

# **EL AL ISRAEL AIRLINES LTD.**

## **FINANCIAL STATEMENTS AS OF SEPTEMBER 30, 2006 (unaudited)**

### CONTENTS

SECTION A - UPDATE OF CHAPTER A TO 2005 ANNUAL REPORT

SECTION B - DIRECTORS' REPORT

SECTION C - FINANCIAL STATEMENTS

UPDATE OF CHAPTER A TO  
2005 ANNUAL REPORT

**Update of Chapter A (Description of the Entity's Business<sup>1</sup>)  
to the Periodic Report for the Year 2005 ("the Periodic Report")  
of El Al Israel Airlines Ltd. (hereafter: "the Company")**

**1. Description of the General Development of the Group's Business**

**To Section 6.3-fluctuations in prices of jet fuel, and to Section 9.5.1-raw materials and suppliers-fuel**

During the quarter ended September 30, 2006, the market prices of jet fuel rose on the average by approximately 10% relative to the corresponding period last year. It should be pointed out that, during the month of September 2006, a sharp decrease of approximately 20-25% took place in market prices of jet fuel. This decrease had almost no effect on the price which the Company paid for jet fuel during the third quarter of the year 2006, since the fuel prices paid by the Company to its suppliers are, for the most part, determined on the basis of market prices during the period of time prior to the month of actual use. During the quarter ended September 30, 2006, fuel prices of the Company, after hedging refunds, rose by approximately 30% in relation to the same period last year, so that fuel expense for the quarter represented approximately 29.5% of total revenues (approximately 22.7% of total revenues during the third quarter of the year 2005). The Company estimates that the increase in jet fuel prices during the quarter ended September 30, 2006, as well as during the quarters ended on March 31, 2006 and June 30, 2006, will have a significant effect on its financial results for the year 2006. For additional details, see also Section 6.2 to the Directors' Report concerning the Company's Affairs, and the update to Section 9.16 below.

**To Section 6.4- currency rate fluctuations**

As of September 30, 2006, there had been a decrease of approximately 6.5% in relation to December 31, 2005, in the rate of exchange of the U.S. dollar vis-à-vis the shekel and a decrease of approximately 6.4% in relation to September 30, 2005.

The weakness of the dollar as compared with various currencies during the year 2006 has had a negative effect on the Group's profitability. See Section 3.4 to the Directors' Report concerning the Company's Affairs for further details.

**To Section 6.5- interest rate fluctuations**

During the quarter ended September 30, 2006, there was a rise of approximately 44% in the average rate of 3-month LIBOR interest, relative to the corresponding quarter last year and a rise of approximately 4% relative to the quarter ended on June 30, 2006. See Section 6.3 to the Directors' Report concerning the Company's Affairs for further details.

**2. Passenger Aircraft Area**

**To Sections 6.2-rise in traffic in the international aviation area, 7.1.3 (B) developments in the Israeli market, 7.1.4-developments in markets of the operating area**

In continuation of what was itemized in the sections of the Periodic Report mentioned in the above header, and as an update of the sections as they were detailed in the update to Chapter A to the financial statements as of June 30, 2006, it should be stated that, during the months of July-August 2006, Israel carried on warfare on two

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<sup>1</sup> The update is being made in accordance with Regulation 39A to the Securities Regulations (Periodic and Immediate Reports), 1970, and includes material changes and developments which took place in the entity's business with regard to every matter which must be described in the Periodic Report. The update makes reference to the numbers of the Sections in Chapter A (Description of the Entity's Business) in the Group's Periodic Report for the year 2005.

fronts: in the Gaza region and the Lebanese border. Fatalities and severe property damage were caused as a result. A cease fire was declared on August 14, but IDF forces remained in Lebanon for a number of weeks subsequent thereto.

The hostilities affected the Company's operations in a number of spheres, principally and most directly, a drastic decrease in the number of bookings and a significant rise in the quantity of cancellations for flights. According to data of the Central Bureau of Statistics, a decrease of approximately 31% in traffic of incoming tourists was recorded for the third quarter in comparison with the parallel quarter last year. A decrease of 7% in international traffic at BGA was recorded in total as compared with the same quarter last year, this vis-à-vis the second quarter of the year 2006, during which an increase in traffic at BGA was recorded. In addition, the hostilities led to higher security and operating costs for the Company. The hostilities had substantial consequences for the Israeli economy, with an indirect effect as well on the operations and operating results of the Company. (See also the discussion on risk factors in the Periodic Report in Sections 9.18.1, 9.18.4, 9.18.7, 9.18.13.)

Due to the aforesaid, the hostilities had a material negative effect on the Company's financial results for the third quarter of the year 2006, and the Company estimates that this will also have a material outcome on the financial results of the Company for the year 2006. (Also see the update to Section 9.16 below.)

**To Sections 7.1.4- market developments, 7.1.10 structure of competition in the operating area and changes in it, 7.8-competition, 9.11.7.4-capacity, 9.18.3- discussion of risk factors: changes in competition**

Continuing what was detailed in these sections in the Periodic Report mentioned in the above header, and in the update of the Sections itemized in the update of Chapter A in the financial statements as of March 31, 2006 and as of June 30, 2006, it should be stated that, despite the fact that a decrease of approximately 7% in international passenger traffic at BGA was recorded in the third quarter of the year 2006, the scheduled foreign airline companies avoided the cancellation of flights and the adjustment of the supply of seats to the decrease in demand. During this quarter, there was an increase of approximately 21%, as compared with the same quarter last year, in the flight capacity of the scheduled foreign airline companies to and from BGA. Most of the growth in their activities was evident in the routes to the U.S., in which the capacity of the scheduled foreign companies increased by approximately 60%. The flight capacity of the scheduled foreign companies on the routes to Western Europe grew by about 25%. There was no change in the total of proposed seats at BGA (all companies, scheduled and charter) in relation to the same quarter last year, due to the reduction of flight capacity of El Al and the charter companies, which adjusted to the fall in demand.

The growth in the number of foreign airline companies operating out of BGA, in the number of scheduled flights and in seat capacity of the foreign companies on the one hand, and the fall in demand on the other hand, have caused excess capacity and an exacerbation of competition in the industry on part of the routes, and the Company estimates that this will have a significant effect on the financial results for the year 2006.

See the updates below to Sections 9.11.2 (g), 9.11.7.2, 9.11.7.4 and 9.11.8 of the Periodic Report for regulatory developments which could have significant implications on competition and capacity.

**To Section 7.1.5 - technological changes that could materially affect the operating area**

In continuation of what was stated in Section 7.1.5 to the Periodic Report with reference to the outfitting of the Company with broad band internet technology for passengers during the flight (Project Connexion), and to the update of this Section, as itemized in the financial statements as of June 30, 2006, we wish to point out that, due to the termination of marketing of the product by Boeing, this service on the Company's flights will terminate on December 30, 2006. Starting from the beginning of the month of October 2006 and until its termination, the service is being given at no cost to customers of the Company.

**To Section 7.2-services in the operating area**

During the month of October 2006, the Company announced a decision in principle to terminate the flight route between Tel Aviv and Cairo, because operating the route is uneconomical due to the high security costs borne by the Company and as part of the Company's efforts to reduce its expenses. The cessation of the flights on this route is anticipated to take place at the end of the month of December 2006.

The Company signed a cooperation agreement during the month of November 2006 with the HOT Company for the upgrading of in-flight entertainment content. In the context of the agreement, the HOT Company will supply updated and diverse content for all in-flight entertainment media (video, printed magazines and sound). The agreement will be effective for three years with an extension option.

See the update above to Section 7.1.5 regarding broad band internet service on aircraft.

**To Section 7.6.2- marketing and distribution**

In continuation of what was detailed in Section 7.6.2 to the Periodic Report, it should be stated that the Company is acting to create the possible ticketing for its flights by means of a global distribution system.

**To Section 7.11-fleet of aircraft in the operating area of passenger aircraft**

- A. Continuing what was said in Section 7.11.1.A, in which it was stated that the Company signed a letter of intent with the Boeing Company for the supply of ten Boeing 787 aircraft during the years 2012-2013, and in this context, the Company paid a deposit which will be refunded in full in the event that a binding agreement is not signed, and as reported by the Company in an Immediate Report dated November 14, 2006, since understandings on certain subjects were not reached during negotiations with the Boeing Company, and due to the condition of the Company as reflected in the reports that it has issued, the Company decided that it is impossible, within the time framework established by the Boeing Company, to enter into a binding agreement with the Boeing Company for the purchase of the aforementioned aircraft. After this, notification was received from the Boeing Company regarding the expiration of the validity of the offer included in the letter of intent and regarding the refund of the deposit which was paid in by the Company, as mentioned above. The amount of the deposit is one and one half million dollars. The Company is examining possible alternatives for the supply of the aircraft, manufactured by Boeing or Airbus, in accordance with the Company's needs and in accordance with the business strategy of the Company, "El Al 2010", and also with respect to subsequent periods. (See the Periodic Report for the year of 2005 regarding the strategic program "El Al 2010").

- B. In accordance with what was stated in Section 7.11.1.B of the Periodic Report, the lease period of a 747-400 aircraft ended in September 2006, and the aircraft was returned to its owners.
- C. In addition to what was mentioned in Section 7.11.1.B and in the update to this Section, as detailed in the update of Chapter A in the financial statements as of March 31, 2006, regarding an agreement which the Company signed for the leasing of a 767-300 ER aircraft, commencing from November 2006 and for 5 years, it should be stated the aircraft was transferred to the Company at the beginning of the month of November 2006.

### **3. Cargo Aircraft Operating Area**

#### **To Section 6.1-rise in traffic in international aviation area and to Section 8.1.3 A - volume of world cargo transport**

According to reports of IATA, during the months of January-September 2006, there was an increase of approximately 5.2% in the volume of world cargo transport in cargo aircraft, as compared with the year 2005, that is, the growth rate continues to be lower than the anticipated annual pace according to estimates of IATA (6.3%).

#### **To Section 8.1.3 B- the volume of cargo transport in aircraft to and from Israel**

In continuation to what was itemized in Section 8.1.3 B in the context of the update to Chapter A of the financial statements as of March 31, 2006 and as of June 30, 2006, it should be pointed out that the data of the Civil Aviation Authority indicate that cargo activity at BGA increased by approximately 4.7% during the months of January-September 2006, similar to the estimate of IATA which forecast annual growth at a volume of approximately 5%.

#### **To Section 8.4-new services, and to Section 8.5-customers, marketing and distribution**

In continuation of what was itemized in the sections of the header to the Periodic Report, it should be stated that a cargo service center was opened in September 2006, in the context of the call center service of the Company.

#### **To Section 8.7.1-conditions of competition in the operating area**

The significant growth in flight capacity of the scheduled foreign airline companies during the second and third quarters of the year 2006, as itemized above with respect to the operating area of passenger aircraft, also has led to substantial growth in the capacity of air transport of cargo in the belly of passenger aircraft of the scheduled foreign airline companies to and from Israel.

Following are the outstanding examples of changes to the operations of the foreign airline companies, which affect the structure of competition in the Israeli cargo market: Turkish Airlines increased the frequency of its weekly flights from 15 to 17. The Civil Aviation Authority approved the requests of British Airways and Lufthansa to increase their flight capacity by means of operating larger aircraft.

Most of the growth is evident in the transatlantic routes, especially due to the start of operations of the Delta Company.

Due to the abovementioned, there has been significant exacerbation of competition in the industry in the operating area of cargo aircraft as well, and as mentioned above-the Company estimates that the severity of competition will have a material effect on its financial results for the year 2006.

**To Section 8.10- fleet of aircraft, and to Section 9.11.9-Special State Share**

In continuation to what was stated in the update to Chapter A in the financial statements as of March 31, 2006 and the financial statements as of June 30, 2006, regarding the application of the Company from the month of April, to obtain the approval of the holder of the Special State Share for the sale of the additional cargo aircraft, and for the reduction of the number of the Company's cargo aircraft to three, it should be noted that, during the month of October 2006, the acquiescence of the holder of the Special State Share to the sale of an additional aircraft was received, subject to a number of conditions. The consent is effective until the end of the year 2006.

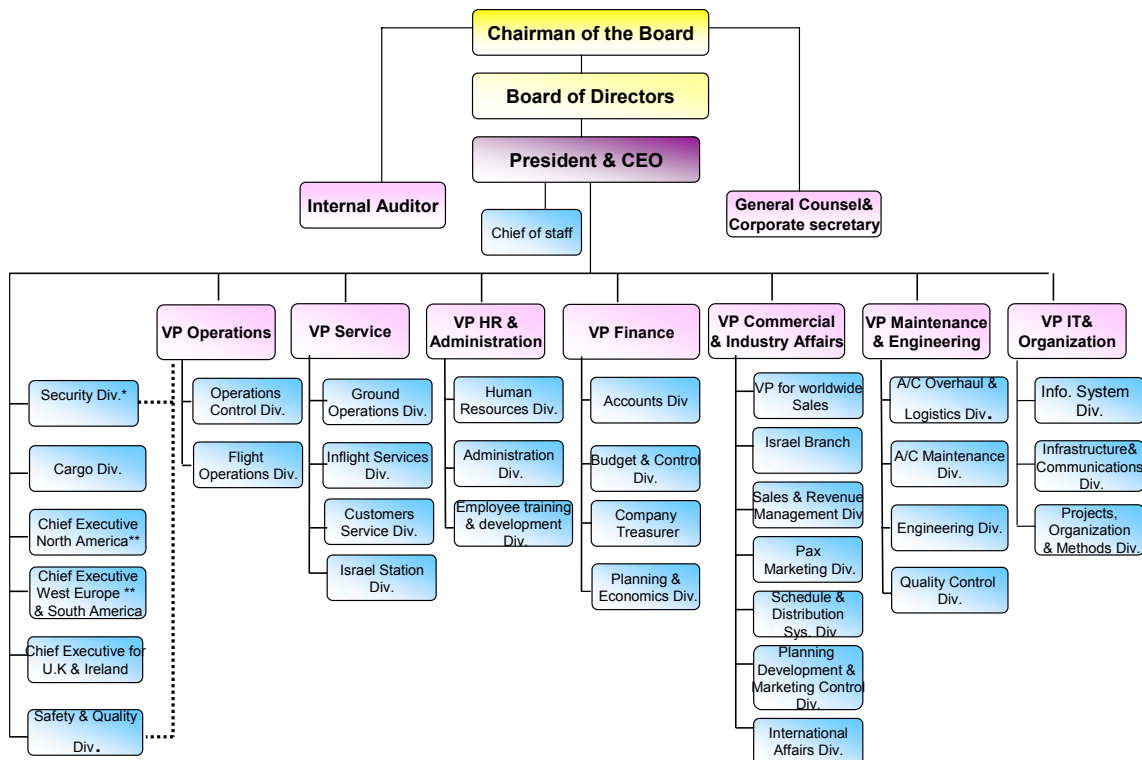
**4. Details Relating to the Two Operating Areas**

**To Section 9.4.1 - organizational structure, to Sections 9.4.2 and 9.4.16 - officers and senior management employees**

In continuation to what was described in Section 9.4.1 to the Periodic Report, and to the update of these Sections as itemized in the financial statements as of March 31, 2006 and as of June 30, 2006, and as the Company reported in an Immediate Report dated October 22, 2006, it was decided to make a number of changes in Company management, as follows:

- A. The function of the Chief Executive Africa, Asia and the Mediterranean Sea was terminated on November 1, 2006, and the areas of his responsibility were divided among the remaining three area division Chief Executives. As the result of this change, the number of senior employees itemized in the table in Section 9.4.2 of the Periodic Report was reduced to 44, and the number of expanded management, mentioned in the table in Section 9.4.16 of the Periodic Report, was updated to 34.
- B. The function of VP for worldwide Sales is to be terminated on November 30, 2006 and his authorities will be transferred to the VP for Commercial and Industry Affairs.
- C. The function of Head of the Planning and Economic Division (which was subordinate to the CFO) will be terminated starting on January 1, 2007.
- D. The Planning development and Marketing Control Division (which was subordinate to the VP for Commercial and Industry Affairs) will be converted into a subdivision, at the head of which will be a sector manager.
- E. The Ground Operations Division (which was subordinate to the VP Service) will be converted into a subdivision, at the head of which will be a deputy head of Division.

The following is a diagram which describes the up-to-date organizational structure of the Company:



\*Security Div. Mgr. and Safety & Quality Div. Mgr. are subordinated to the CEO and coordinated by VP Operations  
 \*\*Regional Chief Executives are subordinated to the CEO and coordinated by VP Commercial & Industry Affairs

**To Section 9.4.7-special collective agreements**

In continuation to what was stated in Section 9.4.7 of the Periodic Report, and as the Company reported in Immediate Reports dated September 5, 2006, October 6, 2006 and October 22, 2006, on September 5, 2006, the Company and the New General employees Histadrut-the Division for Professional Unions and the employees' representatives signed a special collective agreement which extends the effectiveness of the special collective agreement for the permanent company employees ("Generation A Agreement") until December 31, 2007, and on October 5, 2006, the approval of the agreement by the Board of Directors of the Company was received.

Concurrently, the employees' representatives took a decision, in view of the economic condition of the Company as reflected by the financial statements, to enter into negotiations with the Company for the purpose of finding joint and agreed solutions to the Company's efficiency, and during the month of October 2006, the holding of actual negotiation was begun. Among the principal subjects which are being discussed in this framework: manpower reductions (temporary and permanent employees), contraction of expenses in the area of wages and ancillaries, including by increasing the rate of participation by the employees in the services provided to them, unification of functions according to Company needs, and various changes in the operations of ground employees and air crews which will contribute to operational flexibility and the reduction of expenses. It should be emphasized that, as of the date of approval of this report, there is no well-founded assessment and/or assurance regarding understandings which will be reached at the end of the negotiations with

respect to every one of the subjects itemized above and/or other matters which might arise during the negotiations.

**To Section 9.6.5 - working capital deficit**

See updates in Section 2 to the Directors' Report concerning the Company's Affairs.

**To Sections 9.8.4, 9.8.5-loans for exclusive use**

In continuation to what was stated in the update to these sections which was included in the financial statements as of June 30, 2006, in relation to a memorandum of intentions which the Company signed with a foreign bank to receive financing in an amount of approximately 80 million dollars against a lien on two 747-400 aircraft, it should be pointed out that during the month of October 2006, the Company signed an agreement to receive this financing, and, as an extension of same, the Company intends to draw approximately 40 million dollars by the end of the month of November 2006.

**To Section 9.10.3-airport noise regulations**

In continuation of what was mentioned in Section 9.10.3 to the Periodic Report, in the matter of restrictions in European countries on the operations of 747-200 aircraft from the standpoint of the noise level, it should be stated that notification was received from the authorities at the Schiphol airport in Amsterdam regarding their intention to hold a discussion on the subject of noise and the imposition of operating restrictions on noisy aircraft. At this stage, the time schedule and/or the extent of the restrictions imposed cannot be assessed. See the detail in Section 9.10.3 as to the implications of the imposition of such restrictions.

**To Section 9.11.2 A- Flight Regulations (Registration, Licensing and Documentation Fees), 1989**

In continuation to what was mentioned in Section 9.11.2.A to the Periodic Report, with regard to a proposal to raise the amounts of fees from the present ones by substantial percentages, it should be stated that, during the month of November, the Economic Committee of the Knesset approved an increase in the fees by a rate that is moderate in compared to that put forward in the original proposal.

**To Section 9.11.2.G-restrictions and supervision over the Company's business-Antitrust**

- a) In continuation to what was written in Section 9.11.2.G (1) to the Periodic Report, it should be noted that, in the context of the proposed Law for Arrangement in the State Economy (Legislative Amendments for Achievement of Budget Goals and Economic Policies for the 2007 Fiscal Year), 2006, a proposal to amend Section 3 (7) to the Antitrust Law is included, according to which the application of the exemption included in it will be reduced with regard to limiting arrangements in the area of international transport. This proposal came about following Decision No. 441 of the Government dated September 12, 2006. According to the proposed amendment, an arrangement which presently falls within the confines of the exemption will, nevertheless, be considered as a limiting arrangement: (1) if the parties to the arrangement are Israeli air carriers; or (2) if the parties to the arrangement are air carriers of which at least one is Israeli and at least one is not Israeli; or (3) if the parties to the arrangement are non-Israeli air carriers and at least one of them carries on operations, or is the owner of a representation in Israel, and one of the major subjects of the arrangement is air transport to

or from Israel and the limitation in the arrangement relates to operations or the prevention of operations in Israel by one of the parties.

In addition, according to the proposed amendment, the arrangement in cases (2) and (3) above will not be considered as being limiting if authorized by the Minister of Foreign Affairs and the Minister of Transportation, in a well reasoned decision, after consulting the Minister of Finance and obtaining the position of the Antitrust Commissioner, for reasons of real impairment in the foreign relations of Israel, including its economic-commercial foreign affairs, or in order to insure the continuity of flight rights between Israel and other nations.

See also Section 9.18.15 B to the Periodic Report (Discussion of Risk Factors) as to this subject.

- b) In continuation to what was detailed in Section 9.11.2 G and to the Company's reporting in Immediate Reports dated September 28, 2006 and October 31, 2006, in February 2006, the U.S. Department of Justice Antitrust Division ("Antitrust Division"), together with additional competition Authorities of other countries, commenced an international investigation into an alleged price fixing conspiracy relating to certain surcharges included in tariffs for carrying air cargo. Numerous air cargo carriers have previously disclosed that they have received grand jury subpoenas in connection with that investigation. On September 27, 2006, the Company received a grand jury subpoena from the Antitrust Division requiring information related to certain pricing practices and surcharges applicable to the Company's air cargo business. The Antitrust Division has informed the Company that the Company is a subject of its ongoing investigation. Penalties for violating competition laws can be severe, involving both criminal and civil liability. The Company is cooperating with the investigation while carrying out its own internal review of cargo pricing practices, and is not in a position either to predict the outcome of the Antitrust Division investigation or to evaluate the potential financial impact of this investigation at this time. However, outcomes could include administrative or civil injunctive proceedings and/or criminal prosecution, as well as fines, penalties, and/or civil liability.

**To Section 9.11.7.2- designated carrier**

In addition to what was mentioned in Section 9.11.7.2 of the Periodic Report, and to the update to this section in the update to Chapter A in the financial statements as of June 30, 2006, it should be stated that:

- a) During the month of August 2006, the rationale of the High Court for Justice was given for the rejection of the Company's petition and additional petitions which were filed by the representatives of the Company's employees and by the Knafaim Company, against the decision of the Minister of Tourism regarding the appointment of the "Israil" Company as an additional designated carrier on the route to New York. Following is a summary of the reasons: the considerations which were enumerated in the Government decision dated 19.5.03 regarding the authority of the minister are not the solitary and comprehensive considerations, but the decision establishes policy courses and guiding principles. The minister is permitted to appoint an additional designated carrier even if the quantitative conditions in the Government decision have not been met, but this only in unusual cases which are in the public interest, as the minister himself directs to consider the interests of El Al and its special status and the tendency to conserve this status. This interpretation of the Government's decision is also expressed in the prospectus of El Al. Therefore, the minister did not deviate from the Government's decision and did not breach a commitment. The minister's

decision is positioned in the realm of reasonableness, especially since it was stipulated that the appointment is for a period of 24 months, during which the implications and additional relevant considerations would be examined.

- b) At the beginning of the month of October 2006, the Civil Aviation Authority notified the Company that the Ministry of Transportation intends to discuss a change to the bilateral airline agreement between Israel and Spain so that each party will be permitted to appoint two designated carriers (double designation), and it requested the Company's reaction. The Company transmitted its reaction, in which it detailed why a change in such bilateral agreement would be a mistake, both from the economic standpoint as well as from a legal standpoint, and will cause irreversible damage to the Israeli airline industry. Despite the above, in airline conversations which took place between Israel and Spain in November 2006, it was agreed that the appointment of multiple designated carriers would be permitted for each party (multi designation), for a period of two years and with a capacity restriction of 21 weekly frequencies for each party. See also Section 9.18.5 of the Periodic Report (Discussion of Risk Factors) regarding this subject.
- c) At the beginning of the month of October 2006, the Civil Aviation Authority approached the Company and requested its reaction to the allegation that the Company's program to operate five weekly flights on the Tel Aviv–Vienna route in Boeing 737 aircraft during the 2006/07 winter season, whereas Austrian Airlines plans to operate 14 weekly flights on the route, might cause the Company to drop below the 20% threshold during the year of 2006, an occurrence which might lead to the Minister of Transportation, as per the Government resolution, to consider the cancellation of the Company's status as a designated carrier on the route.  
The Company transmitted its reaction, in which it itemized the reasons for not considering the impairment of the rights currently being granted to the Company. See also Section 9.18.5 of the Periodic Report (Discussion of Risk Factors) regarding this subject.
- d) In October 2006, the Company was appointed as a designated carrier on the route to Uzbekistan, in place of the Arkia Company. The appointment was made at the request of the Company in view of its intention to operate cargo flights between Europe and Eastern Asia via Tashkent.

**To Section 9.11.7.2-designated carrier, and to Section 9.11.7.4-capacity, and to Section 9.11.8-the international civil airline policies of Israel**

In continuation of what was stated in the sections in the header in the Periodic Report, it should be pointed out that, in Government Decision No. 441 dated September 12, 2006, bearing the title "Encouragement of Competition in the Area of Civil Aviation to and from Israel", it was decided that an inter-ministerial "steering committee" would be established to guide negotiations with the European Union for the formulation of a uniform, global airline agreement with the nations of the European Union, to replace the existing bilateral airline agreements between Israel and the Union nations. The director general of the Ministry of Transportation and Road Safety will head the team and it will include representatives from the Ministry of Finance, the Ministry of Foreign Affairs and the Ministry of Tourism. The team will appoint representatives for negotiations with the European Union, and will instruct the representatives to include the following principles in the new airline agreement: giving proper consideration to the interests of the Israeli airline companies, including, and in particular, the utilization of "freedoms" as well as flight times and frequencies; maximum utilization of the possibilities of arrival to the State of Israel, among other

things, by means of increasing the number of designated carriers in instances in which the existing bilateral agreements restrict their number to one carrier per nation, and encouraging the entry of low cost companies into to operate in Israel; in the Government decision, it was determined that the team would act to formulate a new airline agreement within one year and will report on the progress made in contacts for composing the agreement. See also Section 9.18.5 of the Periodic Report (Discussion of Risk Factors) regarding this subject.

It should be pointed out that, at the same time, the Ministry of Transportation established the "Public Committee for the Examination of the issue of Open Skies", headed by the director general of the Ministry of Transportation, and representatives of the Company appeared before this committee in order to present the Company's position.

**To Section 9.14-legal proceedings**

- A. As to new proceedings-see update (b) above to Section 9.11.2(g) in the matter of the ongoing investigation against the Company by the Antitrust Division of the U.S. Department of Justice with regard to the area of cargo air transportation.
- B. In continuation to what was stated in Section 9.14.6 to the Periodic Report, it should be stated that, on July 23, 2006, the Supreme Labor Tribunal handed down a judgment which confirms the judgment of the District Tribunal to reject the claim against the Company, and rejects the appeals of the claimant pilots.
- C. In continuation to what was stated in Section 9.14.12 to the periodic report, it should be noted that the court rejected out of hand the plaintiffs' claim against the Company, and during the month of October 2006, the plaintiffs filed an appeal with the Tel Aviv District Court.

**Section 9.16- forecasted developments in the coming year**

- 1) As the Company reported in the Immediate Report dated July 19, 2006, as a follow up to reports and updates by the Company in the past in the context of the Periodic Report for the year 2005 and the reports for the first and second quarters of the year 2006, the trend of exacerbation in market conditions and the competitive business environment in which the Company operates, as well as the trend of rising prices of jet fuel, have continued. In view of this, and in light of recent developments in the security situation in Israel, the Company estimates that they will have a significant effect on its financial results for the year 2006, and that the year 2006 is expected to end in a loss, as to the extent of which the Company lacks materialized, forecasted data, this especially due to uncertainty on the security situation, its extent and its implications.
- 2) The Company's forecast of losses, as above in paragraph 1, is derived primarily from these factors:
  - (A) The extreme worsening of market conditions and the competitive business environment in which the Company operates, due to the continuing effect of the trends and developments in this area of activity - see details and information above in the update to Sections 7.1.4, 7.1.10, 7.8, 9.11.7.4 (developments in markets, competition and capacity).
  - (B) The ongoing trend of rising jet fuel prices-see Sections 6.3 and 9.5.1 to the Periodic Report, the update of those Sections in the update of Chapter A in the financial statements as of March 31, 2006 and June 30, 2006. In the Company's estimation, based upon current jet fuel market conditions, the rise in jet fuel prices will add approximately 75 million dollars to the Company's operating expenses in comparison to the year 2005, after offsetting anticipated returns of hedging in both periods.
  - (C) The recent developments and the intensification of the security situation in Israel and their possible implications on the Israeli economy, in general, and

on the Company's operations, in particular.-See details above in the updates to Sections 6.2, 7.1.3 (b), 7.1.4.

(D) Estimates and forecasts of the Company in connection with anticipated trends and developments in the industry during the fourth quarter of the year 2006.

- 3) The forecast included in this Section represents prospective information, as defined in the Securities Law, 1968. This data is information that is uncertain as it pertains to the future and is based principally on working assumptions, estimates and forecasts of the Company as they are known as of the date of this report, with relation to existing trends and anticipated developments in: the business environment in Israel and in the world, including the geopolitical and security situation and the rates of growth; the industry environment, including changes in passenger traffic (scheduled and charter) and cargo traffic, as well as changes in competition and the behavior and reactions of competitors; in exogenous factors, including changes in jet fuel prices, interest rates, currency rates and security costs; in prices of supplies and expenses, including rates of commissions to agents, rates of occupancy on aircraft, retirement of personnel, Consumer Price Index in Israel and global supplies prices.

It should be emphasized that the actual results, in whole or in part, may not be realized as aforesaid, be realized only in part or differ substantially, positively or negatively, from the estimated results, which are derived or implied from this information, if the working assumptions, expectations and estimations of the Company are not realized. Realization of the above forecast in full or in part or in a manner which significantly varies from it (positively or negatively) or its non realization as aforesaid, could be affected, among other things, by the following principal factors:

(A) Additional significant changes in current competition in the areas of activity of the Company, for any reason and/or cause, and, in particular, under conditions where the Company will have difficulty reacting. Without detracting from the generality of this, changes in competition are likely to result, inter alia:

- (1) From the entry of new competition into the market, additional flight capacity and/or flight frequency of companies that are presently operating, and from the business behavior of competitors, including in the area of prices;
- (2) From regulatory changes and the manner of their application and/or changes in the airline policies of the State of Israel and the manner of their implementation, including: civil airline policies regarding the appointment of designated carriers in the network of routes and/or authorization of charter flights; civil airline policies regarding the allowable capacity for foreign airline companies (scheduled and charter);
- (3) From expansion of the operations of "network" companies (which represent part of a global concordat) in the Israeli market in a manner which will make it difficult for the Company to join a concordat of this nature, and will impair its market share;
- (4) From the entry into the market of the "low cost" companies and the degree of influence that this will have on the worsening of competition in the industry, the lowering of prices and the need to carry out a process of cost compatibility in the Company;

- (5) From creation of a European aviation bloc which might fundamentally alter the structure of flight rights in the Market countries, to expand the number of companies and the sources of capacity between Israel and the Market countries on an unrestrained basis, and to impose a threat to the level of flight prices and the share of the Company in these routes;
- (6) From imposition of limitations on the Company in the sphere of business restrictions.

(B) The Company currently bears exceptional security expenses, which are out of its control, in relation to competing airline companies. An increase or decrease in these expenses from the force of circumstances or due to a governmental decision, will definitely affect the Company's profitability;

(C) The possible implications of economic and/or security changes in the world, in general, and in Israel, in particular, on the volume of the Company's operations. These changes could impose a threat to the Company due to the lack of flexibility in its ability to carry out changes in part of the expense structure (such as flight equipment and salaries) and could create difficulties in implementing the process of conforming the Company's expenses;

(D) Fluctuations in jet fuel prices, which represents a substantial component of the Company's expenses, as well as the risks from varying currency and interest rates;

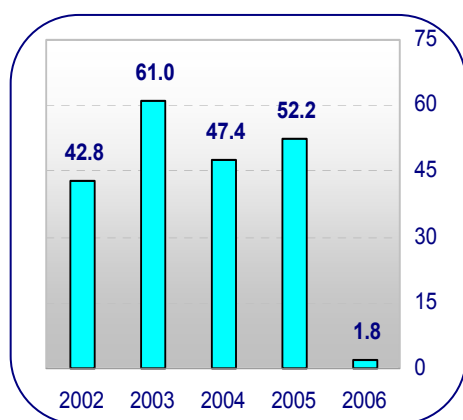
(E) Changes in the level of cooperation on the part of employees' associations with regard to updating labor agreements and observing "industrial tranquility".

DIRECTORS' REPORT

**EL AL ISRAEL AIRLINES LTD.**  
**REPORT OF THE BOARD OF DIRECTORS**  
**CONCERNING THE COMPANY'S AFFAIRS FOR THE PERIOD**  
**ENDED SEPTEMBER 30, 2006**

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**Net income in the  
third quarter by year:  
(in millions US dollars)**



We are pleased to submit herewith the directors' report regarding the Company's state of affairs as of September 30, 2006.

El Al Airlines Ltd. (hereafter: "the Company") concluded the three months ended September 30, 2006 with a profit of approximately \$ 1.8 million ("m") as compared with a profit of approximately \$ 52.2m in the corresponding period last year.

The quarter's results were adversely affected, primarily, by the Second Lebanese War, which broke out at the beginning of the month of July and caused a decrease of approximately 31% in incoming tourism, and additionally, by the trend of exacerbation of market conditions and of the competitive business environment in which the Company operates. The continued rise in jet-fuel prices and the revaluation of the shekel and the Euro against the dollar during the reporting period also affected business results.

Revenues of the Company in the third quarter of the year fell by approximately 8% in comparison with the same quarter last year and amounted to approximately \$ 447m.

The balances of cash and short-term investments as of September 30, 2006 totaled approximately \$ 126.9m.

Shareholders' equity amounted to approximately \$248.2m as of September 30, 2006.

## 1. The Company's business environment

### 1.1 Overview

The Company serves as Israel's designated carrier on most international routes to and from the country.

Most of its activity as well as that of its subsidiaries entails the carrying of passengers and cargo, including baggage and mail, through scheduled flights and, as far as passengers are concerned, also chartered flights between Israel and foreign countries.

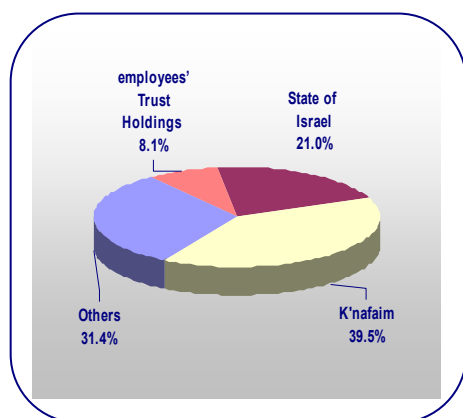
The Company is also engaged in the leasing of flight equipment, rendering handling and maintenance services at its home base Ben Gurion Airport ("BGA"), the sale of duty-free products and - through its investees - in related activities, the most significant of which constitute the supply of passenger meals and managing several travel agencies.

The Company's business environment constitutes international civil aviation and tourism to and from Israel, which is characterized by seasonal factors and fierce competition. This competition intensified during 2006 mainly due to the expanded activity of foreign airlines by the increased capacity, frequency of flights and use of larger planes on the route.

The Group operates in the following two business segments:

- a) **Air transport - passenger aircraft** - carrying passengers and cargo (including baggage and mail) plus related services, such as the sale of duty-free products and the leasing of passenger aircraft.
- b) **Air transport - cargo aircraft** - carrying cargo and providing related services.

**Shareholdings in the Company at September 30, 2006:**



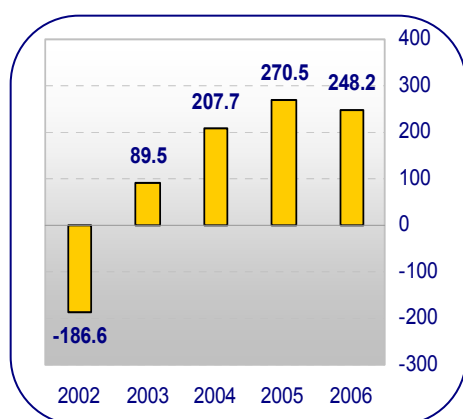
### 1.2 Privatization of the Company

On September 30, 2006 the shares in the Company were held by K'nafaim Holdings Ltd. ("K'nafaim") (39.5%), the state of

Israel (21.0%), Holdings in Trust for the Employees of EL AL Ltd. (the employees' company) (8.1%) and others (31.4%).

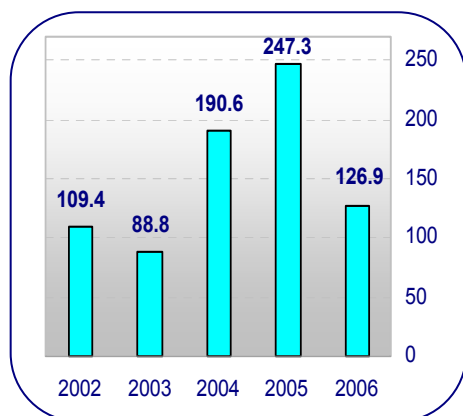
As for additional details concerning privatization - see Note 1.b to the 2005 annual financial statements.

Shareholders' equity at September 30, (in millions US dollars)



Cash and short-term investments at September 30: (in millions US dollars)

(in millions US dollars)



## 2. Financial position (consolidated data)

	30.09.2006 in thousands US dollars	31.12.2005 in thousands US dollars	change in thousands US dollars	
			US dollars	%
<b>Assets</b>				
Cash and short-term investments	126,867	206,763	(79,896)	(39%)
Trade accounts receivable	157,748	123,846	33,902	27%
Receivables	49,215	48,684	531	1%
Deferred income taxes	22,619	46,698	(24,079)	(52%)
Inventory	19,072	22,445	(3,373)	(15%)
Investments	5,698	5,846	(148)	(3%)
Fixed assets	1,157,927	1,163,765	(5,838)	(1%)
Other assets	3,249	4,671	(1,422)	(30%)
	<b>1,542,395</b>	<b>1,622,718</b>	<b>(80,323)</b>	<b>(5%)</b>
<b>Equity &amp; liabilities</b>				
Short-term bank borrowings	103,462	75,713	27,749	37%
Trade accounts payable	147,266	155,046	(7,780)	(5%)
Payables and other current liabilities	355,497	324,546	30,951	10%
Long-term loans from financial institutions	547,442	627,363	(79,921)	(13%)
Accrued severance pay, net	117,341	120,526	(3,185)	(3%)
Deferred income taxes	22,274	46,300	(24,026)	(52%)
Other long-term liabilities	869	2,215	(1,346)	(61%)
Shareholders' equity	248,244	271,009	(22,765)	(8%)
	<b>1,542,395</b>	<b>1,622,718</b>	<b>(80,323)</b>	<b>(5%)</b>

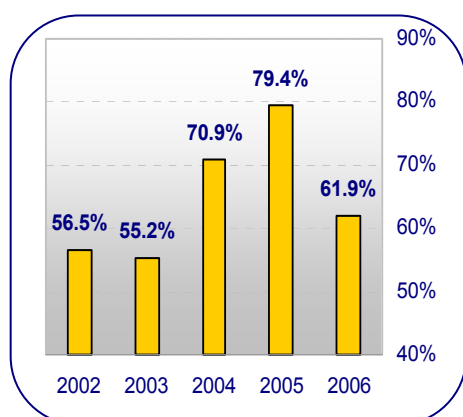
Major changes in assets, liabilities and shareholders' equity on September 30, 2006 as compared with the balances of December 31, 2005 are:

- A decrease in cash and short-term investments, stemming mainly from payments on account of aircraft purchases, investments in fixed assets and loan repayments, which has partly been offset by positive cash flows from operating activities.
- An increase in trade accounts receivable, mainly due to higher seasonal passenger revenues.
- A decrease in short-term deferred tax receivable along with a concurrent decline in the long-term deferred tax liability stems from the reclassification of a tax asset

(in respect of carry-forward losses) from short to long-term receivables in the first quarter of 2006.

- The decrease in other assets is mainly explained by the change in the classification of loan-attainment expenses from "other assets" to a reduction in long-term loans in accordance with Accounting Standard No. 22 of the Israeli accounting Standards Board.
- An increase in short-term credit and current installments as the result of the anticipated final payment during the coming year of a loan received from a banking institution.
- A decline in the balance of trade payables derived primarily from seasonal changes.
- A rise in payables and other current liabilities, mainly due to higher deferred income from sale of tickets not yet realized, as well as an higher accrued expenses.
- The balance of long-term loans (including current maturities) has declined, mainly due to current repayments of long-term loans.
- A decrease in shareholders' equity stemming mainly from the loss for the period. This decrease was offset by the following factors: deposits made by the Government of Israel to the severance-pay fund, which has raised the "capital reserve from transactions with a former controlling party", the exercise of options into shares and the recording during the reporting period of a benefit associated with the employee options program.

**Current ratio by % -  
at September 30:**

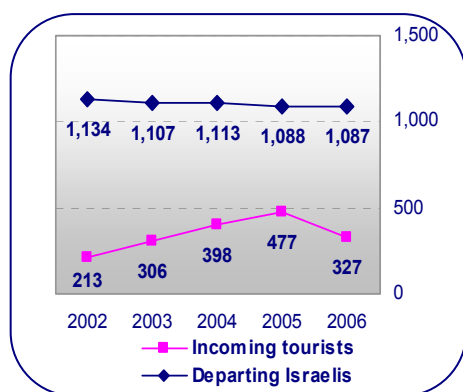


As of September 30, 2006 the Company had a working-capital deficiency of approximately \$ 231 m and a current ratio of 61.9% as compared with \$107m and 80.8% on December 31, 2005, respectively.

The increase in this deficiency stems mostly from declining cash, short-term investments and short-term deferred-tax receivable, along with higher current installments of long-term loans, and from a rise in current liabilities, arising from an increase in deferred revenues from the sale of flight tickets not yet realized.

The working capital deficiency stems from current liabilities which include two material components: deferred income from the sale of flight tickets and current maturities of long-term loans (including a one time current installment, as explained below). These components, which are characterized by the business cycle, are included in current liabilities and in fact explain most of the working-capital deficiency.

**Passenger traffic at BGA  
Incoming tourists & Departing  
Israelis, third quarter by year:  
(In thousands)**



### 3. Analysis of business activities

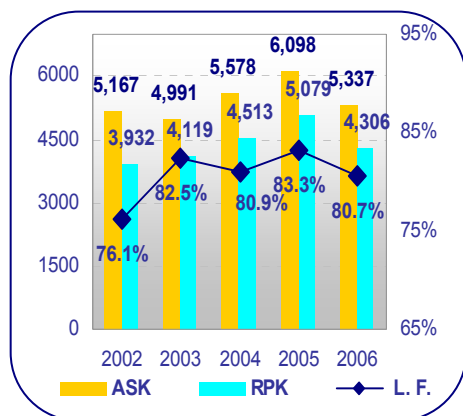
#### 3.1 Market data

Passenger and cargo traffic at BGA	2006	2005	change	
	in thousands	in thousands	in thousands	%
<b>Jul - Sep</b>				
Incoming tourists *	327	477	(150)	(31%)
Departing Israelis *	1,087	1,088	(1)	(0%)
Cargo import - tons **	35	31	4	13%
Cargo export - tons **	40	35	5	14%
<b>Jan - Sep</b>				
Incoming tourists *	1,220	1,229	(9)	(1%)
Departing Israelis *	2,450	2,376	74	3%
Cargo import - tons **	101	95	6	6%
Cargo export - tons **	137	132	5	4%

(\*) Source: The Israeli Bureau of Statistics.

(\*\*) Excluding cargo in transit.

**Operating data,  
third quarter by year:  
(in millions)**



**3.2 Operating data of the Company**

	Jul - Sep 2006	Jul - Sep 2005	change
Passenger leg (scheduled and chartered) - in thousands	1,014	1,168	(13%)
RPK (scheduled) - in millions	4,306	5,079	(15%)
ASK (scheduled) - in millions	5,337	6,098	(12%)
Load factor (scheduled)	80.7%	83.3%	(3%)
The Company's market share (scheduled and chartered)	39.1%	41.7%	(6%)
Cargo, in thousand tons	34	32	7%
RTK - in millions	199	182	9%
Weighted flying hours (including leased equipment) - in thousands (*)	45	48	(6%)
<u>Average man-years (EI AL only):</u>			
Permanent	3,707	3,534	5%
Temporary	2,650	2,772	(4%)
<b>Total</b>	<b>6,357</b>	<b>6,306</b>	<b>1%</b>

	Jan - Sep 2006	Jan - Sep 2005	change
Passenger leg (scheduled and chartered) - in thousands	2,757	2,769	(0%)
RPK (scheduled) - in millions	12,262	12,416	(1%)
ASK (scheduled) - in millions	15,124	15,719	(4%)
Load factor (scheduled)	81.1%	79.0%	3%
The Company's market share (scheduled and chartered)	41.6%	43.3%	(4%)
Cargo, in thousand tons	119	116	2%
RTK - in millions	639	641	(0%)
Weighted flying hours (including leased equipment) - in thousands (*)	130	131	(1%)
<u>Average man-years (EI AL only):</u>			
Permanent	3,701	3,494	6%
Temporary	2,548	2,428	5%
<b>Total</b>	<b>6,249</b>	<b>5,922</b>	<b>6%</b>
Aircraft in operation - end of period - number of units	34	33	1
Average age of owned fleet at the end of the period - in years	14.6	14.0	0.6

**Reading:**

Passenger Leg - flight coupon in one direction.

RPK - Revenue Passenger Kilometer - number of paying passengers x distance flown.

ASK - Available Seat Kilometer - number of seats offered for sale x distance flown.

RTK - Revenue Ton Kilometer - cargo weight in tons x distance flown.

Passenger Load factor - Revenue Passenger Kilometer, expressed as percentage of Available Seat Kilometer.

\*Aircraft weighted block hours in terms of Boeing 767/757:

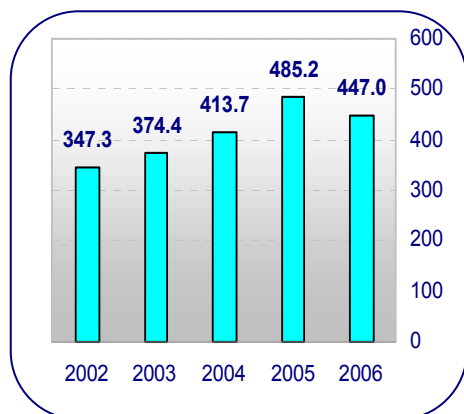
Boeing 767/757 = 1.0; Boeing 747=2.0; Boeing 777 =1.6; Boeing 737=0.6.

These values have been determined on the basis of total expenses incurred for each type of aircraft and used consistently for computing weighted flight hours as an indicator of the volume of aviation activity.

### 3.3 Data on operating results:

#### Operating revenues third quarter by year:

(in millions US dollars)

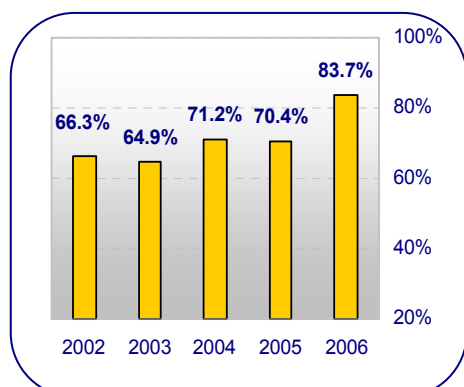


Three-month period ended September 30, 2006 (consolidated):

	Jul - Sep 2006		Jul - Sep 2005		change	
	in thousands US dollars	% of operating revenues	in thousands US dollars	% of operating revenues	in thousands US dollars	%
Operating revenues	447,001	100%	485,186	100%	(38,185)	(8%)
Operating expenses	(373,919)	(83.7%)	(341,623)	(70.4%)	(32,296)	9%
<b>Gross profit</b>	<b>73,082</b>	<b>16.3%</b>	<b>143,563</b>	<b>29.6%</b>	<b>(70,481)</b>	<b>(49%)</b>
Selling expenses	(46,673)	(10.4%)	(55,614)	(11.5%)	8,941	(16%)
General and administrative expenses	(22,116)	(4.9%)	(23,385)	(4.8%)	1,269	(5%)
<b>Operating income before financing</b>	<b>4,293</b>	<b>1.0%</b>	<b>64,564</b>	<b>13.3%</b>	<b>(60,271)</b>	<b>(93%)</b>
Financing expenses, net	(6,725)	(1.5%)	(6,224)	(1.3%)	(501)	8%
Other income (expenses), net	4,329	1.0%	(5,980)	(1.2%)	10,309	
Income taxes	(166)	(0.0%)	(322)	(0.1%)	156	(48%)
<b>Income after taxes</b>	<b>1,731</b>	<b>0.4%</b>	<b>52,038</b>	<b>10.7%</b>	<b>(50,307)</b>	<b>(97%)</b>
Company's equity in results of affiliates, net	34	0.0%	133	0.0%	(99)	(74%)
<b>Net Income for the period</b>	<b>1,765</b>	<b>0.4%</b>	<b>52,171</b>	<b>10.8%</b>	<b>(50,406)</b>	<b>(97%)</b>

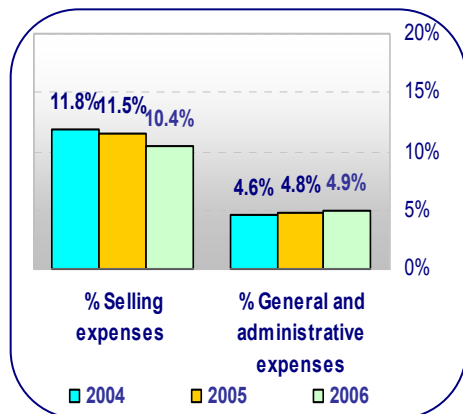
**Major factors affecting the business results for the three-month period ended September 30, 2006 as compared with the corresponding period last year, are as follows:**

#### Operating expenses as % of operating revenues, third quarter by year :



- The decrease in operating revenues resulted mainly from a reduction in passengers revenue due to the Second Lebanese War, which broke out at the beginning of July and caused a decrease of approximately 31% in incoming tourism, and also the continuing trend of exacerbation in market conditions and in the environment of business competition in which the Company operates. Cargo revenues rose in the reporting quarter in comparison to the parallel quarter last year.
- Operating expenses rose in the third quarter of 2006 over the same period last year, mainly due to: continued higher jet-fuel prices (despite continued receipts of substantial hedging refunds), a rise in

**Selling expenses & general and administrative expenses as % of operating revenues, third quarter by year:**



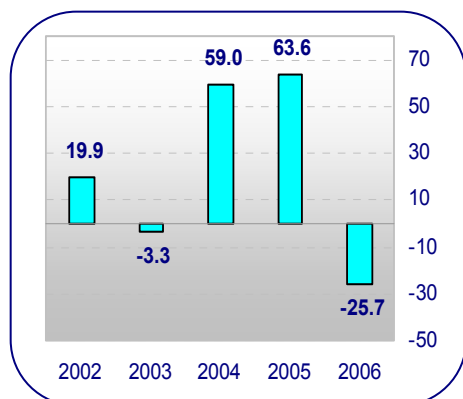
wages, as detailed below, the revaluation of the shekel and the Euro in relation to the dollar, thus increasing the Company's expenses in dollars, both with respect to liabilities in these currencies as well as with respect to current operational expenses. In addition the gradual process of adjusting expenses to falling demand, caused by the outbreak of the war.

- The average price of jet-fuel for the Company, net of hedging refunds, rose during the third quarter of 2006 by approximately 30% over the corresponding quarter last year. The Company's jet-fuel expenses increased by approximately 20% from about \$110.0m to about \$131.9m, net of hedging rebates of approximately \$17.5m.
- Aircraft-leasing expenses rose mainly due to the addition of two 737-800 and one 767-300 aircraft.
- Selling expenses decreased, mostly because of lower distribution costs due to declining sales. The ratio of selling expenses to revenues during the reporting period declined in relation to their ratio in the comparative period last year.
- There was a moderate decline in administrative and general expenses as compared to the parallel period last year.
- Current wage expenses rose, among other reasons, due to the revaluation of the shekel and the Euro in relation to the dollar during the quarter, the recording of an expense associated with the options program for employees and executives, the payment of a cost of living increase during the reporting period and a decline in profits on severance pay funds as compared with the same quarter last year.

As for the effect of changes in the shekel-dollar exchange rate on the Company's provisions - see item 3.4 below.

- The rise in the LIBOR interest rates and the revaluation of the shekel and the Euro in relation to the dollar led to higher financing expenses which were offset by a reduction in the outstanding loans of the Company and by interest and foreign currency hedging transactions executed by the Company.
- The Company recorded a capital gain for the reporting period in the amount of approximately \$5.9m from the sale of a cargo aircraft. In the comparative period last year, an expense in the amount of approximately \$ 6m was recorded as a provision for early retirement programs.

**Net income(loss) in  
Jan - Sep by year:  
(in millions US dollars)**



**Data on operating results**

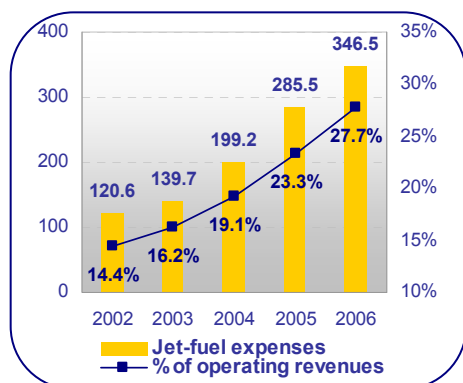
Nine-month ended on September 30, 2006 (consolidated)

	Jan - Sep 2006		Jan - Sep 2005		change	
	in thousands US dollars	% of operating revenues	in thousands US dollars	% of operating revenues	in thousands US dollars	%
Operating revenues	1,248,750	100%	1,227,273	100%	21,477	2%
Operating expenses	(1,052,236)	(84.3%)	(926,262)	(75.5%)	(125,974)	14%
<b>Gross profit</b>	<b>196,514</b>	<b>15.7%</b>	<b>301,011</b>	<b>24.5%</b>	<b>(104,497)</b>	<b>(35%)</b>
Selling expenses	(135,714)	(10.9%)	(150,412)	(12.3%)	14,698	(10%)
General and administrative expenses	(67,640)	(5.4%)	(66,820)	(5.4%)	(820)	1%
<b>Operating income (loss) before financing</b>	<b>(6,840)</b>	<b>(0.5%)</b>	<b>83,779</b>	<b>6.8%</b>	<b>(90,619)</b>	
Financing expenses, net	(21,860)	(1.8%)	(13,980)	(1.1%)	(7,880)	56%
Other income (expenses), net	3,052	0.2%	(5,985)	(0.5%)	9,037	
Income taxes	(217)	(0.0%)	(578)	(0.0%)	361	(62%)
<b>Income (loss) after taxes</b>	<b>(25,865)</b>	<b>(2.1%)</b>	<b>63,236</b>	<b>5.2%</b>	<b>(89,101)</b>	
Company's equity in results of affiliates, net	129	0.0%	338	0.0%	(209)	(62%)
<b>Net Income (loss) for the period</b>	<b>(25,736)</b>	<b>(2.1%)</b>	<b>63,574</b>	<b>5.2%</b>	<b>(89,310)</b>	

**Major factors affecting the business results for the nine-month period ended September 30, 2006 as compared with the corresponding period last year are as follows:**

- The higher operating revenues stemmed mainly from an increase in income from cargo transport.
- During the first nine months of the year 2006, there was an increase in operating expenses of the Company derived, principally, from the rise in jet fuel prices, from the rise in aircraft leasing expenses, from increased aircraft and flight equipment maintenance expenses and from higher wage expenses as detailed below.
- Average jet-fuel prices for the Company, net of hedging rebates, rose during the first nine months of 2006 by approximately 24% over the corresponding period last year. The Company's expenses for jet-fuel increased by approximately 21% from \$ 285.5m to about \$ 346.5m, net of hedging rebates of approximately \$ 52.0m
- Aircraft and flight-equipment maintenance expenses

**Total Jet-fuel expenses and  
% of operating revenues,  
Jan - Sep by year:  
(in millions US dollars)**



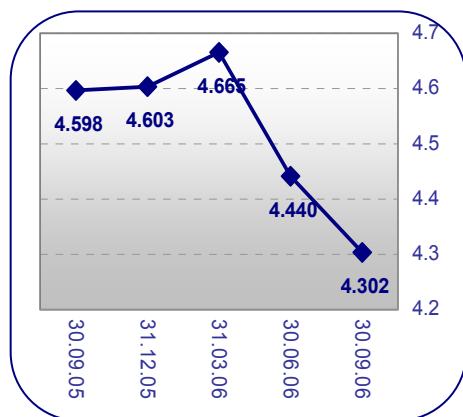
rose mainly due to fluctuations in timing of engine repairs, price increases of spare parts and the beginning of payments for additional engines whose insurance coverage had expired.

- Aircraft-leasing expenses rose mainly due to the addition of two 737-800 and one 767-300 aircraft.
- Selling expenses declined as well as their ratio to revenues in the reporting period compared to the same period last year.
- General and administrative expenses increased moderately by 1%, although, their ratio to revenues, remained unchanged from the same period last year.
- Current wages expense rose, among other reasons, due to an increase in the average workforce, revaluation of the shekel and the Euro in relation to the dollar, recording an expense associated with the options program for employees and executives of the Company, payment of a cost of living increase during the reporting period and a decline in earnings of severance pay funds as compared with the same period last year.

As for the effect of the change in the shekel-dollar exchange rate on the Company's provisions - see item 3.4 below.

- Higher LIBOR interest rates and the revaluation of the shekel and of the Euro in relation to the dollar have led to an increase in financing expenses, offset due to reduction in total outstanding loans and by higher interest income on bank deposits due to higher interest rates, and interest and foreign currency hedging transactions executed by the Company.

**Changes in US dollar exchange rate:**



**3.4 Effect of exchange-rate changes on the Company's liabilities for severance pay (including its early retirement programs), sick leave and vacation pay**

During the third quarter the shekel was revalued by 3.1% against the dollar, as compared with a devaluation of 0.5% in the same quarter last year.

During the first nine months of 2006 the shekel was revalued by 6.5% against the dollar, as compared with a devaluation of 6.7% in the corresponding period last year.

On September 30, 2006 the Company had liabilities totaling \$160m in respect of severance pay, retirement programs, sick-leave and vacation pay. Since most of these liabilities are denominated in shekels while the Company's functional currency is the US dollar, their translation into dollars creates exchange-rate differences stemming from changes in the exchange rate. Such changes are not one-sided thus creating income or expenses which neither affect cash flows nor short-term operating expenses. In order to be able to compare business results over time it is necessary to neutralize these income and expense items. This impact progressively declines along with the State's deposits to the severance-pay fund.

During the third quarter there was an increase in expenses, due to this component, of \$3.8m as compared with the reduction in expenses of \$0.6m for the same period last year.

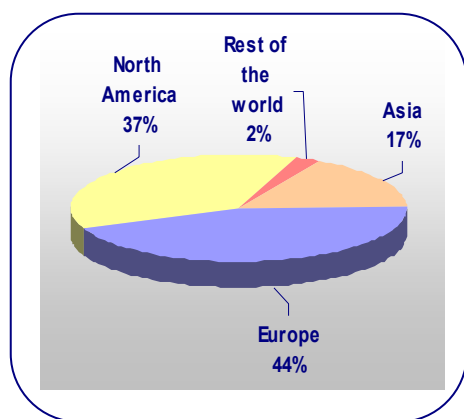
During the first nine months of 2006 there was an increase in expenses, due to this component, of \$7.9m as compared with the reduction in expenses of \$8.9m for the same period last year.

The following table presents the business results neutralizing the exchange-rate effect on the accrued severance pay, as explained above:

Three-month period ended September 30,	<u>Before neutralizing the exchange-rate effect on the accrued severance pay</u>		<u>After neutralizing the exchange-rate effect on the accrued severance pay</u>	
	2006	2005	2006	2005
	(in thousands US dollars)			
Operating expenses	373,919	341,623	371,495	342,007
Gross profit	73,082	143,563	75,506	143,179
Gross profit rate	16.3%	29.6%	16.9%	29.5%
Selling, general and administrative expenses	68,789	78,999	68,316	79,076
Operating income before financing expenses	4,293	64,564	7,190	64,103
Operating income rate before financing	1.0%	13.3%	1.6%	13.2%
Other income (expenses), net	4,329	(5,980)	5,192	(6,115)
Net income for the period	1,765	52,171	5,525	51,575
Net income for the period rate	0.4%	10.8%	1.2%	10.6%

Nine-month period ended September 30,	<u>Before neutralizing the exchange-rate effect on the accrued severance pay</u>		<u>After neutralizing the exchange-rate effect on the accrued severance pay</u>	
	2006	2005	2006	2005
	(in thousands US dollars)			
Operating expenses	1,052,236	926,262	1,047,206	931,399
Gross profit	196,514	301,011	201,544	295,874
Gross profit rate	15.7%	24.5%	16.1%	24.1%
Selling, general and administrative expenses	203,354	217,232	202,372	218,271
Operating income (loos) before financing expenses	(6,840)	83,779	(828)	77,603
Operating income (loos) rate before financing	(0.5%)	6.8%	(0.1%)	6.3%
Other income (expenses), net	3,052	(5,985)	4,969	(8,681)
Net income (loss) for the period	(25,736)	63,574	(17,807)	54,702
Net income (loss) for the period rate	(2.1%)	5.2%	(1.4%)	4.5%

Operating revenues attributed to geographical segments - January - September 2006:



### 3.5 Reporting by segments

The following is data by geographical segments on a consolidated basis:

Three-month period ended:				
30.09.2006 -(unaudited)	North America	Europe	Central Asia & Far East	Rest of the world
(in millions US dollars)				
operating revenues	162.4	193.0	73.4	10.8
Operating income *	7.5	29.1	3.8	3.8
% of operating revenues	4.6%	15.1%	5.2%	35.1%
30.09.2005 -(unaudited)				
operating revenues	181.9	222.7	64.5	9.8
Operating income *	34.7	62.4	8.7	3.7
% of operating revenues	19.1%	28.0%	13.4%	37.5%

<b>Nine-month period ended:</b>				
<b>30.09.2006 -(unaudited)</b>	<b>North America</b>	<b>Europe (in millions US dollars)</b>	<b>Central Asia &amp; Far East</b>	<b>Rest of the world</b>
operating revenues	441.2	541.4	216.6	28.5
Operating income *	11.8	73.9	27.5	8.7
% of operating revenues	2.7%	13.6%	12.7%	30.5%
<b>30.09.2005 -(unaudited)</b>				
operating revenues	439.5	545.4	196.8	26.0
Operating income *	56.3	132.1	24.0	8.8
% of operating revenues	12.8%	24.2%	12.2%	34.0%
<b>Year ended:</b>				
<b>31.12.2005 -(audited)</b>	<b>North America</b>	<b>Europe (in millions US dollars)</b>	<b>Central Asia &amp; Far East</b>	<b>Rest of the world</b>
operating revenues	568.3	710.3	277.1	34.9
Operating income *	58.5	166.4	33.8	11.6
% of operating revenues	10.3%	23.4%	12.2%	33.2%

(\*) The revenues are allocated to geographic segments based upon flight destinations.

(\*\*) Excluding unclassified, segment revenues and expenses (see Note 8 to the interim financial statements).

During the third quarter, a decline in revenues of the North American and European segments took place in comparison to the same period last year, primarily due to the decrease in the quantity of passengers as a result of the Second Lebanese War, which began in the month of July 2006.

A decrease in the rates of operating income occurred in all segments during the third quarter of the year 2006 as compared with the same period last year.

These decreases were derived principally from higher operating expenses, especially jet-fuel prices, as explained in item 3.3 above.

Revenues from all geographical segments rose during the nine month period ended September 30, 2006 over the corresponding period last year, except for a moderate decline in the European segment.

The increased operating expenses described in item 3.3 above caused a decline in the rates of operating income for the first nine months of the year 2006 from the same period last year in all geographical segments, except for the Central Asia and Far

East segment, which recovered from the aftermath of the Tsunami that had affected operations during the year of 2005.

#### **4. Seasonal factors**

The passenger traffic at BGA is characterized by strong seasonality, with the primary activity taking place during the summer months, (peaking in July-September). The winter months (January-March) are characterized by slow passenger traffic coupled with strong export cargo of agricultural produce to Europe.

It should be pointed out that the Second Lebanese War, which took place during the months of July and August 2006, led to a decline at the rate of approximately 7% in passenger traffic at BGA during the reporting quarter vis-à-vis the comparative quarter last year.

#### **5. Liquidity and financing sources**

	<b>Jul - Sep 2006 in thousands US dollars</b>	<b>Jul - Sep 2005 in thousands US dollars</b>	<b>change in thousands US dollars</b>
Cash flows from operating activities	(14,363)	55,037	(69,400)
Cash flows used for investing activities	(2,099)	(22,478)	20,379
Cash flows used for financing activities	(21,272)	(18,756)	(2,516)
Net increase (decrease) in cash	(37,734)	13,803	(51,537)

	<b>Jan - Sep 2006 in thousands US dollars</b>	<b>Jan - Sep 2005 in thousands US dollars</b>	<b>change in thousands US dollars</b>
Cash flows from operating activities	49,107	160,330	(111,223)
Cash flows used for investing activities	(28,243)	(108,595)	80,352
Cash flows used for financing activities	(51,426)	(43,644)	(7,782)
Net increase (decrease) in cash	(30,562)	8,091	(38,653)

The change in cash flows from operating activities during the period of three months ended September 30, 2006 compared to the same period last year resulted mainly from declining earnings for the period and from seasonal changes in the payables and trade receivables sections.

The change in cash flows from operating activities during the period of the nine months ended September 30, 2006 compared with the same period last year resulted mainly from the loss for the period and from seasonal changes in the payables section.

During the third quarter of the year 2006, the Company used approximately \$ 24.0m for payments on account of the acquisition of aircraft and of fixed assets, spare parts and accessories (as compared with about \$ 10.1m in the corresponding period last year). During the reporting period, the Company realized approximately \$ 15.5m, net, in short-term deposits (as compared with deposits of approximately \$ 12.7 m, net, in the same period last year), and also received proceeds from the sale of fixed assets in the amount of approximately \$ 6.3m. In total, the Company used approximately \$ 2.1m for investment activities during the period of three months ended September 30, 2006 as compared with about \$ 22.5m used for investment activities during the parallel quarter last year.

During the period of nine months ended September 30, 2006, the Company used approximately \$ 84.7m for payments on account of the acquisition of aircraft and of fixed assets, spare parts, accessories and other assets (as compared with about \$ 34.3m in the corresponding period last year). During the reporting period, the Company realized approximately \$ 49.1m, net, in short-term deposits (as compared with deposits of approximately \$ 87.9m, net, in the same period last year), and also received proceeds from the sale of fixed assets in the amount of approximately \$ 6.7m.

In total, the Company used approximately \$ 28.2m for investment activities during the period of nine months ended September 30, 2006 as compared with about \$ 108.6m used for investment activities during the parallel period last year.

During the period of three months ended September 30, 2006, the Company used approximately \$ 20.2m for repaying long-

term loans as compared with about \$ 19.9m in the same period last year. In total, the Company used about \$ 21.3m during the third quarter of the year 2006 for financing activities, as against about \$ 18.8 million in the comparative period last year.

During the period of nine months ended September 30, 2006, the Company used approximately \$ 49.7 m for repaying long-term loans as compared with about \$ 48.3 m in the same period last year. In total, the Company used about \$ 51.4 m during the nine months ended September 30, 2006 for financing activities, as against about \$ 43.6 m in the comparative period last year.

Total cash and cash equivalents and short-term investments as of September 30, 2006 amounted to \$ 126.9 m as compared with \$ 206.8 m as of December 31, 2005.

During the period of three months ended September 30, 2006, the State deposited approximately \$ 0.1 m into the employees' severance-pay fund, in accordance with the terms of the prospectus.

During the first nine months of the year 2006, the State deposited approximately \$ 0.8 m into the employees' severance-pay fund, in accordance with the terms of the prospectus and the Company received approximately \$ 0.3 m from the exercise of options (Series 1), which were also deposited to that fund.

## **6. Quality reporting concerning exposure to market risks and methods used for managing them**

### **6.1 Company's policy for managing market risks, responsibility for managing them, means of supervision and policy implementation**

The Committee for Market Risks Management of the Board of Directors, headed by the Chairman of the Finance, Budget and

Balance Sheet Committee, Mr. Nadav Palti, is responsible for establishing policy to cover exposures to existing risks. The CFO is responsible for carrying out this policy and reporting to the Committee for Market Risks Management.

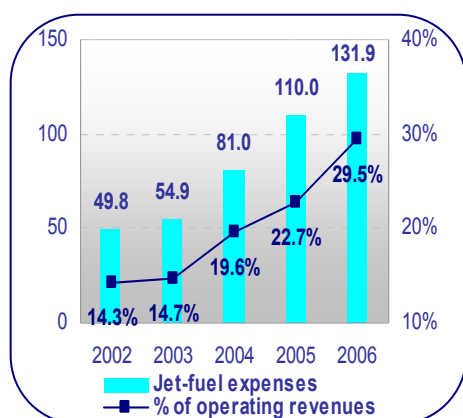
The Committee for Market Risks Management determines frameworks of jet-fuel consumption in the future which are to be covered by financial hedging transactions. The Committee also examines, from time to time, the need to invest in derivative financial instruments for the reduction of interest and currency risks.

During the reporting period, the Company's policy for managing market risks, the means of supervision and the implementation of the policies was unchanged from what was described in the Directors' Report on Business Affairs of the Company for the year ended December 31, 2005 and in the notes to the financial statements as of that same date. See items 6.2, 6.3 and 6.4 below for details of the policies which were actually implemented.

## 6.2 Hedging jet-fuel prices

The following is an outline of the hedging transaction positions of jet fuel prices (recognized for accounting purposes), which were outstanding on September 30, 2006:

**Total jet-fuel expenses and % of operating revenues, third quarter by year:**  
(in millions US dollars)



Type of transaction	Period	Transaction's currency	Fair value in thousand US dollars
HJFP Financial instruments	Up to One year	US dollar	6,760
HJFP Financial instruments	Over One year	US dollar	1,685

For more details, see Note 20b.1 to the Periodic Report as of December 31, 2005.

## 6.3 Hedging interest on loans

During 2004 and 2005, the Company executed several transactions with banks in Israel which are geared as protection against existing exposure in the Company's long-term credit portfolios to changes in interest rates. During the first quarter of

the year 2006, an additional transaction was executed.

Some of the aforementioned financial instruments are not recognized for accounting purposes as hedging transactions. The fair value of these financial instruments as of September 30, 2006 was approximately \$ 2.8 m, and they are presented in the financial statements under the heading of receivables and other current assets. Other agreements are recognized for accounting purposes as hedging transactions. Following these transactions, about 74% of the outstanding loans of the Company as of September 30, 2006 were at fixed rates, for up to five years.

On the basis of the instruments which were selected to hedge against interest exposures, part of the hedging transactions fluctuated at market interest rates, after they had passed the exit points established in agreements with the banks as of that date.

For additional details, see Note 20b.2 to the Periodic Report as of December 31, 2005.

#### **6.4 Transactions to hedge exchange rates**

During the first quarter of the year 2006, the Company carried out several financial transactions designed to protect the Company from a decline in the exchange rate of the dollar against the shekel. These transactions are not recognized for accounting purposes. The fair value of these transactions as of September 30, 2006 amounted to approximately \$ 1.1m and they are presented in the financial statements under the heading receivables and other current assets.

## 7. Report of linkage bases

The following is a report on linkage bases on a consolidated basis, as of September 30, 2006:

	In, or linked to the US dollar	In Israeli currency	In, or linked to the euro	In, or linked to the other currencies	Non-monetary items	Total
(in thousands US dollars)						
<b>Assets</b>						
Cash and cash equivalents	55,580	4,282	391	3,114	-	63,367
Short-term investments	63,500	-	-	-	-	63,500
Trade accounts receivable	128,072	90	13,234	16,352	-	157,748
Receivables and other current assets	17,179	4,583	635	1,188	25,630	49,215
Deferred income taxes	-	-	-	-	22,619	22,619
Inventory	-	-	-	-	19,072	19,072
Long-term bank deposits	-	1,800	-	-	-	1,800
Investment in another company	-	-	-	-	1,905	1,905
Investees	1,229	-	-	-	764	1,993
Fixed assets	74,202	-	-	-	1,083,725	1,157,927
Other assets	-	-	-	-	3,249	3,249
	<b>339,762</b>	<b>10,755</b>	<b>14,260</b>	<b>20,654</b>	<b>1,156,964</b>	<b>1,542,395</b>
<b>Liabilities &amp; Equity</b>						
Short-term borrowings	(102,426)	(565)	(190)	(281)	-	(103,462)
Trade accounts payable	(96,966)	(22,822)	(19,090)	(8,388)	-	(147,266)
Payables and other current liabilities	(90,777)	(96,473)	(2,730)	(4,462)	(161,055)	(355,497)
Long-term loans	(547,442)	-	-	-	-	(547,442)
Accrued severance pay, net	(14,934)	(95,277)	(5,588)	(1,542)	-	(117,341)
Deferred income taxes	-	-	-	-	(22,274)	(22,274)
Other long-term liabilities	(869)	-	-	-	-	(869)
Shareholders' equity	-	-	-	-	(248,244)	(248,244)
	<b>(853,414)</b>	<b>(215,137)</b>	<b>(27,598)</b>	<b>(14,673)</b>	<b>(431,573)</b>	<b>(1,542,395)</b>
<b>Monetary assets, net of monetary liabilities (monetary liabilities, net of monetary assets)</b>	<b>(513,652)</b>	<b>(204,382)</b>	<b>(13,338)</b>	<b>5,981</b>	<b>725,391</b>	<b>-</b>

The following is a report on linkage bases on a consolidated basis, as of September 30, 2005:

	In, or linked to the US dollar	In Israeli currency	In, or linked to the euro	In, or linked to the other currencies	Non-monetary items	Total
(in thousands US dollars)						
<b>Assets</b>						
Cash and cash equivalents	66,948	2,207	1,996	1,587	-	72,738
Short-term investments	173,588	986	-	-	-	174,574
Trade accounts receivable	128,938	510	7,679	12,911	-	150,038
Receivables and other current assets	14,198	5,434	906	1,302	22,132	43,972
Inventory	-	-	-	-	12,540	12,540
Long-term bank deposits	-	1,705	-	-	-	1,705
Investment in another company	-	-	-	-	1,778	1,778
Investees	1,554	-	-	-	903	2,457
Fixed assets	6,845	-	-	-	1,135,688	1,142,533
Other assets	-	-	-	-	4,402	4,402
	<b>392,071</b>	<b>10,842</b>	<b>10,581</b>	<b>15,800</b>	<b>1,177,443</b>	<b>1,606,737</b>
<b>Liabilities &amp; Equity</b>						
Short-term borrowings	(83,370)	-	(728)	(80)	-	(84,178)
Trade accounts payable	(80,374)	(26,469)	(22,523)	(10,720)	-	(140,086)
Payables and other current liabilities	(99,423)	(78,574)	(10)	(340)	(168,908)	(347,255)
Long-term loans	(633,405)	-	-	-	-	(633,405)
Accrued severance pay, net	(42,083)	(79,866)	(5,122)	(1,377)	-	(128,448)
Other long-term liabilities	(2,778)	-	-	-	(130)	(2,908)
Shareholders' equity	-	-	-	-	(270,457)	(270,457)
	<b>(941,433)</b>	<b>(184,909)</b>	<b>(28,383)</b>	<b>(12,517)</b>	<b>(439,495)</b>	<b>(1,606,737)</b>
<b>Monetary assets, net of monetary liabilities (monetary liabilities, net of monetary assets)</b>	<b>(549,362)</b>	<b>(174,067)</b>	<b>(17,802)</b>	<b>3,283</b>	<b>737,948</b>	<b>-</b>

The following is a report on linkage bases on a consolidated basis, as of December 31, 2005:

	In, or linked to the US dollar	In Israeli currency	In, or linked to the euro	In, or linked to the other currencies	Non-monetary items	Total
(in thousands US dollars)						
<b>Assets</b>						
Cash and cash equivalents	78,279	11,345	1,503	2,802	-	93,929
Short-term investments	111,841	993	-	-	-	112,834
Trade accounts receivable	99,877	45	10,331	13,593	-	123,846
Receivables and other current assets	19,592	6,085	232	1,042	21,733	48,684
Deferred income taxes	-	-	-	-	46,698	46,698
Inventory	-	-	-	-	22,445	22,445
Long-term bank deposits	-	1,779	-	-	-	1,779
Investment in another company	-	-	-	-	1,878	1,878
Investees	1,554	-	-	-	635	2,189
Fixed assets	26,763	-	-	-	1,137,002	1,163,765
Other assets	-	-	-	-	4,671	4,671
	<b>337,906</b>	<b>20,247</b>	<b>12,066</b>	<b>17,437</b>	<b>1,235,062</b>	<b>1,622,718</b>
<b>Liabilities &amp; Equity</b>						
Short-term borrowings	(75,713)	-	-	-	-	(75,713)
Trade accounts payable	(95,380)	(28,412)	(21,398)	(9,856)	-	(155,046)
Payables and other current liabilities	(103,547)	(84,357)	(10)	(1,058)	(135,574)	(324,546)
Long-term loans	(627,363)	-	-	-	-	(627,363)
Accrued severance pay, net	(29,332)	(84,762)	(5,058)	(1,374)	-	(120,526)
Deferred income taxes	-	-	-	-	(46,300)	(46,300)
Other long-term liabilities	(2,215)	-	-	-	-	(2,215)
Shareholders' equity	-	-	-	-	(271,009)	(271,009)
	<b>(933,550)</b>	<b>(197,531)</b>	<b>(26,466)</b>	<b>(12,288)</b>	<b>(452,883)</b>	<b>(1,622,718)</b>
<b>Monetary assets, net of monetary liabilities (monetary liabilities, net of monetary assets)</b>	<b>(595,644)</b>	<b>(177,284)</b>	<b>(14,400)</b>	<b>5,149</b>	<b>782,179</b>	<b>-</b>

## **8. Explanation regarding an issue to which the independent auditors of the Company drew attention in their review letter on the interim financial statements**

In their review letter on the interim financial statements, the independent auditors of the Company drew attention to Notes 2.5 and 7 concerning the Company's exposure to legal proceedings.

Although the matter to which the independent auditors drew attention do not elicit a change from the standard terminology used by independent auditors, calling attention is required due to its possible material impact on the Company.

**9. Subsequent event**

See Note 9 to the interim financial statements as to events subsequent to the balance sheet date (agreement for the receipt of financing from a foreign bank )

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Prof. Israel (Izzy)

Borovich

Chairman of the Board

November 28, 2006

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Haim Romano

Chief Executive Officer

FINANCIAL STATEMENTS

**EL AL ISRAEL AIRLINES LTD.  
CONDENSED CONSOLIDATED  
INTERIM FINANCIAL STATEMENTS  
AS OF SEPTEMBER 30, 2006  
(unaudited)**

**EL AL ISRAEL AIRLINES LTD.**

**Contents**

	<u>Page</u>
<b>Accountants' review report</b>	C-1
<b>Condensed consolidated interim financial statements (unaudited)</b>	
Balance sheets	C-2-C-3
Statements of operations	C-4
Statements of changes in shareholders' equity	C-5-C6
Statements of cash flows	C-7-C-8
Notes to the financial statements	C-9-C-22

The Board of Directors  
El Al Israel Airlines Ltd.  
Ben-Gurion Airport

Gentlemen:

**Review of the unaudited condensed consolidated interim financial statements  
at September 30, 2006 and for the nine and three-month periods then ended**

Pursuant to your request we have reviewed the accompanying condensed consolidated interim balance sheet of El Al Israel Airlines Ltd. ("the Company") at September 30, 2006 and the condensed consolidated interim statements of operations, changes in shareholders' equity and cash flows for the nine and three-month periods then ended.

Our review has been performed in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel. These procedures included, among other things: reading the aforementioned financial statements, reading the minutes of the shareholders' meetings and the meetings of the board of directors and its committees and making inquiries with persons responsible for the financial and accounting affairs.

We have been furnished reports of other accountants relating to the review of condensed interim financial statements of subsidiaries whose assets constitute 0.7% of total assets included in the condensed interim consolidated balance sheet and whose revenues constitute about 0.3% and 0.2% of total revenues included in the condensed interim consolidated statements of operations for the nine and three-month periods ended September 30, 2006 respectively.

Since the performed review is limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the aforementioned condensed interim financial statements.

In performing our review, which included the reading of the reports of other accountants, nothing came to our attention indicating that material modifications are required to these financial statements for them to be deemed prepared in conformity with generally accepted accounting principles and in accordance with Chapter D of the Israeli Securities Regulations (Periodic and Immediate Financial Statements), 1970.

We wish to bring your attention to the contents of Notes 2.5 and 7 to the financial statements regarding exposure from legal actions against the Company.

Respectfully,

Brightman Almagor & Co.  
Certified Public Accountants  
Tel Aviv, November 28, 2006

**EL AL ISRAEL AIRLINES LTD.**  
**CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS**

	<b>September 30,</b>	<b>December 31,</b>
	<b>2 0 0 6</b>	<b>2 0 0 5</b>
	<b>(unaudited)</b>	<b>(audited)</b>
	<b>(in thousand US dollars)</b>	
<b>Current assets</b>		
Cash and cash equivalents	63,367	72,738
Short-term investments	63,500	174,574
Trade accounts receivable	157,748	150,038
Receivables and other current assets	49,215	43,972
Deferred income taxes	22,619	-
Inventory	19,072	12,540
	375,521	453,862
<b>Investments</b>		
Long-term bank deposits	1,800	1,705
Investment in another company	1,905	1,778
Investees	1,993	2,457
	5,698	5,940
<b>Fixed assets</b>	1,157,927	1,142,533
<b>Other assets</b>	3,249	4,402
	1,542,395	1,606,737
		1,622,718

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS**

	<u>September 30,</u>		<u>December 31,</u>
	<u>2 0 0 6</u>	<u>2 0 0 5</u>	<u>2 0 0 5</u>
	<u>(unaudited)</u>		<u>(audited)</u>
	<u>(in thousand US dollars)</u>		
<b>Current liabilities</b>			
Short-term borrowings and current maturities	103,462	(*) 84,178	75,713
Trade accounts payable	147,266	140,086	155,046
Payables and other current liabilities	355,497	(*)347,255	324,546
	<u>606,225</u>	<u>571,519</u>	<u>555,305</u>
<b>Long-term liabilities</b>			
Long-term loans from financial institutions	547,442	633,405	627,363
Accrued severance pay, net	117,341	128,448	120,526
Deferred income taxes	22,274	-	46,300
Other long-term liabilities	869	2,908	2,215
	<u>687,926</u>	<u>764,761</u>	<u>796,404</u>
<b>Total liabilities</b>	<u>1,294,151</u>	<u>1,336,280</u>	<u>1,351,709</u>
<b>Shareholders' equity</b>			
Share capital	131,536	131,318	131,318
Share premium	904	826	826
Capital reserve from transactions with a former controlling party	299,894	299,119	299,119
Capital reserve from an employee options program	1,900	-	-
Accumulated deficit	(185,990)	(160,806)	(160,254)
	<u>248,244</u>	<u>270,457</u>	<u>271,009</u>
	<u>1,542,395</u>	<u>1,606,737</u>	<u>1,622,718</u>

(\*) Reclassified.

\_\_\_\_\_  
Prof. Israel (Izzy) Borovich  
Chairman of the Board

\_\_\_\_\_  
Haim Romano  
Chief Executive Officer

\_\_\_\_\_  
Nissim Malki  
Chief Financial Officer

Approval date of the financial statements - Ben Gurion Airport, November 28, 2006

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**CONDENSED CONSOLIDATED INTERIM STATEMENT OF OPERATIONS**

	Nine-month period ended September 30		Three-month period ended September 30		Year ended December 31
	2006	2005	2006	2005	2005
	(unaudited)				(audited)
	(in thousand US dollars)				
Operating revenues	1,248,750	1,227,273	447,001	485,186	1,619,469
Operating expenses	1,052,236	926,262	373,919	341,623	1,243,198
<b>Gross profit</b>	<u>196,514</u>	<u>301,011</u>	<u>73,082</u>	<u>143,563</u>	<u>376,271</u>
Selling expenses	135,714	150,412	46,673	55,614	198,591
General and administrative expenses	67,640	66,820	22,116	23,385	88,758
	<u>203,354</u>	<u>217,232</u>	<u>68,789</u>	<u>78,999</u>	<u>287,349</u>
<b>Operating income (loss) before net financing expenses</b>	(6,840)	83,779	4,293	64,564	88,922
Net financing expenses	<u>21,860</u>	<u>13,980</u>	<u>6,725</u>	<u>6,224</u>	<u>20,606</u>
<b>Operating income(loss) after net financing expenses</b>	(28,700)	69,799	(2,432)	58,340	68,316
Other income (expenses), net	<u>3,052</u>	<u>(5,985)</u>	<u>4,329</u>	<u>(5,980)</u>	<u>(4,519)</u>
<b>Pre-tax income (loss)</b>	(25,648)	63,814	1,897	52,360	63,797
Income taxes	<u>(217)</u>	<u>(578)</u>	<u>(166)</u>	<u>(322)</u>	<u>(304)</u>
<b>Income (loss) after income taxes</b>	(25,865)	63,236	1,731	52,038	63,493
Company's equity in earnings of affiliates, net	<u>129</u>	<u>338</u>	<u>34</u>	<u>133</u>	<u>633</u>
<b>Net income (loss) for the period</b>	<u>(25,736)</u>	<u>63,574</u>	<u>1,765</u>	<u>52,171</u>	<u>64,126</u>
<b>Basic earnings (loss) per share – in dollars</b>	<u>(0.06)</u>	<u>(*) 0.16</u>	<u>0.004</u>	<u>(*) 0.13</u>	<u>(*) 0.16</u>
<b>Number of shares used in the computation of basic EPS (in thousands)</b>	<u>400,643</u>	<u>399,583</u>	<u>400,788</u>	<u>399,780</u>	<u>399,633</u>
<b>Fully diluted earnings per share – in dollars</b>	<u>-</u>	<u>0.13</u>	<u>0.004</u>	<u>0.11</u>	<u>0.13</u>
<b>Number of shares used in the computation of fully diluted EPS (in thousands)</b>	<u>-</u>	<u>495,721</u>	<u>495,721</u>	<u>495,721</u>	<u>495,721</u>

(\*) Restated – see Note 1.3.1.

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**INTERIM STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

	Share capital	Share premium	Capital reserve		Accumulated deficit	Total
			(*)	(**)		
(in thousand US dollars)						
<b>Nine-month period ended September 30, 2006 (unaudited):</b>						
Balance - January 1, 2006	131,318	826	299,119	-	(160,254)	271,009
Receipts on account of government of Israel debt	-	-	775	-	-	775
Exercise of options into shares	218	78	-	-	-	296
Benefit value of options program (see Note 6.3)	-	-	-	** 1,900	-	1,900
Loss for the period	-	-	-	-	(25,736)	(25,736)
<b>Balance - September 30, 2006</b>	<u>131,536</u>	<u>904</u>	<u>299,894</u>	<u>1,900</u>	<u>(185,990)</u>	<u>248,244</u>
<b>Three-month period ended September 30, 2006 (unaudited):</b>						
Balance - July 1, 2006	131,536	904	299,821	**973	(187,755)	245,479
Receipts on account of government of Israel debt	-	-	73	-	-	73
Benefit value of options program (see Note 6.3)	-	-	-	**927	-	927
Net income for the period	-	-	-	-	1,765	1,765
<b>Balance - September 30, 2006</b>	<u>131,536</u>	<u>904</u>	<u>299,894</u>	<u>1,900</u>	<u>(185,990)</u>	<u>248,244</u>
<b>Nine-month period ended September 30, 2005 (unaudited):</b>						
Balance - January 1, 2005	130,940	699	273,328	***2,232	(224,380)	182,819
Differences (***)	-	-	-	*** (104)	-	(104)
Realization of an investment in an investee	-	-	-	*** (2,128)	-	(2,128)
Receipts on account of government-of Israel debt	-	-	25,791	-	-	25,791
Exercise of options into shares	378	127	-	-	-	505
Net income for the period	-	-	-	-	63,574	63,574
<b>Balance - September 30, 2005</b>	<u>131,318</u>	<u>826</u>	<u>299,119</u>	<u>-</u>	<u>(160,806)</u>	<u>270,457</u>
<b>Three-month period ended September 30, 2005 (unaudited):</b>						
Balance - July 1, 2005	131,318	826	299,119	-	(212,977)	218,286
Net income for the period	-	-	-	-	52,171	52,171
<b>Balance - September 30, 2005</b>	<u>131,318</u>	<u>826</u>	<u>299,119</u>	<u>-</u>	<u>(160,806)</u>	<u>270,457</u>

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**INTERIM STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

	Share capital	Share premium	Capital reserve		Accumulated deficit	Total
			(*)	(**)		
(in thousand US dollars)						
<b>Year ended</b>						
<b>December 31, 2005</b>						
<b>(unaudited):</b>						
Balance - January 1, 2005	130,940	699	273,328	***2,232	(244,380)	182,819
Differences (***)	-	-	-	*** (104)	-	(104)
Realization of an investment in an investee	-	-	-	***(2,128)	-	(2,128)
Receipts on account of government of Israel debt	-	-	25,791	-	-	25,791
Exercise of options into shares	378	127	-	-	-	505
Benefit value of options program (see Note 6.3)	-	-	-	-	-	-
Net income for the year	-	-	-	-	64,126	64,126
<b>Balance –December 31, 2005</b>	<u>131,318</u>	<u>826</u>	<u>299,119</u>	<u>-</u>	<u>(160,254)</u>	<u>271,009</u>

- (\*) From transactions with the former controlling party.  
(\*\*) From an employee options program.  
(\*\*\*) From the translation of investees' financial statements.

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS**

	Nine-month period ended September 30		Three-month period ended September 30		Year ended December 31
	2006	2005	2006	2005	2005
	(unaudited)				(audited)
	(in thousand US dollars)				
<b>CASH FLOWS –</b>					
<b>OPERATING ACTIVITIES</b>					
Net income (loss) for the period	(25,736)	63,574	1,765	52,171	64,126
Adjustments required to present net cash flows provided by operating activities (Appendix A)	74,843	*96,756	(16,128)	*2,866	119,493
<b>Net cash provided by (used for) operations activities (*)</b>	49,107	160,330	(14,363)	55,037	183,619
<b>CASH FLOWS –</b>					
<b>INVESTING ACTIVITIES</b>					
Proceeds from realization of investments in investees	-	12,800	-	-	13,656
Investment in other assets	(901)	(1,031)	-	-	(1,485)
Additions to fixed assets (including payments on account of aircraft purchases)	(83,786)	(33,287)	(24,012)	(10,077)	(82,822)
Proceeds from disposition of fixed assets	6,690	535	6,302	338	954
Decrease (increase) in short-term deposits, net	49,094	(87,929)	15,500	(12,718)	(26,428)
Investment in long-term deposits	(151)	(245)	(50)	(65)	(368)
Realization of long-term deposits	489	384	121	42	678
Investment in supplier deposits	(46)	(35)	-	(35)	(121)
Redemption of supplier deposits	41	41	40	39	130
Dividends received, net of investees' earnings, net	-	22	-	-	-
Decrease (increase) in investments and loans to investees, net	327	150	-	(2)	151
<b>Net cash provided by (used for) investing activities, net</b>	(28,243)	(108,595)	(2,099)	(22,478)	(95,655)
<b>CASH FLOWS –</b>					
<b>FINANCING ACTIVITIES</b>					
Proceeds from exercise of options into shares	296	505	-	-	505
Receipt of long-term loans from financial institutions	-	-	-	-	14,169
Repayment of long-term loans from financial institutions	(48,110)	(46,807)	(19,635)	(19,390)	(77,160)
Receipt of another long-term loan	488	-	488	-	-
Repayment of another long-term loan	(1,599)	(1,507)	(564)	(505)	(2,017)
Net increase (decrease) in short term bank borrowings	(2,501)	*4,165	(1,561)	*1,139	5,821
<b>Net cash used for financing activities</b>	(51,426)	(43,644)	(21,272)	(18,756)	(58,682)
<b>Increase (decrease) in cash and cash equivalents</b>	(30,562)	8,091	(37,734)	13,803	29,282
<b>Cash and cash equivalents at the beginning of the period</b>	93,929	64,647	101,101	58,935	64,647
<b>Cash and cash equivalents at the end of the period</b>	63,367	72,738	63,367	72,738	93,929
(*) Reclassified.					
(**) Without depositing the issuance proceeds in the severance-pay fund for covering past liabilities.	45,402	160,865	(14,353)	55,057	184,154

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**CONDENSED CONSOLIDATED INTERIM STATEMENT OF CASH FLOWS**

	Nine-month period ended September 30		Three-month period ended September 30		Year ended December 31
	2006	2005	2006	2005	2005
	(unaudited)				(audited)
	(in thousand US dollars)				
<b>Appendix A - Adjustments required to present net cash flows provided by operating activities</b>					
<b>Income and expenses not involving cash flows:</b>					
Depreciation and amortization (including disposals of accessories, components no longer in use and consumption of supplies)	89,567	79,970	30,481	26,692	108,269
Adjustment in the value of long-term deposits	(119)	114	(56)	10	108
Equity in losses (earnings) of affiliates, net of dividends received (**)	(129)	-	(34)	(133)	(273)
Increase (decrease) in accrued severance pay, net	1,523	(3,613)	(1,819)	(4,262)	(10,298)
Increase in capital reserve from an employee options program	1,900	-	927	-	-
Capital gains from disposition of fixed assets, net	(6,092)	(361)	(5,974)	(231)	(590)
Capital gain from realization of investments in investees	-	(8,002)	-	-	(8,297)
Adjustment in value of supplier deposits	(22)	52	-	(5)	(51)
Deferred income taxes	53	-	83	-	(77)
<b>Changes in assets and liabilities:</b>					
Decrease (Increase) in trade accounts receivable	(33,902)	(38,858)	7,113	26,858	(12,667)
Decrease (increase) in receivables and other current assets	(531)	(10,855)	4,594	2,338	(16,087)
Decrease (increase) in inventory	3,373	(3,065)	1,044	(752)	(12,970)
Increase (decrease) in trade accounts payable	(7,780)	3,960	81	(13,615)	18,920
Increase (decrease) in payables and other current assets	27,016	*77,511	(52,557)	*(33,940)	53,566
Decrease in other long-term liabilities	(14)	(97)	(11)	(94)	(60)
	<u>74,843</u>	<u>96,756</u>	<u>(16,128)</u>	<u>2,866</u>	<u>119,493</u>
(*) Reclassified.					
(**) Dividends received	<u>-</u>	<u>360</u>	<u>-</u>	<u>-</u>	<u>360</u>
<b>Appendix B – Non-cash transactions</b>					
Government deposits to the employees' severance-pay fund	<u>775</u>	<u>25,791</u>	<u>73</u>	<u>-</u>	<u>25,791</u>

The accompanying notes are an integral part to the condensed interim financial statements.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING RULES AND ACCOUNTING POLICY**

**1.1** The interim financial statements have been prepared in a condensed format, in conformity with the accounting principles generally accepted for the preparation of interim financial statements, as prescribed by Standard No.14 of the Israeli Accounting Standards Board and Chapter D of the Israeli Securities Regulations (Preparation of Periodic and Immediate Financial Statements), 1970. The significant accounting policies adopted in the Company's 2005 audited annual financial statements have been consistently applied during the reported period, except for the notation made in item 1.3 below. These interim financial statements should be read in conjunction with the 2005 annual financial statements, including their accompanying notes.

**1.2** Changes in the consumer-price index (CPI) and the Dollar/NIS and Dollar/Euro exchange rates:

	<u>CPI (in points)</u>	<u>\$/NIS</u>	<u>\$/€</u>
September 30, 2006	186.5	4.302	0.789
September 30, 2005	184.2	4.598	0.832
December 31, 2005	185.1	4.603	0.845
<b>Change - %:</b>		<b>%</b>	
Nine-month period ended:			
September 30, 2006	0.8	(6.5)	(6.6)
September 30, 2005	1.9	6.7	13.5
Three-month period ended:			
September 30, 2006	(0.8)	(3.1)	0.3
September 30, 2005	1.4	0.5	0.5
Year ended December 31, 2005	2.4	6.8	15.3

**1.3 Initial implementation of new accounting standards**

**1.3.1 Accounting Standard No.21 - Earnings per share**

In February 2006 the Israeli Accounting Standards Board issued Accounting Standard No. 21 ("Earnings per Share"), which went into effect on January 1, 2006. Upon the introduction of this standard, Opinion No. 55 of the Institute of Certified Public Accountants in Israel on EPS was superseded. The standard establishes that an entity is to compute its basic EPS in regard to income or loss attributable to holders of ordinary shares of the reporting entity, and that the entity shall compute its basic EPS with respect to any income or loss from continuing operations attributable to holders of ordinary shares. Basic EPS are to be computed by dividing income or loss attributed to holders of ordinary shares of the reporting entity (numerator), by the weighted average of the outstanding ordinary shares (denominator) during the period. In its computation of diluted EPS the entity must adjust its income or loss attributable to holders of ordinary shares and the weighted average of the outstanding shares for the effects of all the dilutive potential ordinary shares. According to the standard, which will apply to financial statements covering periods starting January 1, 2006 and thereafter, its provisions are to be applied retroactively in respect of comparative EPS data relating to prior periods. Pursuant to the standard's provisional rules, the Company restated its EPS data pertaining to prior periods and, consequently, its basic EPS for 2005 and for the nine and three-month periods ended on September 30, 2005 rose by \$0.03, \$0.03 and \$0.02, respectively. The fully diluted EPS for 2005 and the nine and three-month periods ended September 30, 2005 remained unchanged.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING RULES AND ACCOUNTING POLICY (Cont.)**

**1.3 Initial implementation of new accounting standards (cont.)**

**1.3.2 Accounting Standard No. 22 - Financial Instruments: Disclosure and Presentation:**

At the end of July 2005 the Israeli Accounting Standards Board published Accounting Standard No. 22 ("Financial Instruments: Disclosure and Presentation"), which went into effect on January 1, 2006, establishing the rules for presentation of financial instruments in the financial statements and outlining the disclosure required in respect thereof. The presentation requirements pertain to the classification of financial instruments as financial assets, financial liabilities or capital instruments. It also addresses the classification of related interest, dividends, losses and profits and to the circumstances under which financial assets and liabilities are to be offset. The standard cancelled, upon its introduction, Opinion No.53 ("Accounting Treatment of Convertible Liabilities") and Opinion no. 48 ("Accounting Treatment of Options"). The effect of the standard on the Company's financial position and results of operations has not been material.

**1.3.3 Accounting Standard No.24 - Stock-Based Payment**

In September 2005 the Israeli Accounting Standards Board published Accounting Standard No. 24 ("Stock-Based Payment"), which went into effect on January 1, 2006, requiring the recognition in financial statements of share-based payments, including transactions with employees or other parties to be settled in cash, other assets or equity instruments; consequently, among other things, expenses incurred in respect of share grants and options given to employees over the vesting period of those grants based on the fair value of each grant at the time granted. The standard establishes measuring rules as well as specific requirements pertaining to transactions with share-based payment which are settled with equity instruments and payment transactions which provide each one of the parties a choice between settling the transaction in cash or in equity instruments. The standard also establishes various disclosure requirements in regard to the share-based payments.

As for stock-based payment transactions settled in cash, the standard requires measuring the acquired merchandise or services and the created liability based on the latter's fair value. Until the liability is paid, its fair should be re-measured at any reporting date and when paying the liability, with any changes therein recognized as income or loss in the period.

With respect to transactions with employees and others who provide similar services, the Standard mandates measurement of fair value on the date of the grant of the capital instruments granted.

As for the standard's implementation in regard to the employee options program on which it was decided during the reported period starting the second quarter of 2006 - see Note 6.3.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING RULES AND ACCOUNTING POLICY (Cont.)**

**1.3 Initial implementation of new accounting standards (cont.)**

**1.3.4 Accounting Standard No.25 - Revenues**

In February 2006 the Israeli Accounting Standard Board published Accounting Standard No.25 ("Revenues"), which went into effect on January 1, 2006, establishes rules for the recognition, measurement and presentation of revenues arising from the sale of goods, rendering of services and use by others of entity assets yielding interest, royalties and dividends. The standard states that an entity should measure its revenues based on the fair value of the proceeds received and/or entitled to. An entity which had not presented its revenues in the past based on the standard's requirement in regard to reporting in gross amounts (the gross amount billed to the customer) or net (the amount billed less the payment made to the supplier of goods or services) is required to retroactively implement the standard's provisions in respect of the entire income in all of the reported periods as comparative figures in the financial statements covering periods beginning January 1, 2006. Assets and liabilities included in the balance sheet on December 31, 2005 in amounts different than those recognized before this standard's implementation will be adjusted on January 1, 2006 to the amounts recognized based on this standard, with the effect of this adjustment recognized as a cumulative effect of an accounting change at the beginning of the period. The new standard has had no effect on the Company's financial statements.

**1.4 Effect of new accounting standards during the pre-implementation period**

**1.4.1 Accounting Standard No.29 – ("Adoption of International Financial Reporting Standards")**

In July 2006 the Israeli Accounting Standards Board published Accounting Standard No.29 ("Adoption of International Financial Reporting Standards" - IFRS), which establishes that the financial statements of entities subject to the Israeli Securities Law and its reporting requirements, other than foreign corporations defined therein, will be prepared for reporting periods starting January 1, 2008 in accordance with the IFRS and their related clarifications published by the International Accounting Standards Board). An entity implementing the IFRS starting January 1, 2008 and electing to report comparative figures strictly for 2007 in accordance with the IFRS will be obliged to prepare an opening balance sheet at January 1, 2007 based on the IFRS. The transition to reporting according to the IFRS will be carried out in accordance with IFRS No.1 ("Initial Adoption of IFRS Standards"), which outlines rules for implementing the transition from financial reporting based on domestic accounting principles to reporting in accordance with the IFRS. IFRS No. 1 supercedes any transitional rules established in other IFRS (including those established in former domestic accounting standards), stating that all IFRS should be adopted retroactively for the opening balance sheet; nevertheless, IFRS No.1 grants allowances on certain issues by not applying the retroactive application in respect thereof. In addition, it contains certain exceptions in regard to the retroactive applications of certain aspects stipulated in other IFRS. Management is currently examining the effect of the transition to the IFRS standards yet is unable at this stage to assess its magnitude on the financial statements. The standard enables entities to chose between the preparation of their financial statements by the IFRS standards before January 1, 2008 for financial statements published subsequent to July 31, 2006. Management has not yet decided whether to adopt the IFRS standard early.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING RULES AND ACCOUNTING POLICY (Cont.)**

**1.4 Effect of new accounting standards during the pre-implementation period (cont.)**

**1.4.2 Accounting Standard No. 27 – Fixed Assets**

During the month of September 2006, the Israeli Accounting Standards Board published Accounting Standard Number 27, "Fixed Assets" (hereafter- "the Standard"), which stipulates the accounting treatment of fixed assets, including the recognition of assets, determining their value in the accounts and the depreciation expenses and losses from impairment of value which will be recognized with respect to them. Additionally, the Standard states the disclosure that is necessary in the financial statements in connection with the fixed assets of an entity. Among other things, the Standard stipulates the following:

An item of fixed assets will be measured at the time of initial recognition at cost which includes, in addition to the purchase price of the asset, all of the costs which can be directly attributed to bringing that item to the location and condition that are necessary in order to enable it to operate in the manner intended by management. In addition, the cost is composed of the initial estimate of the costs to dismantle and remove the item and to restore the location of the item as to which the entity had an obligation when the item was acquired, or as the result of using it over a specific period other than for the purpose of producing inventory during that same period.

The cost of an overall renovation ("overhaul") of the engine of an aircraft will be charged as an asset in the balance sheet and will be depreciated over the period of economic benefit derived from this renovation. The accounting policy currently being followed is to record the cost of the renovation as an expense at the time that the renovation is performed.

The Standard stipulates that upon purchasing fixed assets in exchange for a non-monetary asset or non-monetary assets or in consideration of a combination of monetary assets and non-monetary assets, the cost will be measured according to fair value, except if (a) the exchange transaction has no commercial substance or (b) the fair value of the asset received and the asset conferred cannot be reliably measured. Should the asset purchased not have been measured on the basis of fair value, its cost will be set according to the book value of the asset conferred.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING RULES AND ACCOUNTING POLICY (Cont.)**

**1.4 Effect of new accounting standards during the pre-implementation period (cont.)**

**1.4.2 Accounting Standard No. 27 – Fixed Assets (cont.)**

After the initial recognition, the Standard permits the entity to select whether to implement measurement of fixed assets as part of its accounting policies either by the cost method or the revaluation method, as long as this policy is implemented for all items of fixed assets from the same group.

- Under the cost method, an item of fixed assets is presented at its cost, less accumulated depreciation and less cumulative losses from impairment of value.
- Under the revaluation method, an item of fixed assets, the fair value of which can be determined in a reliable manner, will be presented at a revalued amount, which is equivalent to its fair value on the date of the revaluation, less depreciation accumulated thereafter, and less cumulative losses from impairment of value. Revaluations will be carried out on a regular basis which is sufficient to assure that book value is not materially different from the value which would have been determined at fair value as of the balance sheet date. If an item of fixed assets is revalued, the entire group of fixed assets to which the asset pertains must be revalued. Should the book value of an asset increase as the result of a revaluation, the increase is to be recorded directly to shareholders' equity, under the heading of Revaluation Surplus. At the same time, the increase will be recognized in operating results up to the amount by which it cancels a decrease which resulted from a revaluation of that same asset which had previously been recognized in operating results. If the book value of the asset decreases as the result of a revaluation, the decrease will be recognized in operating results. Nevertheless, the decrease will be recorded directly to shareholders' equity under the heading of Revaluation Surplus up to the amount as to which any credit balance with relation to such asset exists in Revaluation Surplus.

Each part of a fixed asset that has a cost which is significant in relation to the total cost of the item should be depreciated separately.

The method of depreciation which is used for an asset and the salvage value determined for the asset should, at a minimum, be reviewed as of the end of each fiscal year and, should a substantial change have taken place in the pattern of utilization of the anticipated future economic benefits incorporated in the asset, the method should be changed in order to reflect these changes. Such change should be treated as a change in accounting estimate.

In accordance with the provisions of the Standard, this Standard will apply to financial statements which relate to periods which commence on January 1, 2007 and thereafter, and will be applied in the manner of retroactive implementation, except for an entity which, as of January 1, 2007, selects the revaluation method as its accounting policy with respect to a group of fixed assets, so that the difference between the revalued book value of the asset as of that date and its cost, represents the Revaluation Surplus on that date.

The Company is assessing the new Standard, including the choice between the cost method and the revaluation method, but is unable, at this stage, to approximate the effect of the Standard, if at all, on its financial condition, results of operations and cash flows.

**EL AL ISRAEL AIRLINES LTD.  
NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1 - REPORTING RULES AND ACCOUNTING POLICY (Cont.)**

**1.4 Effect of new accounting standards during the pre-implementation period (cont.)**

**1.4.3 Accounting Standard No. 26 – Inventory**

During the month of August 2006, the Israeli Accounting Standards Board published Accounting Standard Number 26, "Inventory" (hereafter- "the Standard"), which stipulates the accounting treatment of inventory.

The Standard applies to all types of inventory, with the exception of the inventory of buildings for sale, to which Accounting Standard Number 2 applies, the construction of buildings for sale, the inventory of work in process deriving from performance contracts, to which Accounting Standard Number 4 applies, works in accordance with a performance contract, financial instruments and biological assets which are related to agricultural operations and to agricultural production during harvest.

The Standard states, among other things, that inventory will be measured at the lower of cost or net realizable value. The cost of the inventory will be determined according to the first-in-first-out (FIFO) method or by means of a weighted average of cost, with consistent use of the same cost formula for all inventory with the same characteristics and uses. In certain cases, the Standard requires that the cost of the inventory be determined by specific identification of its costs. The cost of the inventory includes all purchase costs, production costs and other costs which were incurred in bringing the inventory to its current location and condition.

In instances in which the inventory was purchased under credit terms, when the arrangement includes a financing component, the inventory will be presented at cost which is equivalent to the purchase cost in cash and the financing element will be recognized as financing expenses over the credit period.

The amount of any decline in value of inventory to its net realizable value and all losses related to inventory are recognized in operating results for the period in which they take place. The amount of the cancellation of any decline in value of inventory, which results from a rise in net realizable value, is recognized in the results of operations for the period in which the cancellation takes place.

In accordance with the provisions of the Standard, this Standard will apply to financial statements which relate to periods commencing on January 1, 2007 or thereafter, and it will be applied in the manner of retroactive implementation. In the estimation of the Company, the Standard will have no effect on the financial condition, results of operations and cash flows of the Company.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 2 - GENERAL**

- 2.1** On July 19, 2006 the Company reported within the framework of immediate reporting that the market adverse conditions, along with high jet-fuel prices, had persisted. Consequently, and also in light of the security situation in Israel, the Company believes that these factors are likely to meaningfully affect its 2006 results, leading to a (not-yet-estimated) loss, especially in light of the uncertainty associated with the present security situation. These forecasts stem mainly from an additional meaningful deterioration in the market conditions and competitive business environment, along with the rising jet-fuel prices and worsening security situation in Israel, with its potential ramifications on the Israeli economy in general and the Company's activity in particular as well as the estimates and forecasts in regard to expected trends and developments in the aviation industry in the third and fourth quarter of 2006.
- 2.2** On January 16, 2006 the Minister of Tourism ("the Minister") announced his decision to comply with the request of Israir Aviation and Tourism Ltd., ("Israir") and appoint it as the State of Israel's additional designated carrier on the Tel Aviv - New York route and, accordingly expand its commercial license. Israir will now be licensed to carry out scheduled flights over a 24-month period and it was noted in the decision that "during this period the Minister will examine the ramifications arising from the addition of a designated carrier as well as additional relevant considerations applicable to this route".

The Company's management believes that the Minister's decision violates the authorities' commitment given to the Company before its privatization on the basis of a government resolution (subsequently approved by the High Court of Justice) and that there is no legal and/or economic justification to this departure from this commitment. Accordingly, on January 29, 2006, the Company filed a motion with the High Court of Justice, asking the court to establish that the Minister's decision lacked legal grounds and should thus be revoked. On February 23, 2006 the court rejected this motion of the Company.

- 2.3** On September 5, 2006, the Company, the Histadrut and the employees' representatives signed a special collective agreement which extends the effective date of the special collective agreement for permanent Company employees ("the A generation agreement") through December 31, 2007. On October 5, 2006, the Board of Directors of the Company approved this agreement. Concurrently, due to the economic condition of the Company, the management of the Company entered into negotiations with the representatives of the employees for purposes of finding joint and concurred solutions to making the Company more cost-effective.
- 2.4** On August 16, 2006 the audit committee and the board ratified an amendment to the CEO's employment contract, based on which the agreement's expiry date was established as December 31, 2010.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 2 - GENERAL**

**2.5** In February 2006, the U.S. Department of Justice Antitrust Division (“Antitrust Division”), together with additional competition Authorities of other countries, commenced an international investigation into an alleged price fixing conspiracy relating to certain surcharges included in tariffs for carrying air cargo. Numerous air cargo carriers have previously disclosed that they have received grand jury subpoenas in connection with that investigation. On September 27, 2006, the Company received a grand jury subpoena from the Antitrust Division requiring information related to certain pricing practices and surcharges applicable to the Company’s air cargo business. The Antitrust Division has informed the Company that the Company is a subject of its ongoing investigation. Penalties for violating competition laws can be severe, involving both criminal and civil liability. The Company is cooperating with the investigation while carrying out its own internal review of cargo pricing practices, and is not in a position either to predict the outcome of the Antitrust Division investigation or to evaluate the potential financial impact of this investigation at this time. However, outcomes could include administrative or civil injunctive proceedings and/or criminal prosecution, as well as fines, penalties, and/or civil liability.

**NOTE 3 - FIXED ASSETS**

**3.1** During the period of nine months ended September 30, 2006, the Company paid the amount of approximately \$49.3 m to the Boeing Corporation on account of two ordered 777-200 aircraft (Of this amount, the amount of approximately \$11m during the three months ended on September 30, 2006). The two aircraft will be received by the Company in the course of the summer of 2007.

In addition, during the period of nine months ended September 30, 2006, the Company paid an additional \$1.5 m to Boeing for the right to order ten 787 aircraft in the future. Subsequent to the balance sheet date, the Company decided not to enter into a binding agreement with Boeing to purchase the above ten aircraft, and, at the same time, received notification from Boeing of the refund of the aforementioned deposit which had been paid by the Company.

**3.2** In July 2006, the Company sold a 747- 200 cargo aircraft which it had owned. It recorded a capital gain on the transaction of approximately \$5.9 m in the financial statements for the third quarter of the year 2006.

**NOTE 4 - SEASONAL FACTORS**

The passenger traffic at Ben-Gurion Airport is characterized by strong seasonality, with the prime activity taking place during the summer months, peaking in July-September. The winter months (January-March) are characterized by slow passenger traffic, but strong export of agricultural produce to Europe.

The Second Lebanese War, which took place during the months of July- August 2006, led to a decrease at the rate of approximately 7% in passenger traffic at Ben Gurion Airport during the period of the third quarter of 2006 as compared to the same period the previous year.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 5 - ACCRUED SEVERANCE PAY, NET**

During the nine-month period ending September 30, 2006 the Government of Israel deposited a total of \$775 thousand to the severance-pay fund of the eligible employees, in respect of the proceeds it had received from the exercise of options. Of this amount, the amount of approximately \$ 73 thousand during the period of three months ended on September 30, 2006.

These deposits, which were made within the framework of the Company's agreement with the government and the employees, were recorded to "capital reserve from transactions with a former controlling party". As for the Company's deposits of proceeds from the exercise of options (Series 1) to the severance-pay fund - see Note 6.1.

**NOTE 6 - SHARE CAPITAL AND SHARE PREMIUM**

- 6.1** During the nine-month period ended September 30, 2006, the public exercised 1,003,247 options (Series 1) into an identical number of ordinary shares of NIS 1.00 par-value each, with the Company's proceeds - \$296 thousand - deposited to the eligible employees' severance-pay fund.
- 6.2** On March 23, 2006 the General Meeting ratified an increase of NIS 54,279,453 in the Company's authorized share capital, bringing the total to NIS 550,000,001, divided into one special State share of NIS 1.00 par value and 550,000,000 registered-in-name par-value ordinary shares of NIS 1.00 each.
- 6.3** On February 26, 2006 the Company's board of directors adopted an employee and officer options program of 17,092,129 options, exercisable into up to 17,092,129 ordinary shares of NIS 1.00 par value each, subject to adjustments. The board will be authorized to increase the number of options from time to time. Concurrently, the board also ratified the allotment of NIS 17,092,129 options to 50 recipients, including 10 officers and 40 other managers. The officers' allotment, which has also been approved by the audit committee on February 26, 2006, is subject to the ratification of the General Meeting for increasing the Company's authorized share capital. This ratification, along with the allotment, took place on March 23, 2006. These options, which were allotted within the framework of a capital-gains track with a trustee in accordance with Section 102 of the Income Tax Ordinance, will not register for trade on a stock exchange but the shares emanating from their exercise will. The options will be fully vested and available for exercise in equal installments over a four-year period starting January 1, 2007 (one-quarter of the options will be vested during each year), so long as the recipient is still employed by the Company or provides services on vesting date. Unexercised options will expire at the end of three years following vesting date. Each option's theoretical price (i.e., an amount not actually paid by the employee) will be NIS 2.9733. Upon exercise, the employee would be eligible to receive a number of shares equaling the difference between the exercise share (an ordinary share's closing price on the Tel Aviv Stock Exchange on exercise-notice date) and the theoretical exercise price (the later subject to customary adjustments made upon dividend distribution and changes in a company's capital structure).

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 6 - SHARE CAPITAL AND SHARE PREMIUM (Cont.)****6.3 (Cont.)**

According to the provisions of Accounting Standard No. 24 ("Stock-Based Payment") of the Israeli Accounting Standards Board, the Company would record option-granting expenses based on their economic value and computed by the Black & Scholes model. The expenses is recorded over the batch's "thawing" period, with the level of the expense constituting a function of the number of options granted as well as the economic value of each option.

The computation of the option's value has been made based on the program's terms and subject to the following assumptions:

- The share price equals market closing price on March 23, 2006 (NIS 3.837).
- Exercise price equals 85% of share price on February 26, 2006 (NIS 2.973).
- The estimated exercise period of each batch has been computed by the average between each batch's vesting period and the expiration date.
- The standard deviation has been computed by the daily yield of the share's market price over the estimated exercise period of each batch (as detailed above). A maximal standard deviation was taken (from the registration of the Company's shares for trade after having neutralized the first trading day) in respect of batches whose life expectancy is longer than the period during which the Company's share is traded.
- Discount rate - the yield on unlinked debentures ("Shachar") applicable to each batch's estimated life expectancy.

Following the resignation of a senior employee during the reporting period, and the expiration of part of the options which were granted to him, 16,173,825 options remained within the framework of the program.

Based on the above assumptions, the Company would bear a total of NIS 28,287 thousand (\$6.6m on the balance-sheet date) in respect of this program, reflecting - based on the Black & Scholes model - an average option price of NIS 1.75.

During the period of nine months ended on September 30, 2006, the Company recorded expenses related to the program in the amount of 1,900 thousand dollars (of which 927 thousand dollars was incurred during the third quarter of 2006), recorded against a capital reserve.

On May 23, 2006 the Company's board of directors decided to increase the number of the employee options program by an additional 3m non-marketable options which may be exercised into up to 3m ordinary shares of NIS 1.00 par value each.

The Company's board of directors appointed the Human Resources Appointment Committee to manage the 2006 options program, empowering it allot the abovementioned options to Company officers in accordance with parameters established by the board.

The options' theoretical exercise price will equal 85% of the average closing price on the Tel Aviv Stock Exchange of an ordinary share during the 30 days preceding the program manager's decision, except for recipients acting as vice president or head of division on March 23, 2006 and who had not received any options based on the allotment resolution of March 2006, in respect of which a theoretical price of NIS 2.9733 had been established.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 7 - CONTINGENT LIABILITIES**

The following two lawsuits were approved by the court in previous years as class action:

- 7.1** In October 1998, a lawsuit for NIS 230.4m (\$54m on the balance-sheet date) was filed in the Nazareth District Court against the Company along with a request to recognize it as a class action. The claim alleged airline ticket over-pricing by travel agents using improper exchange rates. In 2002 the court approved the request as class action for the Consumer Protection Law purposes. The Company filed a request to be permitted to appeal to the Supreme Court. In the opinion of management, based on the advice of legal counsel, it is not possible at this stage to assess the outcome of this challenge to the decision to treat the case as a class action and of the claim itself should the appeal not be approved. No provision has been included in these financial statements in respect thereof.
- 7.2** A lawsuit for NIS 21.7m (\$5.0m on the balance-sheet date ) was filed in September 1999 with the Tel Aviv District Court against the Company, the Airports Authority and Ophir Tours (a travel agency), together with a request for recognition as a class action. The plaintiff alleges that the travel agent charged travel tax at a rate above the legal limit, which is the shekel's representative exchange rate. In 2002 the court approved the request for class action under Regulation 29 of the civil law. The Company filed a request to be permitted to appeal to the Supreme Court.

In October 2005 the Supreme Court ruled in the case of A.S.T that a class action would strictly emanate from specific legislations and that it is not available under Regulation 29 of the civil code. Accordingly, the parties were requested by the court to submit their motions on how to continue with the proceedings. The plaintiff informed the court that she wanted to continue proceedings under the Consumer Protection Law, which had not approved by the district court. The Supreme Court has not yet ruled on this matter. Based on the advice of its legal counsel, management believes that - at this stage - it is not possible to assess the outcome of this appeal and the claim itself. No provision has been included in these financial statements in respect thereof.

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 8 - OPERATING SEGMENTS**

<b>Geographical segments - consolidated</b>	<b>North America</b>	<b>Europe</b>	<b>Central Asia &amp; Far East</b>	<b>Rest of the world</b>	<b>Total</b>
<b>(in thousand US dollars)</b>					
<b>Nine-month period ended September 30, 2006 (unaudited)</b>					
Revenues -					
Segment revenues	<u>441,248</u>	<u>541,383</u>	<u>216,579</u>	<u>28,528</u>	1,227,738
Revenues not allocated by segment					<u>21,012</u>
Total revenues (consolidated)					<u>1,248,750</u>
Operating income -					
Operating income, by segment	<u>11,849</u>	<u>73,934</u>	<u>27,491</u>	<u>8,725</u>	121,999
Net corporate expenses					<u>(128,839)</u>
Operating loss, before financing expenses (consolidated)					<u>(6,840)</u>
<b>Three-month period ended September 30, 2006 (unaudited)</b>					
Revenues -					
Segment revenues	<u>162,443</u>	<u>192,963</u>	<u>73,378</u>	<u>10,781</u>	439,565
Revenues not allocated by segment					<u>7,436</u>
Total revenues (consolidated)					<u>447,001</u>
Operating income -					
Operating income by segment	<u>7,544</u>	<u>29,133</u>	<u>3,839</u>	<u>3,801</u>	44,317
Net corporate expenses					<u>(40,024)</u>
Operating loss, before financing expenses (consolidated)					<u>4,293</u>

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 8 - OPERATING SEGMENTS (Cont.)**

<b>Geographical segments - consolidated</b>	<b>North America</b>	<b>Europe</b>	<b>Central Asia &amp; Far East</b>	<b>Rest of the world</b>	<b>Total</b>
	<b>(in thousand US dollars)</b>				
<b>Nine-month period ended September 30, 2005 (unaudited)</b>					
Revenues -					
Segment revenues	<u>439,482</u>	<u>545,382</u>	<u>196,803</u>	<u>26,025</u>	1,207,692
Revenues not allocated by segment					<u>19,581</u>
Total revenues (consolidated)					<u><u>1,227,273</u></u>
Operating income -					
Operating income by segment	<u>56,272</u>	<u>132,104</u>	<u>24,011</u>	<u>8,843</u>	221,230
Net corporate expenses					<u>(137,451)</u>
Operating income, before financing expenses (consolidated)					<u>83,779</u>
<b>Three-month period ended September 30, 2005 (unaudited)</b>					
Revenues -					
Segment revenues	<u>181,894</u>	<u>222,710</u>	<u>64,466</u>	<u>9,834</u>	478,904
Revenues not allocated by segment					<u>6,282</u>
Total revenues (consolidated)					<u><u>485,186</u></u>
Operating income -					
Operating income by segment	<u>34,696</u>	<u>62,390</u>	<u>8,671</u>	<u>3,686</u>	109,443
Net corporate expenses					<u>(44,879)</u>
Operating income, before financing expenses (consolidated)					<u>64,564</u>

**EL AL ISRAEL AIRLINES LTD.**  
**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 8 - OPERATING SEGMENTS (Cont.)**

<b>Geographical segments - consolidated</b>	<b>North America</b>	<b>Europe</b>	<b>Central Asia &amp; Far East</b>	<b>Rest of the world</b>	<b>Total</b>
	<b>(in thousand US dollars)</b>				
<b>Year ended December 31, 2005 (audited)</b>					
Revenues -					
Segment revenues	<u>568,289</u>	<u>710,265</u>	<u>277,101</u>	<u>34,853</u>	1,590,508
Revenues not allocated by segment					<u>28,961</u>
Total revenues (consolidated)					<u>1,619,469</u>
Operating income -					
Operating income by segment	<u>58,501</u>	<u>166,379</u>	<u>33,765</u>	<u>11,555</u>	270,200
Net corporate expenses					<u>(181,278)</u>
Operating income, before financing expenses (consolidated)					<u>88,922</u>

**NOTE 9 - SUBSEQUENT EVENT**

In October 2006, the Company signed an agreement with a foreign bank for the receipt of financing in the amount of approximately \$80m , against a lien on two 747- 400 aircraft (with an option for an additional \$10m for each aircraft in order to finance the conversion to cargo- should it be decided to convert them to cargo). The Company has the right to withdraw the funds until the month of November 2007. The amounts to be received could be used to reschedule part of the existing loans or for other investments, as the Company will see fit at the time that it withdraws the loans. The financing is for a period of 10 years from the first withdrawal, with quarterly repayments of principal plus interest. The Company intends to withdraw \$40 m in this context by the end of the month of November 2006.