s revenues during the benefits period be derived from sales into a single country with a population of at least 12 million.

In addition, the amendment addresses benefits that are being granted to Approved Enterprises and the length of the benefits period. For example, under the alternative program, an Approved Enterprise located in certain areas that used to be tax-exempt is now entitled to elect to pay an 11.5% tax rate instead, and, in such case, upon the distribution of its profits, no additional corporate tax will be paid. In addition, if an Approved Enterprise elects to pay the 11.5% tax rate, dividends that may be distributed to foreign residents will be subject only to a 4% withholding tax.

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There can be no assurance that we or our subsidiaries will comply with the above conditions in the future or that we will be entitled to any additional benefits under the investment law. In addition, we cannot assure you that we will designate the profits that are being distributed in a way that would reduce shareholders tax liability.

Law for the Encouragement of Industry (Taxes), 1969

We believe that our subsidiary, Telematics Wireless, which is part of our consolidated operations, currently qualifies as an Industrial Company within the meaning of the Law for the Encouragement of Industry (Taxes), 1969, which we refer to as the Industry Encouragement Law. The Industry Encouragement Law defines an Industrial Company as a company resident in Israel, of which 90% or more of its income in any tax year, other than of income from defense loans, capital gains, interest and dividends, is derived from an Industrial Enterprise owned by it. An Industrial Enterprise is defined as an enterprise whose major activity in a given tax year is industrial production.

The following corporate tax benefits, among others, are available to Industrial Companies:

- amortization of the cost of purchased know-how and patents over an eight-year period for tax purposes;
- accelerated depreciation rates on equipment and buildings;
- under specified conditions, an election to file consolidated tax returns with additional related Israeli Industrial Companies; and
- expenses related to a public offering are deductible in equal amounts over three years.

Telematics Wireless status as an industrial company is not contingent upon the receipt of prior approval from any government authority. However, entitlement to certain benefits under the law is conditioned upon receipt of approval from Israeli tax authorities. Also, the Israeli tax authorities may determine that Telematics Wireless does not qualify as an industrial company, which would entail the loss of the benefits that

relate to this status. In addition, Telematics Wireless might not continue to qualify for industrial company status in the future, in which case the benefits described above might not be available to it in the future.

Tax Benefits for Research and Development

Israeli tax law allows a tax deduction in the year incurred for expenditures, including capital expenditures, in scientific research and development projects, if the expenditures are approved by the relevant Israeli government ministry and the research and development are for the promotion of the enterprise. Expenditures not so approved are deductible over a three-year period.

Capital Gains Tax Applicable to Resident and Non-Resident Shareholders

Israeli law generally imposes a capital gains tax on the sale of capital assets located in Israel, including shares in Israeli resident companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a treaty between Israel and the country of the non-resident provides otherwise. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain that is equivalent to the increase of the relevant asset s purchase price which is attributable to the increase in the Israeli consumer price index or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

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Generally, up until the 2006 tax year, capital gains tax was imposed on Israeli resident individuals at a rate of 15% on real gains derived on or after January 1, 2003 from the sale of shares in, among others, (i) Israeli companies publicly traded on a recognized stock market in a country that has a treaty for the prevention of double taxation with Israel (such as Nasdaq), or (ii) companies dually traded on both the TASE and Nasdaq or another recognized stock market outside of Israel (such as Ituran). This tax rate was contingent upon the shareholder not claiming a deduction for financing expenses in connection with such shares (in which case the gain was generally taxed at a rate of 25%), and did not apply to: (1) dealers in securities; (2) shareholders that report in accordance with the Adjustments Law; or (3) shareholders who acquired their shares prior to an initial public offering; or (4) the sale of shares to a relative (as defined in the Tax Ordinance).

As of January 1, 2006, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 20% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a Material Shareholder at any time during the 12-month period preceding such sale, i.e. such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company, the tax rate shall be 25%. Israeli Companies are subject to the Corporate Tax rate on capital gains derived from the sale of shares, unless such companies were not subject to the Adjustments Law (or certain regulations) at the time of publication of the aforementioned amendment to the Tax Ordinance that came into effect on January 1, 2006, in which case the applicable tax rate is 25%. However the foregoing tax rates will not apply to: (i) dealers in securities; and (ii) shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement).

The tax basis of shares acquired prior to January 1, 2003 will be determined in accordance with the higher of the average closing share price in the three trading days preceding January 1, 2003, and cost.

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares publicly traded on the TASE, provided such gains did not derive from a permanent establishment of such shareholders in Israel, and are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock market outside of Israel (including Nasdaq), provided however that such shareholders did not acquire their shares prior to an initial public offering, that such capital gains are not derived from a permanent establishment in Israel, and that such shareholders are not subject to the Adjustments Law. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In addition, under the convention between the United States and Israel concerning taxes on income, as amended, or the U.S.-Israel Tax Treaty, generally, Israeli capital gains tax will not apply to the sale, exchange or disposition of shares by a person who holds the shares as a capital asset and who qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty, and who is entitled to claim the benefits available by the U.S.-Israel Tax Treaty. However, this exemption will not apply if (i) the treaty U.S. resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding the sale, exchange or disposition, subject to specified conditions, or (ii) the capital gains from such sale, exchange or disposition can be allocated to a permanent establishment in Israel. In this case, the sale, exchange or disposition would be subject to Israeli tax, to the extent applicable. However, under the U.S.-Israel Tax Treaty, the treaty U.S. resident would be permitted to claim a credit for the taxes against the U.S. federal income tax imposed on

the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

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Taxation of Non-Resident Shareholders

Non-residents of Israel are subject to Israeli income tax on income accrued or derived from sources in Israel, including passive income such as dividends, royalties and interest. On distributions of dividends, other than bonus shares and stock dividends, income tax is withheld at the source at the following rates: (i) for dividends distributed prior to January 1, 2006 25%; (ii) for dividends distributed on or after January 1, 2006 20%, or 25% for a shareholder that is considered a Material Shareholder at any time during the 12-month period preceding such distribution; unless a different rate is provided in a treaty between Israel and the shareholder s country of residence. As aforesaid, dividends of income generated by an Approved Enterprise are subject to withholding tax at a rate of 15%.

Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of shares who is a treaty U.S. resident is 25% or 15% if the dividends are generated by an Approved Enterprise (or Benefited Enterprise). Such tax rate is reduced to 12.5% for dividends not generated by an Approved Enterprise (or Benefited Enterprise) if the non-resident is a U.S. corporation and holds 10% or more of our voting power during the part of the tax year that precedes the date of payment of the dividend and during the whole of its prior tax year, and provided that not more than 25% of the Israeli company s gross income consists of interest or dividends.

F. DIVIDENDS AND PAYING AGENTS

Not Applicable

G. STATEMENT BY EXPERTS

Not Applicable

H. DOCUMENTS ON DISPLAY

We are required to file reports and other information with the Securities and Exchange Commission under the Securities Exchange Act of 1934 and the regulations thereunder applicable to foreign private issuers. Reports and other information filed by us with the Securities and Exchange Commission may be inspected and copied at the Securities and Exchange Commission s public reference facilities described below. We are not required to file periodic information as frequently or as promptly as United States companies. As a foreign private issuer, we are also exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements; and our officers, directors and principal shareholders are exempt from the reporting and other provisions of Section 16 of the Exchange Act.

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You may review a copy of our filings with the Securities and Exchange Commission, including any exhibits and schedules, at the Securities and Exchange Commission s public reference facilities at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may also obtain copies of such materials at prescribed rates by writing to the Public Reference Section of the Securities and Exchange Commission at 100 F Street, N.E., Washington, D.C. 20549. You may call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the public reference rooms. As a foreign private issuer we are now required to file through the Securities and Exchange Commission s EDGAR system and our periodic filings are therefore available on the Securities and Exchange Commission s Web site. You may read and copy any reports, statements or other information that we file with the Securities and Exchange Commission at the Securities and Exchange Commission facilities listed above. These Securities and Exchange Commission filings are also available to the public from commercial document retrieval services.

I. SUBSIDIARY INFORMATION

Not Applicable

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The principal market risks to which we are exposed as a result of our operations are foreign exchange rate risks and interest rate risks.

Foreign exchange rate risk

Although we report our consolidated financial statements in dollars, in 2004 and in 2005, a portion of our revenues and expenses was derived in other currencies. In the year 2004 and 2005, we derived approximately 45.6% and 48.9% of our revenues in dollars, 33.3% and 20.4% in NIS, 15.8% and 23.3% in Brazilian Reals and 5.3% and 7.4% in Argentine Pesos, respectively. In the year 2004 and 2005, 43.5% and 44.2% of our expenses were incurred in dollars, 41.5% and 35.2% in NIS, 11.2% and 15.5% in Brazilian Reals and 3.8% and 5.1% in Argentine Pesos, respectively.

Exchange differences upon conversion from our functional currency to dollars are accumulated as a separate component of accumulated other comprehensive income under shareholders equity. As of December 31, 2005, accumulated other comprehensive income increased by $0.9 million compared to December 31, 2004. As of December 31, 2004, accumulated other comprehensive income decreased by $0.5 million compared to December 31, 2003. Exchange differences upon conversion from the functional currency from our other selling and marketing subsidiaries to dollars are reflected in our income statements under financing expenses, net.

The fluctuation of the other currencies in which we incur our expenses or generate revenues against the NIS or the dollar has had the effect of increasing or decreasing (as applicable) reported revenues, cost of revenues and operating expenses in such foreign currencies when converted into dollars from period to period. The following table illustrates the effect of the changes in exchange rates on our revenues, gross profit and operating income for the periods indicated:

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	Year Ended December 31,					
	2005		2004		2003	
	Actual	At 2004 exchange rates[1]	Actual	At 2003 exchange rates[1]	Actual	At 2002 exchange rates[1]
	(In thousands)					
Revenues	$ 90,126	$ 86,653	$ 77,926	$ 77,263	$ 64,071	$ 63,440
Gross profit	42,540	40,761	36,038	35,895	26,623	26,947
Operating income	19,922	19,065	18,263	18,370	10,286	10,929

(1) Based on average exchange rates during the period.

In the past, we entered into foreign currency forward contracts generally of 12 to 18 months duration to hedge a portion of our foreign currency risk on the subscription fees payable in connection with our location-based services. The objective of these transactions is to hedge cash flow against fluctuations in the exchange rates of the dollar, NIS, Brazilian Real and Argentine Peso. All these contracts expired in September 2004. Our policy remains to reduce exposure to exchange rate fluctuations by entering into foreign currency forward transactions that qualify as hedging transactions under FAS No. 133, the results of which are reflected in our income statements as revenues. The result of these transactions, which are affected by fluctuations in exchange rates, could cause our revenues, gross profit and operating income to fluctuate.

In addition, due to increased fluctuations in the exchange rate of the US dollar vis-a-vis the Israeli Shekel in 2002, in December 2002 we commenced acquiring derivative financial instruments in order to convert currency fluctuation risks related to our US dollar denominated loans from the US dollar to other currencies which we thought would be more stable. We do not anticipate entering into such transactions in the future unless we incur significant debt in currencies that are different from the functional currency of the entity within our group incurring such debt, and any decision to enter into such transactions will require the approval of our Board of Directors and will only be made after consulting with our advisors. Gains or losses from such derivative financial instruments do not qualify for hedge accounting under FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and are reflected in financing expenses, net. As of June 2005, we have no more open positions on such derivative financial instruments and any remaining effects on our financial results from such derivative financial instruments are reflected

in our financial results for the second quarter of 2005 and will not affect our results of operations for any subsequent period.

Interest rate risk

We invest our cash balances primarily in bank deposits and therefore, we are exposed to market risks resulting from changes in general interest rates, primarily in the United States and Israel, but we do not believe such risks to be material. We do not use derivative financial instruments to limit exposure to interest rate risk.

ITEM 12. DESCRIPTIONS OF SECURITIES OTHER THAN EQUITY SECURITIES

Not Applicable.

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PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

A. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS

Effective as of September 27, 2005, our shareholders adopted amended and restated articles of association. These amended and restated articles were primarily adopted in order to match the provisions of the new Israeli Companies Law. Therefore, most of the material modifications were prescribed by the changes in the companies law. In addition, the amended and restated articles of association provided for a staggered board of directors as more fully discussed in Item 6.C. Board Practices under the caption Board of Directors above.

E. USE OF PROCEEDS

The effective date of our first registration statement, filed on Form F-1 under the Securities Act of 1933 (No. 333-128028) relating to the initial public offering of our ordinary shares, was September 27, 2005. The offering was managed by UBS Securities LLC, JP Morgan Securities Inc., William Blair & Company, LLC and C.E. Unterberg, Towbin, LLC.

In the offering, we sold 4,256,000 ordinary shares for an aggregate offering price of $55.3 million and the selling shareholders, sold 1,064,000 shares for an aggregate offering price of $13.8 million.

The amount of the underwriting discount paid by us in the offering was $3.6 million and the expenses of the offering, not including the underwriting discount, were approximately $2.3 million.

Net proceeds to us from our initial public offering in the United States were approximately $49.4 million. Since our public offering of our shares on the Nasdaq National Market, we did not use these proceeds.

ITEM 15. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and the person serving in the capacity of our chief financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based on that evaluation, our chief executive officer and person serving in the capacity of our chief financial officer concluded that our disclosure controls and procedures were effective, although certain additional procedures should be devised with respect to our foreign subsidiaries.

During the period covered by this report, no material changes in our internal control over financial reporting have occurred that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors determined that Mr. Israel Baron, one of our independent directors, is an audit committee financial expert , as defined by the applicable regulations promulgated under Section 407 of the Sarbanes-Oxley Act.

ITEM 16B. CODE OF ETHICS

In 2005, we have adopted a Code of Ethics that applies to our senior management, including chief executive officer, chief financial officer, internal auditor and other individuals performing similar functions. This code of ethics has been posted on our website at www.ituran.com.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Fahn Kanne & Co., a member firm of Grant Thornton International has served as our independent public accountants for each of the fiscal years ended in the three-year period ended December 31, 2005. The following table presents aggregate fees for professional audit services and other services rendered by Fahn Kanne & Co., for the year ended December 31:

	2005	**2004**
	($ in thousands)	
Audit Fees	100	99
Audit Related Fees	7	-
Tax Fees	19	-
All Other Fees	2	2
Total	**128**	**101**

The audit fees for the years ended December 31, 2005 and 2004, respectively, were for professional services rendered for the audits of our annual consolidated financial statements, review of consolidated quarterly financial statements, statutory audits of Ituran, and assistance with review of documents filed with the SEC.

Tax fees for the years ended December 31, 2005 and 2004, respectively, were for services related to tax compliance, including the preparation of tax returns and claims for refund; tax planning and tax advice, including assistance with tax audits.

Our audit committee has pre-approved certain audit and non-audit services provided by Fahn Kanne & Co. during the year 2005, up to a certain amount.

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ITEM 16D. EXEMPTIONS FROM THE LISTING STANDRDS FOR AUDIT COMMITTEES

In reliance upon Nasdaq Marketplace Rule 4350(a)(1), as a foreign private issuer, we have elected to follow our home country practices, absent home country rules requiring otherwise, in lieu of certain Nasdaq Marketplace Rules. Specifically, in Israel, it is not required that a public company have (i) a majority of its board of directors be independent, as defined in Marketplace Rule 4350(c), (ii) an audit committee comprised solely of members who are able to read and understand fundamental financial statements as required by Nasdaq Marketplace Rule 4350(d)(2) or (iii) a nominating committee as required by Nasdaq Marketplace Rule 4350(c)(4). As a result, we have elected to follow Israeli law regarding independence requirements of our Board of Directors and the composition of our Board of Directors will remain as is. See External directors. Similarly, we have elected to follow Israeli law with regard to the composition of our existing audit committee, which has three independent (as defined in Marketplace Rule 4350(c)) members, two of whom are external directors under the Israeli Companies Law and meet the requirements of Nasdaq Marketplace Rule 4350(d)(2) and at least one of which meets the requirement of the Directive of the Israel Securities Authority that one non-employee member has financial and accounting skills to, among other things, understand, on a high level, matters relating to business, accounting, internal auditing and financial statements. See also Audit committee. In addition, our Board of Directors has not appointed a nominating committee as required by Nasdaq Marketplace Rule 4350(c)(4) and, instead, elected to follow Israeli law, which provides that a company may determine its method of nominating its directors. In our case, Board of Director members (other than the External Directors) are nominated by our Board of Directors, as is the custom in Israel. By law, shareholders holding at least 1% of a company s voting rights may nominate directors and our company complies with this law. External Directors are nominated by the board of directors and must be elected at the shareholders general meeting that must approve them by a majority and in addition, either (i) one third of the non-controlling shareholders participating in such vote have voted for such External Directors; or (ii) the shareholders opposing such nomination that are not controlling shareholders must not represent in excess of 1% of the total voting rights in the company.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Not Applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

Not Applicable.

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ITEM 18. FINANCIAL STATEMENTS

The following consolidated financial statements and related registered public accounting firms reports are filed as part of this annual report.

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ITEM 19. EXHIBITS

Exhibit Number	Description of Document
1.1	Amended and Restated Articles of Association of the Company (1)
1.2	Form of Memorandum of Association of the Company (English Translation) (1)
2.1	Shareholders Agreement, dated May 18, 1998, by and between Moked Ituran Ltd., Moked Services, Information, Management, Investments, Yehuda Kahane Ltd., F.K. Generators and Equipment Ltd., Gideon Ezra, Ltd., Efraim Sheratzky, and Yigal Shani (English translation). (1)
2.2	Form of Amendment to Shareholders Agreement dated May 18, 1998, by and between Moked Ituran Ltd., Moked Services, Information, Management and Investments, Yehuda Kahane Ltd., F.K. Generators and Equipment Ltd., Gideon Ezra, Ltd., Efraim Sheratzky and/or T.S.D. Holdings Ltd., and Yigal Shani and/or G.N.S. Holdings Ltd. (English translation). (1)
4.1	Radio Location System License Agreement, dated December 16, 1993, by and between Pactel Teletrac and Tadiran Ltd. (1)
4.2	Assignment, Assumption, Consent and Amendment Agreement, dated April 30, 1996, by and between Teletrac, Inc, Airtouch Services, Tadiran Ltd. and the Registrant. (1)
4.3	Amendment Agreement (to Assignment, Assumption, Consent and Amendment Agreement dated April 30, 1996), dated March 1, 1999, by and between Teletrac, Inc. and the Registrant. (1)
4.4	Radio Location System License Agreement, dated July 13, 2004, by and between Teletrac, Inc., and Telematics Wireless Ltd. (1)
4.5	Radio Location System License Agreement, dated July 13, 1999, made by and among Teletrac, Inc., Teletrac License, Inc. and Ituran U.S.A. Inc. (1)
4.6	Amendment No. 1 to Radio Location System License Agreement, dated May 8, 2000, made by and among Teletrac, Inc., Teletrac License, Inc. and Ituran U.S.A. Inc. (1)

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4.7	Integrated Base Station Unit Development Agreement, dated December 13, 1996, by and between Teletrac, Inc., Tadiran Telematics Ltd. (1)
4.8	License and Ownership Agreement, dated as of September 29, 1999, by and between Tadiran Telematics Ltd. and Teletrac, Inc. (1)
4.9	Radio Location System License Agreement, dated March 1, 1999, by and between Teletrac, Inc. and Beheermaatschappij de Rooij B.V. (1)
4.10	Radio Location System License Agreement, dated December 21, 1999, by and between Teletrac, Inc. and Greenport Enterprises A.V.V., and assignment thereof to Ituran NY Corporation dated January 1, 2002. (1)
4.11	License and Supply Agreement for Radio Location System, dated August 31, 2004, by and between Vision Plant Inc. and Telematics Wireless Ltd. and ancillary Representation Agreement, dated June 2004 (1)*
4.12	Amendment No. 1 to the License and Supply Agreement for Radio Location System between Korean Location Information and Communications Company Ltd. and Telematics Wireless Ltd., dated June 15, 2005.(1)*
4.13	

	Agreement for the Supply of Ituran Ltd. Radio Location System in greater China, dated August 29, 2004, by and between Golden Net Communication Technology Ltd., Digitrack (China) Group Co. Ltd. and Telematics Wireless Ltd., and ancillary Cooperation and Annex I-2-Beijing Ituran System Deployment in Beijing Statement of Work, Prices, and Terms of Payment, dated March 23, 2005. (1)*
4.14	Cooperation Agreement, dated December 3, 2000, made by and between Arad Technologies Ltd. and Tadiran Telematics Ltd. (English translation). (1)*
4.15	RMR Production Agreement, dated June 14, 2001, by and between Arad Technologies Ltd. and Tadiran Telematics Ltd.(1)*
4.16	Appendix to the Cooperation Agreement and RMR Production Agreement, dated December 11, 2002, by and between Arad Technologies Ltd. and Telematics Wireless Ltd. (English translation). (1)*
4.17	Second Appendix to the Cooperation Agreement and RMR Production Agreement, dated December 28, 2003, by and between Arad Technologies Ltd. and Telematics Wireless Ltd. (English translation). (1)*
4.18	Third Appendix to the Cooperation Agreement and RMR Production Agreement, dated December 28, 2004, made by and between Arad Technologies Ltd. and Telematics Wireless Ltd. (English translation).(1)*
4.19	CIH-Transponders Supply Agreement, dated December 3, 2000, by and between Derech Eretz Highways (1997) Ltd. and Tadiran Telematics Ltd. (1)

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4.20	Agreement with an Independent Contractor, dated February 1, 2003, by and between the Registrant, Izzy Sheratzky, and A. Sheratzky Holdings Ltd. (English translation). (1)
4.21	Agreement with an Independent Contractor, dated September 5, 2002, by and between the Registrant, Eyal Sheratzky, and A. Sheratzky Holdings Ltd., addendum thereof, dated October 28, 2002, and resolution of the Registrant's shareholders dated February 24, 2004 (English translation). (1)
4.22	Agreement with an Independent Contractor, dated September 5, 2002, by and between the Registrant, Nir Sheratzky, and A. Sheratzky Holdings Ltd., addendum thereof, dated October 28, 2002 ,and resolution of the Registrant's shareholders dated February 24, 2004 (English translation). (1)
4.23	Individual Employment Agreement, dated August 1, 1995, by and between Moked Ituran Partnership (1995) and Jacob Suet (English translation). (1)
4.24	Individual Employment Agreement, dated August 20, 1995, by and between Moked Ituran Partnership (1995) and Harel Broida (English translation). (1)
4.25	Individual Employment Agreement, dated July 15, 1998, by and between Moked Ituran Partnership (1995) and Shlomo Kaminsky (English translation). (1)
4.26	Consulting Services Agreement, dated March 23, 1998, by and between the Registrant and Yehuda Kahane Ltd., including addendum thereof, as of May 25, 2003 (English translation). (1)
4.27	Agreement, dated December 30, 2002, by and between the Registrant, Eddy Kafry, Avri Franko, Roman Sternberg and Telematics Wireless Ltd. (English translation) (1)
4.28	Unprotected Lease Agreement, dated February 7, 2002, by and between Mofari Ltd. and the Registrant and addendum thereof, dated February 19, 2002 (English translation) (1)
4.29	Lease Agreement, dated September 13, 1998, by and between Tadiran, Ltd. and Tadiran Telematics, Ltd., and addendum thereof, dated May 29, 2002 (English translation). (1)

4.30	Lease Agreement, dated May 29, 2002, by and between Rinat Yogev Nadlan and Ituran Cellular Communication Ltd. (English translation). (1)
4.31	Deed of undertaking and indemnification, dated November 12, 2000, executed by the Registrant to the benefit of Bank Hapoalim, B.M. on behalf of Ituran Localizacao e Controle (English translation). (1)
4.32	Indenture, dated August 6, 2001, by the Registrant for the benefit of Bank Hapoalim, B.M. (English translation). (1)
4.33	Indenture, dated January 29, 2002, by the Registrant for the benefit of Bank Hapoalim, B.M. (floating lien) (English translation). (1)
4.34	Indenture, dated January 29, 2002, by the Registrant for the benefit of Bank Hapoalim, B.M. (English translation). (1)

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4.35	Deed of undertaking for repayment of loan, dated May 20, 2004, made by the Registrant in favor of Bank Hapoalim, B.M. (English translation). (1)
4.36	Lease Agreement, dated March 16, 2000, by and between Teleran Localizacao e Controle Ltda. and T4U Holding B.V., and addendum thereof, dated May 31, 2000. (1)
4.37	Lease Agreement, dated November 23, 2001, by and between Ituran de Argentina S.A. and El Sr. Mario Galuppo (English translation). (1)
4.38	Lease Agreement, dated September 7, 2001, by and between Ituran de Argentina S.A. and El Sr. Gustavo Eduardo Bazan (English translation). (1)
4.39	Form of Directors' Letter of Indemnity (English translation). (1)
4.40	Form of Underwriting Agreement (1)
8	List of significant subsidiaries
12.1	Certification by chief executive officer as required by Rule 13a-14(a).
12.2	Certification by person serving in the capacity of chief financial officer as required by Rule 13a-14(a).
13	Certification by co-chief executive officers and the person serving in the capacity of chief financial officer as required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.

(1) Incorporated by reference to Registrant s Registration Statement on Form F-1 (File No. 333-128028) filed on September 23, 2005.
* Certain portions of this exhibit have been omitted pursuant to an order granting confidential treatment by the United States Securities and Exchange Commission. The omitted non-public information has been filed with the United States Securities and Exchange Commission

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ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES

Consolidated Financial Statements
as of December 31, 2005

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES

Consolidated Financial Statements
as of December 31, 2005

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Certified Public Accountants

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
TO THE SHAREHOLDERS OF
ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES**

We have audited the accompanying consolidated balance sheets of **Ituran Location and Control Ltd. (the Company) and its subsidiaries** as of December 31, 2004 and 2005, and the related consolidated statements of income, changes in shareholders equity and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Board of Directors and management of the Company. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We did not audit the 2003 and 2004 financial statements of a certain subsidiary, whose assets included in the consolidation constituted approximately 6.5% of total consolidated assets as of December 31, 2004, and whose revenues included in the consolidation constituted approximately 13% and 10% of total consolidated revenues for the years ended December 31, 2003 and 2004, respectively. The financial statements of this subsidiary were audited by other independent auditors, whose report has been furnished to us. Our opinion, insofar as it relates to the amounts included in respect of this company, is based solely on the report of the other independent auditors.

We conducted our audits in accordance with auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit includes consideration of internal controls over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal controls over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by the Board of Directors and management of the Company, 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 report 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, 2004 and 2005, and the consolidated results of operations, changes in shareholders equity and cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States.

Fahn Kanne & Co.
Certified Public Accountants (Isr.)
Member firm of Grant Thornton International

Tel-Aviv, Israel
June 21, 2006

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(in thousands)	US dollars December 31, 2004	US dollars December 31, 2005
Current assets		
Cash and cash equivalents	4,604	58,429
Accounts receivable (net of allowance for doubtful accounts)	19,993	22,494
Other current assets (Note 2)	1,614	2,747
Contracts in process, net (Note 3)	30	-
Inventories (Note 4)	6,416	6,330
	32,657	90,000
Long-term investments and debit balances		
Investments in affiliated companies (Note 5)	821(*)	872
Accounts receivable	-	280
Deposit	1,393	1,300
Deferred income taxes (Note 16)	5,507	5,168
Funds in respect of employee rights upon retirement	2,854	2,959
	10,575	10,579
Property and equipment, net (Note 6)	9,204	9,904
Intangible assets, net (Note 7)	3,676	3,201
Goodwill (Note 8)	2,911(*)	2,800
Total assets	59,023	116,484

(*) Reclassified.

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

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(in thousands)	US dollars	
	December 31,	
	2004	2005
Current liabilities		
Credit from banking institutions - mainly current maturities of long-term loans (Note 9)	6,586	3,315
Accounts payable	10,574	10,298
Deferred revenues	3,824	3,900
Other current liabilities (Note 10)	9,165	11,492
	30,149	29,005
Long-term liabilities		
Long-term loans from banking institutions (Note 11)	3,615	373
Liability for employee rights upon retirement	4,256	4,504
Deferred income taxes (Note 16)	-	212
	7,871	5,089
Contingent liabilities, liens and guarantees (Note 12)		
Minority interest	108	734
Capital Notes (Note 13)	5,894	5,894
Shareholders' equity (Note 14)		
Share capital - ordinary shares of NIS $0.33^1/_3$ par value:	1,626	1,953
Authorized - December 31, 2004, 2005 - 22,575,000 shares, December 31, 2005 - 60,000,000 shares		
Issued and outstanding - December 31, 2004 - 18,595,197 shares, December 31, 2005 - 23,091,383 shares		
Additional paid-in capital	23,876	73,554
Accumulated other comprehensive loss	(2,487)	(3,409)
Cost of Company shares held by subsidiaries - December 31, 2004 and 2005 - 20,736 shares	(384)	(384)
Accumulated deficit	(7,630)	4,048
Total shareholders' equity	15,001	75,762
Total liabilities and shareholders' equity	59,023	116,484

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

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(in thousands except per share data)	US dollars		
	Year ended December 31,		
	2003	2004	2005
Revenues:			
Location-based services	32,088	36,549	44,128
Wireless communications products	23,527	33,461	43,806
Other	8,456	7,916	2,192
	64,071	77,926	90,126
Cost of revenues:			
Location-based services	12,258	12,944	14,987
Wireless communications products	19,071	23,224	30,956
Other	6,119	5,720	1,643
	37,448	41,888	47,586
Gross profit	26,623	36,038	42,540
Research and development expenses	1,692	2,020	2,799
Selling and marketing expenses	2,888	4,074	4,876
General and administrative expenses	11,443	11,693	14,959
Other expenses (income), net	314	(12)	(16)
Operating income	10,286	18,263	19,922
Financing income (expenses), net (Note 15)	(616)	(2,059)	906
Income before taxes on income	9,670	16,204	20,828
Taxes on income (Note 16)	(3,417)	(4,423)	(5,295)
	6,253	11,781	15,533
Share in losses of affiliated companies, net	(235)	(324)	(355)
Minority interests in income of subsidiaries	(173)	(238)	(803)
Net income for the year	5,845	11,219	14,375
Earnings per share (Note 17):			
Basic	0.32	0.60	0.73
Diluted	0.31	0.58	0.71
Weighted average number of shares outstanding (in thousands):			
Basic	18,273	18,585	19,736
Diluted	19,086	19,192	20,254

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

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(in thousands)

	Ordinary shares								
	Number of shares	**Amount of shares**	**Receipts on account of shares**	**Additional paid in capital**	**Accumulated other comprehensive income (loss)**	**Accumulated deficit**	**Cost of Company shares held by subsidiaries**	**Deferred compensation**	**Total**
US dollars									
Balance as of January 1, 2003	17,826	1,572	1,320	23,423	(2,712)	(23,367)	(2,595)	(562)	(2,921)
Changes during 2003:									
Net income	-	-	-	-	-	5,845	-	-	5,845
Gains in respect of derivative instruments designated for cash flow hedge, net of related taxes	-	-	-	-	366	-	-	-	366
Translation losses of non-Israeli currency financial statements of subsidiaries and from the translation of the functional currency to the reporting currency	-	-	-	-	88	-	-	-	88
Total comprehensive loss									6,299
Amortization of deferred compensation related to employee stock option plans	-		-	(41)	-			433	392
Issuance of share capital	715	50	(1,320)	1,289	-	-	-	-	19
Balance as of December 31, 2003	18,541	1,622	-	24,671	(2,258)	(17,522)	(2,595)	(129)	3,789
Changes during 2004:									
Net income	-	-	-	-	-	11,219	-	-	11,219
Losses in respect of derivative instruments designated for cash flow hedge, net of related taxes	-	-	-	-	(644)	-	-	-	(644)
Translation losses of non-Israeli currency financial statements of subsidiaries and from the translation of the functional currency to the reporting currency	-	-	-	-	415	-	-	-	415
Total comprehensive income									10,990
Amortization of deferred compensation related to employee stock option plans	-	-	-	-	-	-	-	129	129
Issuance of share capital	54	4	-	-	-	-	-	-	4
Sale of Company shares held by subsidiary	-	-	-	(795)	-	-	2,211	-	1,416
Dividend paid	-	-	-	-	-	(1,327)	-	-	(1,327)
Balance as of December 31, 2004	18,595	1,626	-	23,876	(2,487)	(7,630)	(384)	-	15,001

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

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (cont.)

	Ordinary shares								
	Number of shares	Amount of shares	Receipts on account of shares	Additional paid in capital	Accumulated other comprehensive income (loss)	Retained earning (accumulated deficit)	Cost of Company shares held by subsidiaries	Deferred compensation	Total
	(in thousands)								
US dollars									
Balance as of January 1, 2005	18,595	1,626	-	23,876	(2,487)	(7,630)	(384)	-	15,001
Changes during 2005:									
Net income	-	-	-	-	-	14,375	-	-	14,375
Translation losses of non-Israeli currency financial statements of subsidiaries and from the translation of the functional currency to the reporting currency	-	-	-	-	(922)	-	-	-	(922)
Total comprehensive income									13,453
Modification of terms of fully vested employee stock options	-	-	-	243	-	-	-	-	243
Issuance of share capital, net	4,464	325	-	49,064	-	-	-	-	49,389
Exercise of warrants	33	2	-	371	-	-	-	-	373
Dividend paid	-	-	-	-	-	(2,697)	-	-	(2,697)
Balance as of December 31, 2005	23,092	1,953	-	73,554	(3,409)	4,048	(384)	-	75,762

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

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	US dollars		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
Cash flows from operating activities			
Net income for the period	5,845	11,219	14,375
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	3,482	3,536	3,341
Exchange differences on principal of deposit and loans, net	(804)	373	104
Increase (decrease) in liability for employee rights upon retirement	(302)	424	521
Share in losses of affiliated companies, net	235	324	355
Deferred income taxes	2,193	1,183	301
Amortization of deferred compensation related to employee stock option plans, net	392	129	243
Capital gains on sale of property and equipment, net	(72)	(40)	(16)
Minority interests in income of subsidiaries, net	173	238	803
Increase in accounts receivable	(627)	(3,002)	(4,912)
Decrease (increase) in other current assets	344	(1,003)	(1,028)
Decrease (increase) in inventories and contracts in process, net	3,633	(1,259)	(269)
Increase (decrease) in accounts payable	(822)	2,582	460
Increase in deferred revenues	267	1,033	321
Increase in other current liabilities	1,850	1,937	3,159
Net cash provided by operating activities	15,787	17,674	17,758
Cash flows from investing activities			
Decrease (increase) in funds in respect of employee rights upon retirement, net of withdrawals	83	(366)	(288)
Capital expenditures	(2,339)	(2,374)	(3,540)
Proceeds from sale of property and equipment	109	125	133
Purchase of intangible assets and minority interest	(67)	(295)	(746)
Loan granted to affiliated company	-	-	(452)
Net cash used in investment activities	(2,214)	(2,910)	(4,893)
Cash flows from financing activities			
Short-term credit from banking institutions, net	(12,642)	(8,560)	181
Receipt of long-term loans	5,119	9,360	-
Repayment of long-term loans	(3,586)	(15,035)	(6,290)
Dividend paid	-	(1,327)	(2,697)
Proceeds from sale of Company shares held by a subsidiary	-	1,416	-
Proceeds from exercise of options by employees	19	4	15
Proceeds from exercise of warrants	-	-	373
Issuance of capital shares, net	-	-	49,673
Net cash provided by (used in) financing activities	(11,090)	(14,142)	41,255

	US dollars		
Effect of exchange rate changes on cash and cash equivalents	108	64	(295)
Net increase in cash and cash equivalents	2,591	686	53,825
Balance of cash and cash equivalents at beginning of period	1,327	3,918	4,604
Balance of cash and cash equivalents at end of period	3,918	4,604	58,429

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

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (cont.)

Supplementary information on investing activities not involving cash flows

At December 31, 2004 and 2005, trade payables included US$ 62,000 and US$ 196,000, respectively, in respect of the acquisition of property and equipment, and goodwill.

At December 31, 2004, the balance of accounts payable included an amount of US$ 527,000, in respect of the acquisition of the minority interest in subsidiaries.

At December 31, 2005, accounts payable and other credit balances included an amount of US$ 299,000 in respect of issuance expenses.

Supplementary disclosure of cash flow information

	US dollars		
	Year ended December 31,		
(in thousands)	2003	2004	2005
Interest paid	1,010	1,198	324
Income taxes paid	587	754	2,049

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

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ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES

A. General

1. Operations

Ituran Location and Control Ltd. (the Company) commenced operations in 1994. The Company and its subsidiaries (the Group) are engaged in the provision of location-based services and machine-to-machine wireless communications products for use in stolen vehicle recovery, fleet management and other applications.

2. Share split

On September 22, 2005, the Company effected a share split pursuant to which each of its ordinary shares was converted into 3 ordinary shares. Unless otherwise noted, all share and per share amounts for all periods presented have been retroactively restated to give effect to this share split.

3. Functional currency and translation to the reporting currency

The functional currency of the Company and its subsidiaries located in Israel is the New Israeli Shekel (NIS), which is the local currency in which those entities operate. The functional currency of the foreign subsidiaries of the Group is their representative local currency.

The consolidated financial statements of the Company and all of its subsidiaries were translated into U.S. dollars in accordance with the principles set forth in *Statement of Financial Accounting Standards* (FAS) No. 52 of the U.S. Financial Accounting Standards Board (FASB). Accordingly, assets and liabilities were translated from local currencies to U.S. dollars using year-end exchange rates, and income and expense items were translated at average exchange rates during the year.

Gains or losses resulting from translation adjustments (which result from translating an entity s financial statements into U.S. dollars if its functional currency is different than the U.S. dollar) are reflected in shareholders equity, under accumulated other comprehensive income (loss)".

Balances denominated in, or linked to foreign currency are stated on the basis of the exchange rates prevailing at the balance sheet date. For foreign currency transactions included in the statement of income, the exchange rates applicable on the relevant transaction dates are used. Transaction gains or losses arising from changes in the exchange rates used in the translation of such balances are carried to financing income or expenses.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

A. General (cont.)

3. Functional currency and translation to the reporting currency (cont.)

The following table presents data regarding the dollar exchange rate and the Israeli CPI:

	Exchange rate of one US dollar	Israeli CPI(*)
At December 31,		
2005	NIS 4.603	117.04 points
2004	NIS 4.308	114.32 points
2003	NIS 4.379	112.95 points
Increase (decrease) during the year:		
2005	6.85%	2.38%
2004	(1.62)%	1.21%
2003	(7.56)%	(1.89)%

(*) Based on the Index for the month ending on each balance sheet date, on the basis of 1998 average = 100.

4. Accounting principles

The consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States (US GAAP).

5. Use of estimates in the preparation of financial statements

The preparation of financial statements in conformity with US GAAP 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 periods. Actual results could differ from those estimates.

B. Principles of consolidation

The consolidated financial statements include the accounts of the Company and all of its subsidiaries. In these financial statements, the term subsidiary refers to a company over which the Company exerts control (ownership interest of more than 50%), and the financial statements of which are consolidated with those of the Company. Significant intercompany transactions and balances were eliminated upon consolidation; profits from intercompany sales, not yet realized outside of the Group, were also eliminated.

C. Cash and cash equivalents

The Group considers all highly liquid investments, which include short-term bank deposits that are not restricted as to withdrawal or use, and short-term debentures, with original periods to maturity not exceeding three months, to be cash equivalents.

D. Company shares held by subsidiaries

Company shares held by subsidiaries are presented as a reduction of shareholders equity, at their cost to the subsidiaries, under the caption Cost of Company shares held by subsidiaries . Gains on sale of these shares, net of related income taxes, are recorded as additional paid-in capital.

Losses on the sale of such shares, net of related income taxes, are recorded as deductions from additional paid-in capital to the extent that previous net gains from sales are included therein, otherwise in retained earnings.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

E. Allowance for doubtful accounts

The allowance for doubtful accounts is determined with respect to amounts the Company has determined to be doubtful of collection. In determining the allowance for doubtful accounts, the Company considers, among other things, its past experience with such customers and the information available on such customers. See Note 20(A).

The allowance in respect of trade receivables at December 31, 2004 and 2005 was US$ 195,000 and US$ 548,000, respectively.

F. Contracts in process

The contracts in process are presented at cost, less customer advances, less a portion of the costs expensed in prior periods (concurrent with the applicable revenue based on percentage of completion), and less the entire expected loss on projects, if any.

Cost includes direct costs of materials, labor, subcontractors, and other direct costs.

G. Inventories

Inventories are stated at the lower of cost or market. Cost is determined as follows: raw materials and finished products mainly on the basis of average cost; work in progress on the basis of direct production costs including materials, labor and subcontractors, plus the allocated portion of indirect production costs, on an average basis.

H. Investment in affiliated companies

Investments in companies in which the Group has significant influence (ownership interest of between 20% and 50%) but less than a controlling interest, which are not subsidiaries (affiliated companies), are accounted for by the equity method. Income on intercompany sales, not yet realized outside of the Group, was eliminated.

I. Derivatives

The Company carries out transactions involving foreign exchange derivative financial instruments (mainly forward exchange contracts) which are designed to hedge the cash flows expected to be received from forecasted revenues resulting from subscription fees, denominated in currencies other than the functional currency of the Company. Such transactions were designated as hedging instruments on the date that the Company entered into such derivative contracts, and qualify as cash flow hedges under FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. For such derivatives, the critical terms are matched to those of the hedged transaction with respect to currency, amount and period, in accordance with the risk management policy of the Company. As a result, subsequent fluctuations of foreign exchange rates have no effect on the correlation between those contracts and hedged transactions. Therefore, the hedging relationship of such derivative and hedged transaction is considered highly effective and there is no ineffectiveness to be recognized in earnings, as long as the critical terms of the hedging relationship are maintained.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

I. Derivatives (cont.)

As a result, the changes in fair value of the derivative are reported as other comprehensive income under gains in respect of derivative instruments designated for cash flow hedge, net of related taxes , and are recognized in the statements of income when the hedged transaction affects earnings.

All other derivatives which do not qualify for hedge accounting under FAS No. 133, or which have not been designated as hedging instruments, are recognized in the balance sheet at their fair value, with changes in the fair value carried to the statements of income and included in financing expenses, net.

J. Property and equipment

1. Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are depreciated on the straight-line method over the shorter of the estimated useful life of the property or the duration of the lease.

2. Rates of depreciation:

	%
Operating equipment (mainly 10%-20%)	6.5-33
Office furniture, equipment and computers	7-33
Vehicles	15
Leasehold improvements	Duration of lease which is less or equal to useful life

K. Impairment of long-lived assets

The Group s long-lived assets are reviewed for impairment in accordance with FAS 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 such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. The Company has not recorded any impairment losses in the reported periods.

L. Deferred income taxes

The Group accounts for income taxes in accordance with FAS No. 109, *Accounting for Income Taxes*. According to FAS No. 109, deferred income taxes are determined utilizing the asset and liability method based on the estimated future tax effects of differences between the financial accounting and the tax bases of assets and liabilities under the applicable tax law. Deferred tax balances are computed using the tax rates expected to be in effect at the time when these differences reverse. Valuation allowances in respect of the deferred tax assets are provided for if, based upon the weight of available evidence, it is more likely than not that all or a portion of the deferred income tax assets will not be realized.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

M. Goodwill and intangible assets

Goodwill represents the excess of the purchase price over the fair value of the identifiable net assets acquired in business combinations accounted for as purchases. Commencing on January 1, 2002, pursuant to the adoption of FAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is no longer amortized but rather tested for impairment at least annually. As of December 31, 2004 and 2005, the Company has determined that there is no impairment with respect to Goodwill. Prior to the adoption of FAS No. 142, goodwill was amortized in equal annual installments over a period of 10 years.

Intangible assets are amortized using the straight-line basis over their useful lives, to reflect the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with FAS No. 142, as follows: technology usage rights and others 10 years; licenses and patents 7 years.

N. Issuance costs of convertible capital notes

Costs incurred in respect of the issuance of convertible capital notes are deferred and expensed as financing expenses over the contractual life of the capital notes.

O. Liability for employee rights upon retirement

The Company s liability for employee rights upon retirement with respect to its Israeli employees is calculated, pursuant to Israeli severance pay law, based on the most recent salary of each employee multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month s salary for each year of employment, or a portion thereof. The Company makes monthly deposits to insurance policies and severance pay funds. The liability of the Company is fully provided for.

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

The liability for employee rights upon retirement in respect of the employees of the non-Israeli subsidiaries of the Company, is calculated on the basis of the labor laws of the country in which the subsidiary is located and is covered by an appropriate accrual.

Severance expenses for the years ended December 31, 2003, 2004 and 2005, amounted to US$ 452,000, US$ 375,000 and US$ 604,000, respectively.

P. Revenue recognition

Revenues are recognized in accordance with Staff Accounting Bulletin No. 104 *Revenue Recognition* when delivery has occurred and, where applicable, after installation has been completed, there is persuasive evidence of an agreement, the fee is fixed or determinable and collection of the related receivable is reasonably assured and no further obligations exist. In cases where delivery has occurred but the required installation has not been performed, the Company does not recognize the revenues until the installation is completed.

The Company s revenues are recognized as follows:

1. Revenues from sales are recognized when title and risk of loss of the product pass to the customer (usually upon delivery).

2. Revenues from installation services are recognized when the installation is completed.

3. Revenues from subscription fees are recognized over the duration of the subscription period.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

P. Revenue recognition (cont.)

4. The Company recognizes revenues as gross or net in accordance with EITF 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19). In most arrangements, the Company contracts directly with its end-user customers, it is the primary obligor and it carries all collectibility risk. Revenues under these arrangements are recorded on a gross basis.

   In some cases, the Company is not considered as the primary obligor according to the criteria established in EITF 99-19, and serves only as distributors of products or services of other parties to end-user customers. In those instances, in accordance with EITF 99-19, the Company reports the revenues on a net basis.

5. Revenues from certain long-term contracts:

   The Company recognizes certain long-term contract revenues, in accordance with Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production Type Contracts*.

   Pursuant to SOP 81-1, revenue is recognized under the percentage of completion method. The Company measures the percentage of completion based on output criteria, such as the number of units delivered or the progress of the engineering process (in contracts that require network buildup before end units are sold).

   Provisions for estimated losses on uncompleted contracts are made during the period in which such losses are first identified, in the amount of the estimated loss on the entire contract.

   The Company believes that the use of the percentage of completion method is appropriate, as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights of the parties to the contract, the consideration to be exchanged and the manner and terms of settlement. In all cases, the Company expects to perform its contractual obligations and the parties are expected to satisfy their obligations under the contract.

   In contracts that do not meet all the abovementioned conditions, the Company utilizes zero estimates of profit; equal amounts of revenue and cost are recognized until results can be estimated with sufficient certainty.

   Revenues and costs recognized pursuant to SOP 81-1 on contracts in process are subject to management estimates. Actual results could differ from these estimates.

6. Deferred revenues include unearned amounts received from customers but not yet recognized as revenues.

7. Sale and leaseback transactions

   The Company accounts for sale and leaseback transactions in accordance with the provisions of FAS No. 13, *Accounting for Leases* as amended by FAS No. 28, *Accounting for Sales with Leasebacks*.

   Accordingly, with respect of a certain leaseback transaction that was determined to be an operating lease and involving the use of more than a minor part but less than substantially all of the asset sold, the entire profit on the sale was deferred and amortized in proportion to rental payments over the term of the lease. There was no recognition of any profit at the date of the sale since the present value of the minimum lease payments exceeded the amount of the profit.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

Q. Warranty costs

The Company provides a warranty for its products to end-users at no extra charge. The Company estimates the costs that may be incurred under its warranty obligation and records a liability at the time the related revenues are recognized.

Among the factors affecting the warranty liability are the number of installed units and historical percentages of warranty claims. The Company periodically assesses the adequacy of the recorded warranty liability and adjusts the amount to the extent necessary. To date, warranty costs and the related liabilities have not been material.

R. Research and development costs

1. Research and development costs (other than computer software-related expenses) are expensed as incurred. Grants received from the Government of Israel for development of approved projects are recognized as a reduction of expenses when the related costs are incurred.

2. Software Development Costs

FAS 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. Research and development costs incurred in the process of developing product improvements or new products, are generally expensed as incurred, net of grants received from the Government of Israel for development of approved projects. Costs incurred by the Company between the establishment of technological feasibility and the point at which the product is ready for general release are insignificant.

3. Purchased In-Process Research and Development

Purchased In-Process Research and Development (IPR&D) represents the value assigned in a purchase business combination to research and development projects of the acquired business that had commenced but had not yet been completed at the date of acquisition and which have no alternative use. In accordance with FAS No. 2 *Accounting for Research and Development Costs*, as clarified by FASB Interpretation No. 4, amounts assigned to IPR&D are expensed as part of the allocation of the purchase price of the business combination.

S. Advertising costs

Advertising costs are expensed as incurred.

Advertising expenses for the years ended December 31, 2003, 2004 and 2005 amounted to US$ 2 million, US$ 3 million and US$ 3.7 million, respectively.

T. Issuance of shares by affiliated companies

Capital gains arising from the issuance of shares by affiliated companies to third parties are carried to income on a current basis. Capital gains arising from the issuance of shares by an affiliated company to the extent that the issuing company is a newly formed company are carried to additional paid in capital.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

U. Earnings per share

Basic earnings per share are computed by dividing net income by the weighted average number of shares outstanding during the year, net of Company shares held by subsidiaries.

In computing diluted earnings per share, basic earnings per share are adjusted to reflect the potential dilution that could occur upon the exercise of options granted under employee stock option plans, using the treasury stock method, and the conversion of the convertible capital notes, using the if-converted method. The assumed conversion of such convertible capital notes that have not been converted during the period, was based on the average quoted share prices prior to each balance date (see also Note 17 regarding the conversion mechanism).

V. Stock based compensation

The Group accounts for its employee stock option plans using the fair value based method of accounting prescribed by FAS No. 123, Accounting for Stock-Based Compensation as amended by FAS No. 148.

According to FAS No. 123, the fair value of stock options granted to employees is estimated on the date of grant using the Black-Scholes option-pricing model. The compensation cost is charged to expense over the vesting period using the graded method, an accelerated method which results in charging a greater portion of the value of options granted in the earlier years of their vesting period.

The Company applied FAS No. 123 and Emerging Issue Task Force (EITF) No. 96-18 Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services with respect to options issued to non-employees.

W. Comprehensive income (loss)

Comprehensive income, presented in shareholders equity, includes, in addition to net income:

(a) gains (losses) in respect of derivative instruments designated for cash flow hedge, net of related taxes, and (b) translation gains (losses) of non-Israeli currency financial statements of subsidiaries and affiliated companies and translation gains and losses from the translation of the functional currency to the reporting currency.

X. Financial instruments with characteristics of both liabilities and equity

In May 2003, the FASB issued FAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. FAS No. 150 establishes standards governing how an issuer classifies and measures certain financial instruments having characteristics of both liabilities and equity. FAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and (except for certain instruments) is otherwise effective at the commencement of the first interim period beginning after June 15, 2003. The Company adopted FAS No. 150 effective July 1, 2003. The adoption of FAS No. 150 did not have a material effect on the Company s financial position or results of operations.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

Y. Recently issued accounting pronouncements

FAS No. 123R, Share-Based Payment

In December 2004, the FASB issued FAS No. 123R, Share-Based Payment (FAS 123R), a revision of FAS No. 123, Accounting for Stock Based Compensation (FAS 123). Among other items, FAS123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize in their financial statements, the cost of employee services received in exchange for awards of equity instruments, based on the fair value of those awards at the grant date. The effective date of FAS 123R is the first reporting fiscal year period beginning after June 15, 2005, which is the first quarter 2006 for the Company.

In March 2005, the SEC issued Staff Accounting Bulletin 107 (SAB 107). In particular, SAB 107 provides supplemental implementation guidance on FAS 123R, including guidance on valuation methods, classification of compensation expense, inventory capitalization of share-based compensation cost, income statement effects, disclosures and several other issues. The Company will apply the principles of SAB 107 in conjunction with the adoption of FAS 123R

As of December 31, 2005 The Company accounted for employees stock based compensation using the fair value based method of accounting under FAS 123.

Therefore the Company expects that the adoption of FAS 123R, would not have a material effect on the Company s financial position or results of operations.

FAS151 Inventory Costs, an Amendment of ARB No. 43, Chapter 4

In November 2004, the FASB issued FAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4 (FAS151). FAS151 clarifies the accounting for abnormal amounts of idle facility expenses, freight, handling costs, and wasted material (spoilage). FAS151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal . In addition, it requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities.

As applicable to the Company, FAS151 will be effective for inventory costs incurred after January 1, 2006. The Company believes that FAS 151, when adopted, will not have a significant impact on its financial position or results of operations.

FAS154 Accounting Changes and Error Corrections

In May 2005, the FASB issued FAS154 Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS154), FAS154 replaces APB Opinion 20, Accounting Changes , and FAS3, Reporting Accounting Changes in Interim Financial Statements , and changes the requirements for the accounting for and reporting of a change in accounting principle. FAS154 applies to all voluntary changes in accounting principle, and to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.

As applicable to the Company, the provisions of FAS 154 are effective as for the year beginning January 1, 2006. The adoption of this Standard is not expected to have a material effect on the Company s financial position and results of operations.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES (cont.)

Y. Recently issued accounting pronouncements (cont.)

FAS 155 Accounting for Certain Hybrid Financial Instruments

In February 2006, the FASB issued FAS 155, accounting for certain Hybrid Financial Instruments, an amendment of FASB statements No. 133 and 140. This statement permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation.

This statement shall be effective for all financial instruments acquired or issued, or subject to remeasurement (new basis) after the beginning of an entity s first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity s fiscal year, provided that no interim period financial statements have been issued for the financial year.

Management is currently evaluating the impact of this statement, if any, on the Company s financial statements or its results of operations.

Z. Certain comparative figures have been reclassified to the current year presentation.

NOTE 2 OTHER CURRENT ASSETS

Composition:

	US dollars	
	December 31,	
(in thousands)	2004	2005
Prepaid expenses	527	843
Government institutions	456	1,002
Deferred taxes	153	352
Minority shareholders in subsidiaries	226	-
Advances to suppliers	111	396
Employees	20	74
Related parties	2	1
Others	119	79
	1,614	2,747

NOTE 3 CONTRACTS IN PROCESS, NET

Composition:

	US dollars	
	December 31,	
(in thousands)	2004	2005
Cost of work	300	1,986
Less - portion expensed in prior periods	(268)	(1,986)

	US dollars	
	32	-
Less - advances from customers	(2)	(28)
	30	(28)(*)

(*) As of December 31, 2005, advances from customers in excess of costs and the portion expensed in prior periods are included in other current liabilities.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 4 INVENTORIES

Composition:

	US dollars	
	December 31,	
(in thousands)	**2004**	**2005**
Finished products	3,472	3,696
Raw materials	1,732	1,915
Work in progress	1,212	719
	6,416	6,330

NOTE 5 INVESTMENTS IN AFFILIATED COMPANIES

A. Locationet Systems Ltd. (Locationet)

The Company holds 21.28% of the shares of Locationet.

The balance of the Company s investment in Locationet as of December 31, 2004 and 2005 was US$ 639,000 and US$ 530,000, respectively.

B. Icomtrade Ltd. (Icomtrade)

The Company holds 50% of the shares of Icomtrade.

The balance of the Company s investment in Icomtrade as of December 31, 2004 and 2005 was US$ 182,000 and US$ 169,000, respectively. As of December 31, 2004 and 2005, these balances included a loan in the amounts of US$ 178,000 and US$ 170,000, respectively.

The loan is linked to the Israeli Consumer Price Index.

C. MatysOnBoard Ltd. (Matys)

The Company holds 25% of the shares of Matys.

The balance of the Company s investment in MatysOnBoard Ltd. as of December 31, 2005 was US$ 173,000. As of December 31, 2005, this balance included a loan in the amount of US$ 452,000.

The loan is linked to the Israeli Consumer Price Index.

NOTE 6 PROPERTY AND EQUIPMENT, NET

Composition:

US dollars
December 31,

(in thousands)	US dollars 2004	2005
Operating equipment	14,603	17,184
Office furniture, equipment and computers	4,211	5,089
Vehicles	591	697
Leasehold improvements	764	778
	20,169	23,748
Less - accumulated depreciation and amortization	(10,965)	(13,844)
	9,204	9,904

In the years ended December 31, 2003, 2004 and 2005, depreciation and amortization expense was US$ 2.5 million, US$ 2.8 million and US$ 2.8 million, respectively and additional equipment was purchased in an amount of US$ 2.2 million, US$ 2.3 million and US$ 3.5 million, respectively.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 7 INTANGIBLE ASSETS, NET

Intangible assets, net, consisted of the following:

(in thousands)	US dollars			
	December 31, 2004	2005	December 31, 2005	2005
	Unamortized balance	Original amount	Accumulated amortization	Unamortized balance
Technology usage rights	1,204	3,592	(2,709)	883
Purchase of licenses and patent registration	1,620	2,466	(972)	1,494
Others	852	4,535	(3,711)	824
	3,676	10,593	(7,392)	3,201

Amortization of intangible assets amounted to US$ 1.0 million, US$ 774,000 and US$ 526,000 for the years ended December 31, 2003, 2004 and 2005, respectively. As of December 31, 2005, the estimated aggregate amortization of intangible assets for the next five years is as follows: 2006 US$ 474,000; 2007 US$ 474,000; 2008 US$ 474,000; 2009 US$ 179,000; 2010 US$ 179,000.

NOTE 8 GOODWILL

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

	US dollars			
	Wireless communications products	Location based services	Cellular communications services	Total
	(in thousands)			
Balance as of January 1, 2004	424(*)	762	313	1,499
Changes during 2004:				
Goodwill acquired during the year(*)	689	716	-	1,405
Translation differences	7	(5)	5	7
Balance as of December 31, 2004	1,120	1,473	318	2,911
Changes during 2005:				
Goodwill acquired during the year(**)	43	187(**)	-	230
Realization of goodwill through partial sale of subsidiary shares to other parties	(192)	-	-	(192)
Translation differences	(71)	(58)	(20)	(149)
Balance as of December 31, 2005	900	1,602	298	2,800

(*) Derives from the acquisition of shares of the Brazilian subsidiaries from the minority interests therein.

(**) Derives from the acquisition of an additional 1% of shares of the Argentine subsidiary from the minority interests therein.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 9 CREDIT FROM BANKING INSTITUTIONS MAINLY CURRENT MATURITIES OFLONG-TERM LOANS

A. Composition:

(in thousands)	Interest rates as of December 31, 2005	US dollars December 31, 2004	US dollars December 31, 2005
	%		
Revolving credit - in NIS	7	32	233
Revolving credit - in US dollars	-	24	-
Current maturities of long-term loans	-	6,530	3,082
		6,586	3,315

B. Lines of credit

Unutilized short-term credit lines of the Group as at December 31, 2005, aggregated to US$ 1.1 million.

C. Liens see Note 12B.

NOTE 10 OTHER CURRENT LIABILITIES

Composition:

(in thousands)	US dollars December 31, 2004	US dollars December 31, 2005
Accrued expenses	2,570	4,550
Employees and institutions in respect thereof	1,629	1,614
Government institutions	3,959	5,219
Related party	750	68
Advances from customers	47	36
Others	210	5
	9,165	11,492

NOTE 11 LONG-TERM LOANS FROM BANKING INSTITUTIONS

A. Composition:

Weighted average interest rate	US dollars
December 31,	December 31,

(in thousands)	Weighted average interest rate	US dollars	
	2005	2004	2005
	%		
US dollar linked	5.49	1,666	1,007
Unlinked (nominal NIS)	6.4	8,479	2,448
Less - current maturities	-	(6,530)	(3,082)
		3,615	373

B. Maturity dates

(in thousands)	US dollars December 31, 2005
2007	373

C. Liens see Note 12B.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 12 CONTINGENT LIABILITIES, LIENS AND GUARANTEES

A. Claims

1. The Company is involved in litigation with Leonardo L.P., a US-based hedge fund, arising out of a financial transaction entered into between the Company and Leonardo in February 2000. Pursuant to the terms of this financial transaction, the Company received a cash investment of $12 million in exchange for certain notes that were convertible into ordinary shares of the Company according to a pre-determined formula. Pursuant to the formula, the conversion price of the notes was the lower of NIS 67.3 ($14.7) or an average trading price of the shares of the Company for a defined period prior to conversion. The conversion price is used to determine the number of shares into which the notes may be converted by dividing the notional principal amount of the notes, initially $12 million, by the conversion price. On the date the notes were issued, March 2, 2000, the notes were convertible into approximately 720,000 of the ordinary shares of the Company. As part of the terms of this financial transaction, and, as required by the rules of the TASE where the ordinary shares of the Company are currently traded, the Company was required to seek the approval from the TASE for the issuance of the ordinary shares underlying the notes. The TASE approved the issuance of 2,250,000 of the ordinary shares of the Company as the number of registered shares that could be issued under the notes. The Company understood the terms of the financial transaction with Leonardo to provide that, except in certain limited circumstances, the amounts advanced to the Company, together with accrued interest on these advances at the annual rate of 3.5%, would be repaid and satisfied solely through the delivery of ordinary shares and that under no circumstance would the Company be required to deliver more than 2,250,000 of its ordinary shares. The Company believes that Leonardo also recognized that there was a limit on the number of shares issuable under the notes, and in fact at no time on or prior to the maturity date of the notes did Leonardo seek to convert the notes for more than 2,250,000 of the ordinary shares of the Company. Prior to the maturity date of the notes, Leonardo converted approximately $6.7 million of the notional principal amount of the notes into an aggregate of 2,241,594 of the ordinary shares of the Company. The Company believes that the holders of the notes are therefore only entitled to convert the balance of their notes into 8,406 shares, although in the pending litigation Leonardo has indicated that it does not believe that the notes were subject to any limit on the number of shares that could be issued to them on conversion and is seeking to recover damages based on this allegation.

   The terms of the documents and agreements that comprise the financial arrangement with Leonardo contain provisions regarding the repayment and conversion of the notes which may be regarded as conflicting or subject to different interpretations. Accordingly, the Company believes that the matter may only be resolved through litigation in which the parties present evidence as to the proper meaning and operation of the repayment and conversion provisions of documents and agreements comprising the financing transaction with Leonardo. The parties are currently in early stages of pleading the case before a district court in Israel and are in the process of undertaking discovery. In its pleadings, Leonardo is seeking alternative remedies and relief, including (a) the repayment in cash of the balance of the notes in the amount of approximately $6.2 million (plus accrued interest and expenses), (b) the delivery to Leonardo of the maximum number of the ordinary shares of the Company into which the notes could have been converted on the maturity date without regard to the 2,250,000 share limitation, or 3,516,462 ordinary shares, plus additional monetary damages, or (c) the payment of a cash amount equal to the amount obtained by multiplying the 3,516,462 shares mentioned in the preceding clause by the highest trading price of the ordinary shares of the Company between the maturity date and the date of the court s decision, plus interest or expenses. Although there can be no assurances as to the final outcome of this litigation, the Company believes that the maximum liability that it could have in this matter, assuming that a court rejects its interpretation of the agreements or determines that the Company has otherwise defaulted in the notes, is approximately $9.6 million.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 12 CONTINGENT LIABILITIES, LIENS AND GUARANTEES (cont.)

A. Claims (cont.)

1. (cont.)

In addition, in June, 2006, Leonardo was permitted to amend its claim to add an additional cause of action, claiming that on January 29, 2002 the Company also breached the same agreement because Moked Ituran Ltd. distributed some of the shares of the Company to other parties, in violation of the covenant that entitles Leonardo the option to redeem the notes Moked Ituran to maintain at least 70% of the number of the shares of the Company that it held at the time the Company entered into the financial transaction with Leonardo. Based on such alleged breach, Leonardo is seeking an additional alternative remedy of $9.6 million, plus interest and expenses. The Company intends to appeal the decision allowing Leonardo to amend its claim on legal grounds and intends to vigorously defend itself in this litigation and the Company believes that it has meritorious defenses to the claims of Leonardo based on the language of the documents and agreements comprising the financial transaction and the additional evidence the Company has reflecting the intentions of the parties. While the Company cannot predict the outcome of this case, if Leonardo prevails, the award to Leonardo of damages, either in cash or by delivery of the ordinary shares of the Company, could result in significant costs to the Company, adversely affecting its results of operations. In addition, the issuance of the ordinary shares of the Company to Leonardo may impact the share price of the ordinary shares of the Company and would dilute its shareholders ownership percentage.

2. On March 17, 2005, a suit was filed against the Company in an amount of NIS 4.7 million, or $1.0 million. The suit was filed by an attorney and the collection company managed by such attorney that acted on behalf of the Company in collecting customer debts claiming that the Company owed him certain amounts in respect of unpaid fees and expenses. A significant portion of such attorney s claim is based on the allegation of damage to the plaintiffs reputation. The Company has filed a counter-claim to this claim. Recently, a settlement agreement was signed between the parties pursuant to which the attorney and the collection company repudiated their claim and accepted the position of the Company in full. Pursuant to the settlement agreement, which was approved by the Court, the claim against the Company was dismissed and the counterclaim of the Company against the plaintiff in the lawsuit was approved. Accordingly, the plaintiff was ordered to pay the Company the sum of approximately NIS 1.37 million (approximately, $300,000) including interest and linkage differentials from the date of filing the lawsuit and until actual date of payment. The Company is currently undergoing proceedings in order to recover payment of said amount.

3. On July 8, 2005, a class action was filed against a subsidiary of the Company, Ituran Florida Corporation, in the First Judicial District Court in Philadelphia, Pennsylvania. The lawsuit claims that Ituran Florida sent fax advertisements to the named plaintiff and the other members of the class allegedly in violation of the Telephone Consumer Protection Act of 1991. Ituran Florida filed a motion for judgment on the pleadings that such claims should not be hared as part of a class action. Such motion was denied by the court and the case is currently at the interrogatories and requests for production of information stage. The plaintiff agreed to limit the class action to Pennsylvania actions only and the maximum potential amount of damages that the Company estimates its subsidiary may be liable for pursuant to the provisions of the Telephone Consumer Protection Act if the plaintiffs prevail is approximately $1.5 million in the aggregate for all class plaintiffs, plus punitive damages and expenses. The Company does not believe that the plaintiffs will prevail and, even if they do prevail, the Company does not believe that the resolution of this claim will have a material effect on revenues, operations or liquidity of the Company.

NOTE 12 CONTINGENT LIABILITIES, LIENS AND GUARANTEES (cont.)

A. Claims (cont.)

4. On December 18, 2005, the Company was served with a statement of claim which has been filed against the Company in the Tel-Aviv District Court. The plaintiffs in said lawsuit are shareholders holding 50% in a company which has entered into an agreement with Ituran, alleging breach of agreement causing damages estimated by the plaintiffs in the sum of approximately $3 million. A couple of months ago, the company that had entered into said agreement (together with another shareholder therein) filed a lawsuit against Ituran alleging the same breach of agreement. Said lawsuit was dismissed by the Tel-Aviv District Court on August 15, 2005. In the lawsuit which Ituran filed against the party to the agreement and said shareholder, in the total sum of approximately $300,000, the court found for Ituran. Since the plaintiff did not deposit with the Court the court fees, the claim against the Company was stroked off (*in limine)*.

B. Liens

To guarantee the liabilities of the Group to banks, the Company has registered the following pledges:

1. On monies due and/or due in the future from the bank clearing house, as well as a first degree floating lien on all of the property and assets of the Company and on the insurance rights thereto.

2. On the ordinary shares of Telematics Wireless.

C. The Company was declared a monopoly under the Israeli Restrictive Trade Practices Law, 1988, in the market for the provision of systems for the location of vehicles in Israel. Under Israeli law, a monopoly is prohibited from taking certain actions, such as predatory pricing and the provision of loyalty discounts, which prohibitions do not apply to other companies. The Israeli antitrust authority may further declare that the Company has abused its position in the market. Any such declaration in any suit in which it is claimed that the Company engages in anti-competitive conduct may serve as *prima facie* evidence that the Company is either a monopoly or that it has engaged in anti-competitive behavior. Furthermore, it may be ordered to take or refrain from taking certain actions, such as setting maximum prices, in order to protect against unfair competition.

D. Commitments

As of December 31, 2005, minimum future rentals under operating leases of buildings for periods in excess of one year were as follows: 2006 US$ 0.9 million; 2007 US$ 0.8 million; 2008 US$ 0.5 million; 2009 US$ 0.4 million; 2010 and thereafter US$ 0.3 million.

The leasing fees expensed in each of the years ended December 31, 2003, 2004 and 2005, were US$ 2.1 million, US$ 2.0 million, US$ 1.2 million, respectively.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 13 CAPITAL NOTES

1. On February 7, 2000, the Company entered into an agreement with Leonardo L.P., a foreign company (Leonardo) for a private placement of capital notes in return for an amount of US$ 12 million.

   The capital notes are convertible into Company shares until the end of the three-year period following their date of issue. The capital notes entitle their holders (until such time as they are converted into shares) to interest of 3.5% per annum, to be paid in cash or to be added to the principal, at the discretion of the Company.

   The capital notes are convertible into ordinary shares of the Company, par value NIS 0.33 each. During the first 90-day period following the issuance of the capital notes, the conversion rate was NIS 67.3 (US$ 14.7) per share. Subsequently, the conversion rate was set as the lower of an amount of NIS 67.3 (US$ 14.7) per share or an amount equal to the average of the lowest 10 prices of the share during the 60 trading-day period prior to the date of the conversion of the capital notes.

   In 2000, 2001 and 2002, capital notes in an amount of US$ 2.5 million were converted into 241,392 Company shares, US$ 985,000 into 297,645 Company shares and US$ 3.2 million into 1,702,557 Company shares, respectively. As of December 31, 2003, 2004 and 2005, the outstanding balance of capital notes could be converted into 8,406 Company shares.

   Since the inception of the agreement with Leonardo, through March 2003 (the contractual term of the capital notes), the Company accrued interest in respect of the capital notes. The interest charge for the year 2003 amounted to US$ 134,000.

   The Company elected not to pay the interest in cash. The effect of the accrued interest was reflected in the number of shares issued.

2. See Note 12(A)(1) for a discussion regarding a pending legal action in connection with the notes.

NOTE 14 SHAREHOLDERS EQUITY

A. Share capital

1. Composition:

December 31,	**2004**	**2004**	**2005**	**2005**
	Registered	**Issued and fully paid**	**Registered**	**Issued and fully paid**
Ordinary shares of NIS $0.33^{1}/_{3}$ each	22,575,000	18,595,197	60,000,000	23,091,383

2. Since May 1998, the Company has been trading its shares on the Tel-Aviv Stock Exchange (TASE). On September 2005, the Company registered its Ordinary shares for trade in the United States. The Company issued 4,256,000 shares for an aggregate price of US$ 55.3 million before issuance expenses (including 416,000 shares which were sold to the underwriters).

3. The Ordinary shares of the Company confer upon their holders the right to receive notice to participate and vote in general meetings of the Company and the right to receive dividends, if and when, declared.

4. Shares held by the subsidiaries of the Company have no voting rights.

5. During 2004, a subsidiary sold 820,875 of such shares for an amount of US$ 2.2 million.

6. As of the balance sheet date, subsidiaries hold 0.09% of the share capital of the Company.

7.

During September 2005, the Company s board of directors authorized the increase of the registered share capital of the Company to 60,000,000 shares.

8. See Note 1(A)(2) regarding share split.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 14 SHAREHOLDERS EQUITY (cont.)

B. Stock option plans of the Company

1. During May 1998, the Company s Board of Directors approved an employee stock option plan (the 1998 Plan) for the grant, without consideration, of up to 120,182 options, exercisable into 360,546 ordinary shares of NIS $0.33^1/_3$ par value of the Company to employees, officers and directors of the Company. The exercise price of each option is NIS $0.33^1/_3$. The options vest over a period of 2-4 years based on the employment status of each grantee. Any option not exercised within 180 days after the date such option vests will expire. Through December 31, 2004, all the options under the 1998 Plan were granted and exercised.

2. On August 23, 2001, the Company s Board of Directors approved an employee stock option plan (the 2001 Plan) for the grant, without consideration, of up to 282,244 options, exercisable into 846,732 ordinary shares of NIS $0.33^1/_3$ par value of the Company to certain employees and senior executives of the Company and its subsidiaries. The exercise price of each option is NIS 1. 32,324 options were fully vested on the date of grant and the remaining options under the plan vest over a period of 1-3 years (mainly 3) based on the employment status of each grantee. Any option not exercised within 3 years after the date such option vests will expire. Through December 31, 2004, all options under the 2001 Plan were granted and fully vested and 154,228 options were exercised.

   Compensation expense in respect of the 2001 Plan for the years ended December 31, 2003 and 2004 amounted to US$ 358,000 and US$ 90,000 respectively.

3. Following is a summary of the status of the option plans as of December 31, 2003, 2004, 2005 and changes during the years ended on those dates:

	Number	Weighted average exercise price(*)	Number	Weighted average exercise price(*)	Number	Weighted average exercise price(*)
Year ended December 31,	**2003**		**2004**		**2005**	
Balance outstanding at beginning of year	300,740	NIS 1	214,920	NIS 1	180,035	NIS 1
Exercised	(85,820)	NIS 1	(17,953)	NIS 1	(68,951)	NIS 1
Granted	-	-	-	-	16,932(**)	-
Expired	-	-	(16,932)(**)	NIS 1	-	NIS 1
Balance outstanding at end of year	214,920	NIS 1	180,035	NIS 1	128,016	NIS 1
Balance exercisable at end of year	201,975	NIS 1	180,035	NIS 1	128,016	NIS 1

(*) Each option is exercisable into 3 shares.

(**) On July 18, 2005, the relevant institutions of the Company, as required under the Israeli Companies Law, approved the issuance of fully vested options to replace those options that expired, at a per-share exercise price of NIS 1. The options shall be exercisable for one year.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 14 SHAREHOLDERS EQUITY (cont.)

B. Stock option plans of the Company (cont.)

4. During February 2000, in return for services rendered in connection with a transaction with a foreign company, the foreign company was offered 50,000 non-negotiable option warrants, exercisable into 150,000 ordinary shares of the Company, par value NIS $0.33^1/_3$ each, at a price of NIS 61.1 per share (US$ 13.27). The options were fully vested on the date of grant and exercisable at any time after their allotment, but no later than May 7, 2005. As of the balance sheet date, no options were exercised and the options expired.

   The fair value of these options was estimated using the Black-Scholes option pricing model with the following weighted-average assumptions: risk-free interest rate of 10%, dividend yield of 0%, volatility factors of the expected market price of the Company s ordinary shares of 30%, and expected life of the options of 2 years. The Company recorded deferred issuance costs in an amount of US$ 440,000, which were amortized over the life of the capital notes.

5. During December 2000, in return for services rendered in connection with a transaction with a foreign company, the foreign company was offered 11,111 non-negotiable option warrants, exercisable into 33,333 ordinary shares of the Company, par value NIS $0.33^1/_3$ each, at a price of NIS 51.85 per share (US$ 11.26). The options were fully vested on the date of grant and exercisable at any time after their allotment, but no later than December 31, 2005. As of December, 31 2005, the options were exercised.

   The fair value of these options was estimated using the Black-Scholes option pricing model with the following weighted-average assumptions: risk-free interest rate of 10%, dividend yield of 0%, volatility factors of the expected market price of the Company s ordinary shares of 30%, and expected life of the options of 3.5 years. The Company recorded deferred issuance costs in an amount of US$ 162,000, which were amortized over the life of the capital notes.

6. The rights to the shares issued upon exercise of the options and warrants will be identical to those of the ordinary shares of the company.

C. Stock option plans of Telematics Wireless

1. Telematics Wireless, a subsidiary of the Company, approved several employee stock option plans (the Subsidiary Plans) for the grant to its employees, without consideration, of options exercisable into ordinary shares of Telematics Wireless and for a grant of restricted shares (options with no exercise price) to three senior executives of Telematics Wireless. The vesting period of such options and restricted stock of Telematics Wireless is generally 3-4 years (33% after the first two years, 33% after three years and 33% after four years) from the date of grant and the rights of the ordinary shares obtained upon exercise of the options will be identical to those of the other ordinary shares of Telematics Wireless. The exercise period of the options granted is mainly five years from the date of grant.

   Compensation expenses attributable to the subsidiary plans for the years ended December 31, 2003 and 2004 amounted to US$ 63,000 and US$ 19,000 respectively.

2. During 2002, after the restricted shares granted to the senior executives of Telematics Wireless became fully vested, the Company purchased the subsidiary shares held by the senior executives. Company shares with an aggregate value of US$ 1.3 million were issued as the consideration for the acquisition (the actual issuance took place in February 2003).

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 14 SHAREHOLDERS EQUITY (cont.)

D. Retained earnings

1. In determining the amount of retained earnings available for distribution as a dividend, the Israeli Companies Law stipulates that the cost of the Company s shares acquired by subsidiaries of the Company (that are presented as a separate item in the statement of changes in shareholders equity) must be deducted from the amount of retained earnings.

2. On January 2004, the board of directors of the Company approved its dividend distribution policy whereby the Company would distribute annually 25% of its net income on the basis of the results of the Company each year, on condition that such distribution would not prevent the Company from meeting its existing and future commitments when they come due.

3. Dividends are declared and paid in NIS. Dividends paid to shareholders outside Israel may be converted into dollars on the basis of the exchange rate prevailing at the date of conversion.

4. In April 2005, the Company distributed a dividend of approximately US$ 2.7 million (NIS 11.8 million), on the basis of the results of the Company for the year ended December 31, 2004.

5. A dividend was declared after the balance sheet date in an amount of US$ 3.8 million, on the basis of the results of the Company for the year ended December 31, 2005.

NOTE 15 FINANCING INCOME (EXPENSES), NET

	US dollars		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
Interest expenses in respect of long-term loans	(399)	(531)	(331)
Short-term interest expenses	(678)	(705)	(210)
Gains (losses) from derivative financial instruments	(2,300)	(693)	79
Amortization of deferred charges and accretion of interest in respect of capital note	(89)	-	-
Exchange differences and others, net	2,850	(130)	1,368
	(616)	(2,059)	906

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 16 TAXES ON INCOME

A. Taxes on income included in the statements of income:

	US dollars		
	Year ended December 31,		
(in thousands)	2003	2004	2005
Income taxes (tax benefit):			
Current taxes:			
In Israel	1,360	2,892	2,039
Outside Israel	133	274	3,065
	1,493	3,166	5,104
Deferred taxes:			
In Israel	895	30	115
Outside Israel	1,298	1,153	186
	2,193	1,183	301
Taxes in respect of prior years:			
In Israel	(269)	74	(332)
Outside Israel	-	-	222
	(269)	74	(110)
	3,417	4,423	5,295

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

The Company and its Israeli subsidiaries report income for tax purposes in accordance with the provisions of the Inflationary Adjustments Law, whereby taxable income is measured in NIS, adjusted for changes in the Israeli Consumer Price Index.

C. The Law for the Encouragement of Capital Investments, 1959 (the Investment Law)

A certain Israeli subsidiary of the Company has been granted Approved Enterprise status according to the Investment Law, under several different investment programs. The subsidiary is entitled to tax benefits deriving from the execution of programs for investments in assets, in accordance with the certificates of approval granted in respect of these investment programs.

Taxable income derived from the Approved Enterprise is tax exempt for a period of two to four years commencing in the first year in which the subsidiary earns taxable income from the approved enterprise and is liable to a reduced corporate tax rate of up to 25% for an additional period of three to five years (up to a total of seven years for each investment program). The benefit period for each of the programs is limited to the earlier of twelve years from the year that the investment plan was implemented, or fourteen years from the year in which the approval was granted.

In the event of distribution of cash dividends out of income which was tax exempt as above, the subsidiary would have to pay the 25% tax in respect of the amount distributed. The Company has decided not to cause declaration of dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the subsidiary Company s Approved Enterprise .

NITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
OTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 16 TAXES ON INCOME (cont.)

C. The Law for the Encouragement of Capital Investments, 1959 (the Investment Law) (cont.)

The entitlement to the above benefits is conditional upon the subsidiary fulfilling the conditions stipulated by the Investment Law, regulations published thereunder and the instruments of approval for the specific investments in Approved Enterprises. In the event of failure to comply with these conditions, the benefits may be cancelled and the 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 CPI and interest. Management of the subsidiary believes that the subsidiary was in compliance with the abovementioned conditions through December 31, 2005.

D. Reduction in corporate tax rates

On July 25, 2005 the Israeli Parliament passed an amendment to the Income Tax Ordinance (No. 147) 2005, gradually reducing the tax rate applicable to the Company (regarding to profits not eligible for approved enterprise benefits mentioned above) as follows: in 2006 31%, in 2007 29%, in 2008 27%, in 2009 26% and in 2010 and thereafter 25%. According to a previous amendment to the Income Tax Ordinance (No. 140) 2004, the tax rates were reduced as follows: in 2004 35% and in 2005 34%.

The effect of the amendment on the deferred income taxes balances was not material.

E. Non-Israeli subsidiaries

Non-Israeli subsidiaries are taxed according to the tax laws and rates in their country of residence.

F. Tax assessments

The Company has received final tax assessments through the 2002 tax year. Two Israeli subsidiaries have received final tax assessments through the 2000 and 2002 tax years, respectively. The other subsidiaries have not been assessed since incorporation.

G. Carryforward tax losses

Carryforward tax losses of an Israeli subsidiary as of December 31, 2005 amount to US$ 90 thousand.

Carryforward tax losses in Israel may be utilized indefinitely.

The Company s non-Israeli subsidiaries in Brazil and the United States have available estimated carryforward tax losses of approximately US$ 5 million and US$ 12.5 million, respectively.

Regarding the subsidiary in the United States, carryforward tax losses may be utilized until 2020.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 16 TAXES ON INCOME (cont.)

H. The following is a reconciliation between the theoretical tax on pre-tax income, at the applicable Israeli tax rate, and the tax expense reported in the financial statements:

	US dollars		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
Pretax income	9,670	16,204	20,828
Tax rate	36%	35%	34%
Tax computed at the ordinary tax rate	3,481	5,671	7,082
Non-deductible expenses	226	266	251
Tax in respect of approved enterprises and translation differences	508	(1,045)	(2,142)
Losses in respect of which no deferred taxes were generated	272	192	-
Utilization of losses of prior years in respect of which no deferred taxes were generated	(1,155)	(1,423)	(1,317)
Deductible financial income (expenses) recorded to additional paid-in capital	(194)	(156)	1,038
Taxes in respect of prior years	(269)	74	(110)
Taxes in respect of withholding at the source from royalties	-	697	181
Others	548	147	312
	3,417	4,423	5,295

I. **Summary of deferred taxes**

Composition:

	US dollars	
	Year ended December 31,	
(in thousands)	**2004**	**2005**
Deferred taxes included in other current assets and other current liabilities, in respect of:		
Provision for employee-related obligations	44	78
Carryforward tax losses	41	-
Other timing differences	68	274
	153	352
Valuation allowance	-	-
	153	352

	US dollars	
Long-term deferred taxes included in long-term investments, other receivables and long-term deferred income taxes:		
Provision for employee related obligations	468	431
Carryforward tax losses	6,647	5,776
Other timing differences, net	176	127
	7,291	6,334
Valuation allowance	(1,784)	(1,378)
	5,507	4,956

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 16 TAXES ON INCOME (cont.)

J. Income before income taxes is composed as follows:

	US dollars		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
The Company and its Israeli subsidiaries	5,204	12,323	10,973
Non-Israeli subsidiaries	4,466	3,881	9,855
	9,670	16,204	20,828

NOTE 17 EARNINGS PER SHARE

The net income and the weighted average number of shares used in computing basic and diluted earnings per share for the years ended December 31, 2003, 2004 and 2005, are as follows:

	US dollars		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
Net income used for the computation of basic earnings per share	5,845	11,219	14,375
Interest expense on capital notes	34	-	-
The effect of inclusion of the earning of subsidiary based on its diluted earning per share, net	(13)	(122)	(217)
Net income used for the computation diluted earning per share	5,866	11,097	14,158

	Number of shares		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
Weighted average number of shares used in the computation of basic income per share	18,273	18,585	19,736
Add:			
Additional shares from the assumed exercise of employee stock options, net	804	598	509
Weighted average number of additional shares issued upon the assumed conversion of capital notes	9	9	9
Weighted average number of shares used in the computation of diluted income per share	19,086(*)	19,192(*)	20,254

	Number of shares		

(*) The effect of the inclusion of the option warrants for all of the reported periods is anti-dilutive.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 18 RELATED PARTIES

A. During 2002, a lease agreement was signed between a subsidiary and a related party. The lease period expires on November 30, 2006.

The annual lease payments are approximately US$ 180,000.

B. The Tzivtit Insurance Ltd. (Tzivtit Insurance), owned by directors of the Company, serves as the Company s insurance agent and provides the Company with elementary insurance and managers insurance.

In respect of these insurance services, Tzivtit Insurance is entitled to receive commissions at various rates, paid by the insurance company (which is not considered a related pary).

C. In February 2003, an agreement was signed between the Company and A. Sheratzky Holdings Ltd., a wholly-owned and controlled company belonging to Mr. Izzy Sheratzky, Chairman of the Company s Board of Directors. The agreement includes, among other things, the cost of Mr. Izzy Sheratzky s monthly employment in an amount of NIS 74,000 (US$ 16,076) (linked to the Israeli CPI), entertainment expenses, car maintenance expenses, cellular phone, and entitlement to participate in the profits of the Company in an amount equal to 5% of the pretax income of the Company, plus the share of the Company in the income or losses of affiliated companies, on the basis of the audited consolidated financial statements.

The agreement is for a two-year period, with automatic two-year extensions, unless either of the parties gives 180-day advance notice of its intention to terminate the agreement.

D. In January 2004, changes in the employment terms of the two Co-CEOs of the Company were approved, whereby each would be entitled to an annual bonus equal to 1% of the pretax income of the Company, plus the share of the Company in the income or losses of affiliated companies, on the basis of the audited consolidated financial statements.

E. In March 1998, an agreement was approved with an interested party, Prof. Yehuda Kahane, for financial consulting, whereby the Company would pay the consultant monthly consulting fees of NIS 4,000 (US$ 869), linked to the Israeli Consumer Price Index in respect of January 1998. In May 2003, the Company approved an increase in the consideration paid, to a total cost of NIS 15,000 (US$ 3,259) a month, linked to the Israeli Consumer Price Index.

NOTE 19 SEGMENT REPORTING

A. General information:

The operations of the Company are conducted through two different core activities: Location-Based Services and Wireless Communications Products. These activities also represent the reportable segments of the Company.

The reportable segments are viewed and evaluated separately by Company management, since the marketing strategies, processes and expected long term financial performances of the segments are different.

Commencing in 1999 and ending in March 2005, the Company, through its subsidiary, Ituran Cellular Communications Ltd., was engaged in the installation of hands-free equipment in cars, and the sale of cellular lines and equipment under an exclusivity agreement with Partner Communications Co. Ltd. In view of the fact that, as of April 1, 2005, this activity is no longer material, it ceased being a reportable segment and is presented below as Other .

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 19 SEGMENT REPORTING (cont.)

A. General information (cont.):

Location-based services:

The location-based services segment consists predominantly of regionally-based stolen vehicle recovery (SVR) services, fleet management services and value-added services comprised of personal advanced locater services and concierge services.

The Company provides location-based services in Israel, Brazil, Argentina and the United States.

Wireless communications products:

The wireless communications product segment consists of short and medium range two-way machine-to-machine wireless communications products that are used for various applications, including automatic vehicle location, automated meter reading and automatic vehicle identification. The Company sells products to customers in Israel, Argentina, Brazil and the United States.

B. Information about reported segment profit or loss and assets:

	US dollars			
(in thousands)	**Location-based services**	**Wireless communications products**	**Other**	**Total**
Year ended December 31, 2003				
Revenues	32,088	23,527	8,456	64,071
Operating income (loss)	9,927	(566)	925	10,286
Assets	2,816	11,371	5,064	19,251
Goodwill	762	424(*)	313	1,499(*)
Expenditures for assets	301	90	154	545
Depreciation and amortization	489	341	357	1,187
Year ended December 31, 2004				
Revenues	36,549	33,461	7,916	77,926
Operating income	11,025	6,045	1,193	18,263
Assets	3,636	18,878	4,719	27,233
Goodwill	1,472	1,121(*)	318	2,911(*)
Expenditures for assets	1,277	1,113	9	2,399
Depreciation and amortization	569	345	185	1,099
Year ended December 31, 2005				
Revenues	44,128	43,806	2,192	90,126
Operating income	13,024	6,666	232	19,922
Assets	124	19,406	189	19,719
Goodwill	1,602	900	298	2,800
Expenditures for assets	-	714	-	714
Depreciation and amortization	-	200	53	253

(*) Reclassified.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 19 SEGMENT REPORTING (cont.)

C. Information about reported segment profit or loss and assets:

The evaluation of performance is based on income from operations of each of the reportable segments.

Accounting policies of the segments are the same as those described in the accounting policies applied in the financial statements.

Due to the nature of the reportable segments, there have been no inter-segment sales or transfers during the reported periods.

Financing expenses, net, other expenses, net, taxes on income, minority interests and the share of the Company in losses of affiliated companies were not allocated to the reportable segments, since these items are carried and evaluated on the enterprise level.

D. Reconciliations of reportable segment revenues, profit or loss, and assets, to the enterprise s consolidated totals:

	US dollars		
	Year ended December 31,		
(in thousands)	**2003**	**2004**	**2005**
Total revenues of reportable segment and consolidated revenues	64,071	77,926	90,126
Operating income			
Total operating income for reportable segments	10,286	18,263	19,922
Unallocated amounts:			
Financing income (expenses), net	(616)	(2,059)	906
Consolidated income before income taxes and extraordinary items	9,670	16,204	20,828
Assets			
Total assets for reportable segments	20,750(*)	30,144(*)	22,519
Other unallocated amounts:			
Current assets	16,871	14,174	75,565
Investments in affiliated companies	1,141(*)	821(*)	872
Property and equipment, net	7,183	6,613	8,885
Other assets	3,868	3,305	2,873
Other unallocated amounts	4,918	3,966	5,770
Consolidated total assets (at year end)	54,731	59,023	116,484

	US dollars		
Other significant items			
Total expenditures for assets of reportable segments	545	2,399	714
Unallocated amounts	1,698	1,371	3,129
Consolidated total expenditures for assets	2,243	3,770	3,843
Total depreciation and amortization for reportable segments	1,187	1,099	253
Unallocated amounts	2,295	2,437	3,088
Consolidated total depreciation and amortization	3,482	3,536	3,341

(*) Reclassified.

ITURAN LOCATION AND CONTROL LTD. AND ITS SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (cont.)

NOTE 19 SEGMENT REPORTING (cont.)

E. Geographic information

	Revenues		
		December 31,	
(in thousands)	**2003**	**2004**	**2005**
Israel	43,843	47,714	40,622
United States	7,720	11,148	13,686
Brazil	7,740	13,004	21,015
Argentina	4,768	5,357	9,063
China and Korea	-	703	5,740
Total	64,071	77,926	90,126

	Property and equipment, net		
		December 31,	
(in thousands)	**2003**	**2004**	**2005**
Israel	3,286	3,452	3,630
United States	1,251	1,014	687
Brazil	1,871	1,866	2,993
Argentina	3,019	2,872	2,594
Total	9,427	9,204	9,904

	Revenues		

Revenues were attributed to countries based on customer location.

Property and equipment were classified based on major geographic areas in which the Company operates.

F. Major customers

During 2004, sales to a single customer amounted to 10.2% of the total revenues. Apart from this customer, there were no sales exceeding 10% of total revenues during 2003 and 2005.

NOTE 20 FINANCIAL INSTRUMENTS AND RISKS MANAGEMENT

A. Concentrations of credit risks

Most of the Group s cash and cash equivalents and short-term investments as of December 31, 2004 and 2005, were deposited with major Israeli banks. The Company is of the opinion that the credit risk in respect of these balances is remote.

Most of the Group s sales are made in Israel, South America and the United States, to a large number of customers, mainly to insurance companies. Accordingly, the Group s trade receivables do not represent a substantial concentration of credit risk.

One of the subsidiaries of the Company performs under long-term contracts with several unrelated parties. At the time of initiation, the subsidiary checks the credit worthiness of the party to each contract, but generally does not require collateral. However, in certain circumstances, the Company or the subsidiary may require a letter of credit, other collateral, or additional guarantees of advance payment.

NOTE 20 FINANCIAL INSTRUMENTS AND RISKS MANAGEMENT (cont.)

B. Fair value of financial instruments

The fair value of the financial instruments included in the working capital of the Group (cash and cash equivalents, accounts receivable and accounts payable) approximates their carrying value, due to the short-term maturity of such instruments. The fair value of the long-term deposit, long-term loans and other long-term liabilities also approximates the carrying value, since they bear interest at rates close to the prevailing market rates.

The fair values of derivatives are: liabilities of US$ 1.4 million at December 31, 2004 and liabilities of US$ 116 thousand at December 31, 2005. The fair value of derivatives generally reflects the estimated amounts that the Company would receive or pay to terminate the contracts at the reporting dates.

As the counterparties to the derivatives transactions are Israeli banks, the Company considers the inherent credit risks remote.

The following table summarizes changes in other comprehensive income (loss) related to derivatives that are classified as cash flow hedges held by the Company during the period from January 1, 2003 through December 31, 2005:

US dollars
December 31,

(in thousands)	US dollars 2003	2004	2005
Balance at beginning of year	278	644	-
Changes in fair value of derivatives	1,007	-	-
Reclassification into earnings from other comprehensive income	(435)	(1,007)	-
Net of tax effect	(206)	363	-
Balance at end of year	644	-	-

C. **Foreign exchange risk management**

The Group operates internationally, which gives rise to exposure to market risks mainly from changes in exchange rates of foreign currencies in relation to the functional currency.

The Company has entered into foreign currency forward transactions in order to protect itself against the risk that the eventual cash flows resulting from anticipated transactions (mainly from subscription fees to be received), denominated in currencies other than the functional currency, will be affected by changes in exchange rates. The Company has certain involvement with derivative financial instruments for trading purposes.

As described in Note 20B, certain transactions were designated and accounted as hedging instruments under FAS No. 133. Other transactions do not qualify as hedging instruments (or have not been designated as such).

NOTE 20 FINANCIAL INSTRUMENTS AND RISKS MANAGEMENT (cont.)

C. **Foreign exchange risk management (cont.)**

The nominal amounts of foreign currency derivatives as of December 31, 2004 and 2005, are as follows:

(In thousands)	US dollars December 31, 2004	2005
Forward transactions - for the exchange of:		
US dollars into Euros	2,728	-
Yen into Euros	27,283	-

NOTE 21 SUBSEQUENT EVENTS

A. In January 2006, the Company s remuneration committee adopted a resolution to pay the Company s managers a quarterly bonus as of the first quarter of 2006 equal to 1.5% of the consolidated profit before tax and after equity and minority profits, which is divided between 13 of the Company s managers in different proportions based on their seniority, level of global and domestic involvement in the operations and other criteria set by the committee.

B. During June 2006, the subsidiary purchased an office building of 8 floors, with an area of approximately 5,356 sq.m., in the amount of 7.5 million Brazilian Reals (approximately US$ 3.3 million).

REPORT OF INDEPENDENT PUBLIC ACCOUNTING FIRM
TO THE SHAREHOLDERS OF
ITURAN CELLULAR COMMUNICATION LTD.

We have audited the accompanying consolidated balance sheets of Ituran Cellular Communication Ltd. and its subsidiary (the company) as of December 31, 2004 and 2003 and the related consolidated statements of operations, changes in shareholders equity (deficiency) and cash flows for each of the three years in the period ended December 31, 2004. 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 conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement 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 consolidated financial position of the Company and its subsidiary as of December 31, 2004 and 2003 and the related consolidated results of its operations and cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1A to the consolidated financial statements, the Company will terminate its communication agreement with Parmer Communication Ltd. On March 31, 2005.

Ziv Haft

/s/ Ziv Haft
Certified Public Accountants (Isr.)
BDO Member Firm

Tel-Aviv, Israel
May 29, 2005

SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

ITURAN LOCATION AND CONTROL LTD.
(Registrant)

By: /s/ Eyal Sheratzky

Eyal Sheratzky
Co-Chief Executive Officer

Dated: June 21, 2006