

RENT A CENTER INC DE
Form 10-K
March 10, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K
FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTIONS 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

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

Commission File No. 0-25370

Rent-A-Center, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

45-0491516

*(I.R.S. Employer
Identification No.)*

5700 Tennyson Parkway,

Suite 100

Plano, Texas 75024

972-801-1100

*(Address, including zip code, and telephone number,
including area code, of registrant's principal executive offices)*

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

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.01 per share

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

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

Aggregate market value of the 72,471,232 shares of Common Stock held by non-affiliates of the registrant at the closing sales price as reported on the National Association of Securities Dealers Automated Quotation System National Market System on June 30, 2005

\$1,687,854,993

Number of shares of Common Stock outstanding as of the close of business on March 8, 2006:

69,243,331

Documents incorporated by reference:

Portions of the definitive proxy statement relating to the 2006 Annual Meeting of Stockholders of Rent-A-Center, Inc. are incorporated by reference into Part III of this report.

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PART I

Item 1. Business.

Overview

Unless the context indicates otherwise, references to we, us and our refers to the consolidated business operations of Rent-A-Center, Inc., the parent, and all of its direct and indirect subsidiaries.

We are the largest operator in the United States rent-to-own industry with an approximate 33% market share based on store count. At December 31, 2005, we operated 2,760 company-owned stores nationwide and in Canada and Puerto Rico, including 21 stores in Wisconsin operated by our subsidiary Get It Now, LLC under the name Get It Now and seven stores located in Canada operated by our subsidiary Rent-A-Centre, Ltd., under the name

Rent-A-Centre. One of our other subsidiaries, ColorTyme, Inc., is a national franchisor of rent-to-own stores. At December 31, 2005, ColorTyme had 296 franchised stores in 38 states, 288 of which operated under the ColorTyme name and eight of which operated under the Rent-A-Center name. These franchise stores represent an additional 4% market share based on store count.

Our stores generally offer high quality, durable products such as major consumer electronics, appliances, computers and furniture and accessories under flexible rental purchase agreements that generally allow the customer to obtain ownership of the merchandise at the conclusion of an agreed upon rental period. These rental purchase agreements are designed to appeal to a wide variety of customers by allowing them to obtain merchandise that they might otherwise be unable to obtain due to insufficient cash resources or a lack of access to credit. These agreements also cater to customers who only have a temporary need or who simply desire to rent rather than purchase the merchandise. Get It Now offers our merchandise on an installment sales basis in Wisconsin. We offer well known brands such as Sony, Hitachi, JVC, Toshiba and Mitsubishi home electronics, Whirlpool appliances, Dell, Compaq and Hewlett-Packard computers and Ashley, England, Berkline and Standard furniture. We also offer high levels of customer service, including repair, pickup and delivery, generally at no additional charge. Our customers benefit from the ability to return merchandise at any time without further obligation and make payments that build toward ownership. We estimate that approximately 70% of our business is from repeat customers.

We were incorporated in Delaware in 1986. Our principal executive offices are located at 5700 Tennyson Parkway, Suite 100, Plano, Texas 75024. Our telephone number is (972) 801-1100 and our company website is www.rentacenter.com. We do not intend for information contained on our website to be part of this Form 10-K. We make available free of charge on or through our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Additionally, we voluntarily will provide electronic or paper copies of our filings free of charge upon request.

Industry Overview

According to the Association of Progressive Rental Organizations, the rent-to-own industry in the United States of America consists of approximately 8,300 stores, and provides approximately 6.9 million products to over 2.7 million households. We estimate the three largest rent-to-own industry participants account for approximately 4,700 of the total number of stores, and the majority of the remainder of the industry consists of operations with fewer than 20 stores. The rent-to-own industry is highly fragmented and, due primarily to the decreased availability of traditional financing sources, has experienced, and we believe will continue to experience, increasing consolidation. We believe this consolidation trend in the industry presents opportunities for us to continue to acquire additional stores on favorable terms.

The rent-to-own industry serves a highly diverse customer base. According to the Association of Progressive Rental Organizations, approximately 73% of rent-to-own customers have incomes between \$15,000 and \$50,000 per year. Many of the customers served by the industry do not have access to significant amounts of credit. For these customers, the rent-to-own industry provides an alternative for them to obtain

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brand name products. The Association of Progressive Rental Organizations also estimates that 95% of customers have high school diplomas. According to an April 2000 Federal Trade Commission study, 75% of rent-to-own customers were satisfied with their experience with rent-to-own transactions.

The study noted that customers gave a wide variety of reasons for their satisfaction, including the ability to obtain merchandise they otherwise could not, the low payments, the lack of a credit check, the convenience and flexibility of the transaction, the quality of the merchandise, the quality of the maintenance, delivery, and other services, the friendliness and flexibility of the store employees, and the lack of any problems or hassles.

Strategy

We are currently focusing our strategic efforts on:

enhancing the operations, revenue and profitability in our store locations;

opening new and acquiring existing rent-to-own stores;

expanding our financial services business within our existing store locations; and

building our national brand.

Enhancing Store Operations

We continually seek to improve store performance through strategies intended to produce gains in operating efficiency, revenue and profitability. For example, we continue to focus our operational personnel on prioritizing store profit growth, including the effective pricing of rental merchandise and the management of store level operating expenses.

We believe we will achieve further gains in revenues and operating margins in both existing and newly acquired stores by continuing to:

use consumer focused advertising, including direct mail, television, radio and print media, while also utilizing new business relationships and strategic alliances to increase store traffic and expand our customer base;

expand the offering of product lines to appeal to more customers to increase the number of product rentals and grow our customer base;

expand our financial services business within our existing store locations;

evaluate other growth strategies, including the entry into additional lines of business offering products and services designed to appeal to our customer demographic;

employ strict store-level cost control;

analyze and evaluate store operations against key performance indicators; and

use a revenue and profit based incentive pay plan.

Opening New and Acquiring Existing Rent-To-Own Stores

We intend to expand our business both by opening new stores in targeted markets and by acquiring existing rent-to-own stores and store account portfolios. We will focus new market penetration in adjacent areas or regions that we believe are underserved by the rent-to-own industry, which we believe represents a significant opportunity for us. In addition, we intend to pursue our acquisition strategy of targeting under-performing and under-capitalized chains of rent-to-own stores. We have gained significant experience in the acquisition and integration of other rent-to-own operators and believe the fragmented nature of the rent-to-own industry will result in ongoing consolidation opportunities. Acquired stores benefit from our improved product mix, sophisticated management information system, purchasing power and administrative network. In addition, we have potential access to our ColorTyme franchise

locations, possessing the right of first refusal to purchase such franchise locations.

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Since March 1993, our company-owned store base has grown from 27 to 2,760 at December 31, 2005, primarily through acquisitions. During this period, we acquired over 2,500 company-owned stores and over 380 franchised stores in approximately 160 separate transactions, including nine transactions where we acquired in excess of 50 stores.

The following table summarizes the store growth activity over the last three fiscal years:

	2005	2004	2003
Stores at beginning of period	2,875	2,648	2,407
New store openings	67	94	101
Acquired stores remaining open	44	191	160
Closed stores ⁽¹⁾			
Merged with existing stores	170	48	20
Sold or closed with no surviving store	56	10	
Stores at end of period	2,760	2,875	2,648
Acquired stores closed and accounts merged with existing stores	39	111	220
Total approximate purchase price of acquisitions	\$ 38.3 million	\$ 195.2 million ⁽²⁾	\$ 126.1 million

⁽¹⁾ Substantially all of the merged, sold or closed stores in 2005 relate to our store consolidation plan discussed in more detail on p. 30.

⁽²⁾ The total purchase price includes non-cash consideration of approximately \$23.8 million in common stock issued and approximately \$6.1 million in fair value assigned to the stock options assumed in connection with the acquisition of Rent Rite, Inc.

2003 Acquisitions. In February 2003, we acquired substantially all of the assets of 295 stores located throughout the United States from Rent-Way, Inc. and certain of its subsidiaries for approximately \$100.4 million in cash. Of the 295 stores, 176 were merged with existing locations.

2004 Acquisitions. On March 5, 2004, we completed the purchase of five Canadian rent-to-own stores for \$3.2 million Canadian dollars (\$2.4 million U.S. dollars). The five stores are located in the cities of Edmonton and Calgary in the province of Alberta. This acquisition marked the commencement of our business operations in Canada and internationally.

On May 7, 2004, we completed the acquisition of Rent Rite, Inc. for an aggregate purchase price of \$59.9 million. Rent Rite operated 90 stores in 11 states, of which we merged 26 stores with our existing store locations. Approximately 40% of the consideration was paid with our common stock, with the remaining portion consisting of cash, the assumption of Rent Rite's stock options and retirement of Rent Rite's outstanding debt.

On May 14, 2004, we completed the acquisition of Rainbow Rentals, Inc. for an aggregate purchase price of \$109.0 million. Rainbow Rentals operated 124 stores in 15 states, of which we merged 29 stores with our existing store locations. We funded the acquisition entirely with cash on hand.

2005 Store Consolidation. In 2005, we critically evaluated every market in which we operate based on market share, operating results, competitive positioning, and growth potential. As a result, we closed or merged 114 stores and sold 35 stores during the third and fourth quarters of 2005.

2006 Acquisitions. Since December 31, 2005, we have acquired two additional stores and additional accounts from three locations for approximately \$2.3 million and opened an additional nine new stores. We also closed nine stores, merging seven of them with existing stores and selling two, resulting in a total store count of 2,762 at March 8, 2006.

We continue to believe there are attractive opportunities to expand our presence in the rent-to-own industry both nationally and internationally. We intend to increase the number of rent-to-own stores in which we operate by an average of approximately 5% per year over the next several years. We plan to accomplish our future growth through both selective and opportunistic acquisitions and new store development.

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Expanding Our Financial Services Business

In 2005, we began offering an array of financial services in addition to traditional rent-to-own products in our existing rent-to-own stores. These financial services include, but are not limited to, short term, secured and unsecured loans, bill paying, debit cards, check cashing and money transfer services. We believe that traditional financial services providers ineffectively market to our customer base and that an opportunity exists for us to leverage our knowledge of this demographic, as well as our operational infrastructure, into a complementary line of business offering financial services designed to appeal to our customer demographic. As of December 31, 2005, 40 locations in the northwestern United States were offering some or all of these financial services. We intend to offer these financial services in 140 to 200 existing Rent-A-Center store locations by the end of 2006. There can be no assurance that we will be successful in our efforts to expand our operations to include such complementary financial services, or that such operations, should they be added, will prove to be profitable.

Building Our National Brand

We have implemented strategies to increase our name recognition and enhance our national brand. As part of that strategy, we utilize television and radio commercials, print, direct response and in-store signage, all of which are designed to increase our name recognition among our customers and potential customers. In 2005, we also continued to pursue strategic alliances and other sponsorship opportunities, which we believe will further enhance our name recognition. We believe that as the Rent-A-Center name gains familiarity and national recognition through our advertising efforts, we will continue to educate the customer about the rent-to-own alternative to merchandise purchases as well as solidify our reputation as a leading provider of high quality branded merchandise and services.

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At December 31, 2005, we operated 2,760 stores nationwide and in Canada and Puerto Rico. In addition, our subsidiary ColorTyme franchised 296 stores in 38 states. This information is illustrated by the following table:

Number of Stores				Number of Stores			
Location	Company Owned	With Financial Services	Franchised	Location	Company Owned	With Financial Services	Franchised
Alabama	60		5	Nebraska	9		
Alaska	6		1	Nevada	22	3	4
Arizona	56		7	New Hampshire	14		2
Arkansas	35		1	New Jersey	43		4
California	150		5	New Mexico	17		10
Colorado	39		1	New York	128		13
Connecticut	37		3	North Carolina	111		11
Delaware	18			North Dakota	2		
District of Columbia	4			Ohio	175		6
Florida	173		19	Oklahoma	42		14
Georgia	106		14	Oregon	31	5	3
Hawaii	12		4	Pennsylvania	126		3
Idaho	11	7	2	Puerto Rico	30		
Illinois	110		8	Rhode Island	17		1
Indiana	102		7	South Carolina	43		7
Iowa	24			South Dakota	5		
Kansas	31		17	Tennessee	94		1
Kentucky	44		1	Texas	261		59
Louisiana	29		6	Utah	15	4	
Maine	25		9	Vermont	7		
Maryland	63		9	Virginia	54		10
Massachusetts	60		2	Washington	46	16	2
Michigan	107		17	West Virginia	22		
Minnesota	4			Wisconsin	21*		
Mississippi	28		2	Wyoming	5		
Missouri	70		6	Alberta, Canada	7		
Montana	9	5		TOTAL	2,760	40	296

* Represents stores operated by Get It Now, LLC, one of our subsidiaries.

Represents stores operated by Rent-A-Centre, Ltd., one of our subsidiaries.

Our stores average approximately 4,600 square feet and are located primarily in strip centers. Because we utilize just in time strategies and receive merchandise shipments in relatively small quantities directly from vendors, we are able to dedicate approximately 75% of the store space to showroom floor, and also eliminate warehousing costs.

Rent-A-Center Store Operations***Product Selection***

Our stores generally offer merchandise from four basic product categories: major consumer electronics, appliances, computers and furniture and accessories. Although we seek to ensure our stores maintain sufficient inventory to offer customers a wide variety of models, styles and brands, we generally limit inventory to prescribed levels to ensure strict inventory controls. We seek to provide a wide variety of high quality

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merchandise to our customers, and we emphasize high-end products from name-brand manufacturers. For the year ended December 31, 2005, furniture and accessories accounted for approximately 38% of our store rental revenue, consumer electronic products for 34%, appliances for 16% and computers for 12%. Customers may request either new merchandise or previously rented merchandise. Previously rented merchandise is generally offered at the same weekly or monthly rental rate as is offered for new merchandise, but with an opportunity to obtain ownership of the merchandise after fewer rental payments.

Major consumer electronic products offered by our stores include high definition televisions, home theatre systems, video game consoles and stereos from top name-brand manufacturers such as Sony, Hitachi, JVC, Toshiba and Mitsubishi. We offer major appliances manufactured by Whirlpool, including refrigerators, washing machines, dryers, microwave ovens, freezers and ranges. We offer personal and laptop computers from Dell, Compaq and Hewlett Packard. We offer a variety of furniture products, including dining room, living room and bedroom furniture featuring a number of styles, materials and colors. We offer furniture made by Ashley, England, Berkline and Standard and other top name-brand manufacturers. Accessories include pictures, lamps and tables and are typically rented as part of a package of items, such as a complete room of furniture. Showroom displays enable customers to visualize how the product will look in their homes and provide a showcase for accessories.

Rental Purchase Agreements

Our customers generally enter into weekly, semi-monthly or monthly rental purchase agreements, which renew automatically upon receipt of each payment. We retain title to the merchandise during the term of the rental purchase agreement. Ownership of the merchandise generally transfers to the customer if the customer has continuously renewed the rental purchase agreement for a period of 7 to 36 months, depending upon the product type, or exercises a specified early purchase option. Although we do not conduct a formal credit investigation of each customer, a potential customer must provide store management with sufficient personal information to allow us to verify their residence and sources of income. References listed by the customer are also contacted to verify the information contained in the customer's rental purchase order form. Rental payments are generally made in the store in cash, by credit card or debit card. Approximately 86% of our customers pay on a weekly basis. Depending on state regulatory requirements, we charge for the reinstatement of terminated accounts or collect a delinquent account fee, and collect loss/damage waiver fees from customers desiring product protection in case of theft or certain natural disasters. These fees are standard in the industry and may be subject to government-specified limits. Please read the section entitled Government Regulation.

Product Turnover

On average, a minimum rental term of 18 months is generally required to obtain ownership of new merchandise. We believe that only approximately 25% of our initial rental purchase agreements are taken to the full term of the agreement. The average total life for each product is approximately 19 months, which includes the initial rental period, all re-rental periods and idle time in our system. Turnover varies significantly based on the type of merchandise rented, with certain consumer electronics products, such as camcorders and DVD players and recorders, generally rented for shorter periods, while appliances and furniture are generally rented for longer periods. To cover the relatively high operating expenses generated by greater product turnover, rental purchase agreements require higher aggregate payments than are generally charged under other types of purchase plans, such as installment purchase or credit plans.

Customer Service

We generally offer same day or 24-hour delivery and installation of our merchandise at no additional cost to the customer. We provide any required service or repair without additional charge, except for damage in excess of normal wear and tear. Repair services are provided through our national network of 23 service centers, the cost of which may be reimbursed by the vendor if the item is still under factory warranty. If the product cannot be repaired at the customer's residence, we provide a temporary replacement while the product is being repaired. The customer is fully liable for damage, loss or destruction of the merchandise, unless the

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customer purchases an optional loss/damage waiver covering the particular loss. Most of the products we offer are covered by a manufacturer's warranty for varying periods, which, subject to the terms of the warranty, is transferred to the customer in the event that the customer obtains ownership.

Collections

Store managers use our management information system to track collections on a daily basis. For fiscal years 2005, 2004, and 2003, the average week ending past due percentages were 6.76%, 6.57% and 6.55%, respectively. Our goal was to have no more than 5.99%, 5.99% and 6.50% of our rental agreements past due one day or more each Saturday evening in 2005, 2004 and 2003, respectively. For the 2006 fiscal year, our goal remains the same as in 2005 at 5.99%. If a customer fails to make a rental payment when due, store personnel will attempt to contact the customer to obtain payment and reinstate the agreement, or will terminate the account and arrange to regain possession of the merchandise. We attempt to recover the rental items as soon as possible following termination or default of a rental purchase agreement, generally by the seventh day. Collection efforts are enhanced by the numerous personal and job-related references required of customers, the personal nature of the relationships between store employees and customers and the fact that, following a period in which a customer is temporarily unable to make payments on a piece of rental merchandise and must return the merchandise, that customer generally may re-rent a piece of merchandise of similar type and age on the terms the customer enjoyed prior to that period.

Pursuant to the rental purchase agreements, customers who become delinquent in their rental payments and fail to return the rented merchandise are or may over time become liable for accrued rent through the date the merchandise is finally returned, the amount of the early purchase option, and, if the merchandise is not returned before expiration of the original term of weeks or months to ownership under the rental purchase agreement, then the total balance of payments necessary to acquire ownership of the merchandise. Generally, the remaining book value of the rental merchandise associated with delinquent accounts is charged off on or before the ninetieth day following the time the account became past due. Charge offs due to customer stolen merchandise, expressed as a percentage of store revenues, were approximately 2.5% in 2005, 2.4% in 2004 and 2.3% in 2003.

In December 2004, we sold to certain qualified buyers our right to collect outstanding amounts due, as well as our interest in the merchandise rented, pursuant to delinquent rental purchase agreements that have been charged off in the ordinary course of business as described above. The accounts ranged from approximately one to five years old. We sold such accounts for approximately \$7.9 million, and recorded that amount as other income in our consolidated statement of earnings. In the future, we may again sell charged off accounts. However, there can be no assurance that such sales will occur, or if consummated, will result in material sales proceeds.

Management

We organize our network of stores geographically with multiple levels of management. At the individual store level, each store manager is responsible for customer and account relations, delivery and collection of merchandise, inventory management, staffing, training store personnel and certain marketing efforts. Three times each week, store management is required to count the store's inventory on hand and compare the count to the accounting records, with the market manager performing a similar audit at least quarterly. In addition, our individual store managers track their daily store performance for revenue collected as compared to the projected performance of their store. Each store manager reports to a market manager within close proximity who typically oversees six to eight stores. Typically, a market manager focuses on developing the personnel in his or her market and ensuring all stores meet our quality, cleanliness and service standards. In addition, a market manager routinely audits numerous areas of the stores operations. A significant portion of a market manager's and store manager's compensation is dependent upon store revenues and profits, which are monitored by our management reporting system and our tight control over inventory afforded by our direct shipment practice.

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At December 31, 2005, we had 390 market managers who, in turn, reported to 62 regional directors. Regional directors monitor the results of their entire region, with an emphasis on developing and supervising the market managers in their region. Similar to the market managers, regional directors are responsible for ascertaining whether stores are following the operational guidelines. The regional directors report to nine senior vice presidents located throughout the country. The regional directors and senior vice presidents receive a significant amount of their compensation based on the revenue and profitability of the stores under their management.

Our executive management team at the home office oversees field operations, with an overall strategic focus. The executive management team directs and coordinates advertising, purchasing, financial planning and controls, employee training, personnel matters, acquisitions and new store initiatives. The centralization and coordination of such operational matters allows our store managers to focus on individual store performance. A significant amount of our executive management compensation is determined in part on the profits generated by us.

Management Information Systems

Through a licensing agreement with High Touch, Inc., we utilize an integrated management information and control system. Each store is equipped with a computer system utilizing point of sale software developed by High Touch. This system tracks individual components of revenue, each item in idle and rented inventory, total items on rent, delinquent accounts, items in service and other account information. We electronically gather each day's activity report, which provides our executive management with access to all operating and financial information concerning any of our stores, markets or regions and generates management reports on a daily, weekly, month-to-date and year-to-date basis for each store and for every rental purchase transaction. The system enables us to track all of our merchandise and rental purchase agreements, which often include more than one unit of merchandise. In addition, our bank reconciliation system performs a daily sweep of available funds from our stores' depository accounts into our central operating account based on a formula from bank balances that is reconciled back to the balances reported by the stores. Our system also includes extensive management software, report-generating capabilities and a virtual private network. The virtual private network allows us to communicate with the stores more effectively and efficiently. The reports for all stores are reviewed on a daily basis by management and unusual items are typically addressed the following business day. Utilizing the management information system, our executive management, senior vice presidents, regional directors, market managers and store managers closely monitor the productivity of stores under their supervision according to our prescribed guidelines.

The integration of our management information system, developed by High Touch, with our accounting system, developed by Lawson Software, Inc., facilitates the production of our internal financial statements. These financial statements are distributed monthly to all stores, markets, regions and our executive management team for their review.

Purchasing and Distribution

Our executive management determines the general product mix in our stores based on analyses of customer rental patterns and the introduction of new products on a test basis. Individual store managers are responsible for determining the particular product selection for their store from the list of products approved by executive management. Store and market managers make specific purchasing decisions for the stores, subject to review by executive management, on our online ordering system. Additionally, we have predetermined levels of inventory allowed in each store which restrict levels of merchandise that may be purchased. All merchandise is shipped by vendors directly to each store, where it is held for rental. We do not utilize any distribution centers. These practices allow us to retain tight control over our inventory and, along with our selection of products for which consistent historical demand has been shown, reduce the number of obsolete items in our stores. The stores also have online access to determine whether other stores in their market may have merchandise available.

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We purchase the majority of our merchandise from manufacturers, who ship directly to each store. Our largest suppliers include Ashley and Whirlpool, who accounted for approximately 16.6% and 14.9%, respectively, of merchandise purchased in 2005. No other supplier accounted for more than 10% of merchandise purchased during this period. We do not generally enter into written contracts with our suppliers that obligate us to meet certain minimum purchasing levels. Although we expect to continue relationships with our existing suppliers, we believe that there are numerous sources of products available, and we do not believe that the success of our operations is dependent on any one or more of our present suppliers.

Marketing

We promote the products and services in our stores through direct mail advertising, radio, television and secondary print media advertisements. Our advertisements emphasize such features as product and name-brand selection, prompt delivery and the absence of initial deposits, credit investigations or long-term obligations. In 2005, we also continued to pursue strategic alliances and other sponsorship opportunities, which we believe will enhance our name recognition. Advertising expense as a percentage of store revenue for the years ended December 31, 2005, 2004 and 2003 was approximately 2.9%, 2.8% and 3.1%, respectively. As we obtain new stores in our existing market areas, the advertising expenses of each store in the market can be reduced by listing all stores in the same market-wide advertisement.

Competition

The rent-to-own industry is highly competitive. According to industry sources and our estimates, the three largest industry participants account for approximately 4,700 of the 8,300 rent-to-own stores in the United States. We are the largest operator in the rent-to-own industry with 2,760 stores and 296 franchised locations as of December 31, 2005. Our stores compete with other national and regional rent-to-own businesses, as well as with rental stores that do not offer their customers a purchase option. With respect to customers desiring to purchase merchandise for cash or on credit, we also compete with retail stores. Competition is based primarily on store location, product selection and availability, customer service and rental rates and terms.

Seasonality

Our revenue mix is moderately seasonal, with the first quarter of each fiscal year generally providing higher merchandise sales than any other quarter during a fiscal year, primarily related to federal income tax refunds. Generally, our customers will more frequently exercise their early purchase option on their existing rental purchase agreements or purchase pre-leased merchandise off the showroom floor during the first quarter of each fiscal year. We expect this trend to continue in future periods. Furthermore, we tend to experience slower growth in the number of rental purchase agreements on rent in the third quarter of each fiscal year when compared to other quarters throughout the year. As a result, we would expect revenues for the third quarter of each fiscal year to remain relatively flat with the prior quarter. We expect this trend to continue in future periods unless we add significantly to our store base during the third quarter of future fiscal years as a result of new store openings or opportunistic acquisitions.

ColorTyme Operations

ColorTyme is our nationwide franchisor of rent-to-own stores. At December 31, 2005, ColorTyme franchised 296 rent-to-own stores in 38 states. These rent-to-own stores offer high quality durable products such as home electronics, appliances, computers and furniture and accessories. During 2005, 40 new franchise locations were added, three were closed and 54 were sold, all of which were sold to another Rent-A-Center subsidiary.

All but 8 of the ColorTyme franchised stores use ColorTyme's trade names, service marks, trademarks, logos, emblems and indicia of origin. These 8 stores are franchises acquired in the Thorn Americas acquisition in 1998 and continue to use the Rent-A-Center name. All stores operate under distinctive operating procedures and standards. ColorTyme's primary source of revenue is the sale of rental merchandise to its

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franchisees who, in turn, offer the merchandise to the general public for rent or purchase under a rent-to-own program. As franchisor, ColorTyme receives royalties of 2.0% to 5.0% of the franchisees' monthly gross revenue and, generally, an initial fee of between \$7,500 per new location for existing franchisees and up to \$35,000 per location for new franchisees.

The ColorTyme franchise agreement generally requires the franchised stores to utilize specific computer hardware and software for the purpose of recording rentals, sales and other record keeping and central functions. ColorTyme retains the right to retrieve data and information from the franchised stores' computer systems. The franchise agreements also limit the ability of the franchisees to compete with other franchisees.

The franchise agreement also requires the franchised stores to exclusively offer for rent or sale only those brands, types and models of products that ColorTyme has approved. The franchised stores are required to maintain an adequate mix of inventory that consists of approved products for rent as dictated by ColorTyme policy manuals. ColorTyme negotiates purchase arrangements with various suppliers it has approved. ColorTyme's largest suppliers are Ashley and Whirlpool, which accounted for approximately 19% and 13% of merchandise purchased by ColorTyme in 2005, respectively.

ColorTyme is a party to an agreement with Wells Fargo Foothill, Inc., who provides \$50.0 million in aggregate financing to qualifying franchisees of ColorTyme generally of up to five times their average monthly revenues. Under the Wells Fargo agreement, upon an event of default by the franchisee under agreements governing this financing and upon the occurrence of certain other events, Wells Fargo can assign the loans and the collateral securing such loans to ColorTyme, with ColorTyme paying the outstanding debt to Wells Fargo and then succeeding to the rights of Wells Fargo under the debt agreements, including the right to foreclose on the collateral. The Wells Fargo agreement expires in October 2006. Although we believe we will be able to renew our existing agreement or find other financing arrangements, we cannot assure you that we will not need to fund the foregoing guarantee upon the expiration of the existing agreement. An additional \$20.0 million of financing is provided by Texas Capital Bank, National Association under an agreement similar to the Wells Fargo financing. Rent-A-Center East, a wholly owned subsidiary of Rent-A-Center, Inc., guarantees the obligations of ColorTyme under each of these agreements, excluding the effects of any amounts that could be recovered under collateralization provisions, up to a maximum amount of \$70.0 million, of which \$30.3 million was outstanding as of December 31, 2005. Mark E. Speese, Rent-A-Center's Chairman of the Board and Chief Executive Officer, is a passive investor in Texas Capital Bank, owning less than 1% of its outstanding equity.

ColorTyme has established a national advertising fund for the franchised stores, whereby ColorTyme has the right to collect up to 3% of the monthly gross revenue from each franchisee as contributions to the fund. Currently, ColorTyme has set the monthly franchisee contribution at \$250 per store per month. ColorTyme directs the advertising programs of the fund, generally consisting of advertising in print, television and radio. ColorTyme also has the right to require franchisees to expend 3% of their monthly gross revenue on local advertising.

ColorTyme licenses the use of its trademarks to the franchisees under the franchise agreement. ColorTyme owns the registered trademarks ColorTyme®, ColorTyme-What's Right for You®, and FlexTyme®, along with certain design and service marks.

Some of ColorTyme's franchisees may be in locations where they directly compete with our company-owned stores, which could negatively impact the business, financial condition and operating results of our company-owned stores.

The ColorTyme franchise agreement provides us a right of first refusal to purchase the franchise location of a ColorTyme franchisee that wishes to exit the business.

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Get It Now Operations

All of our Wisconsin stores are operated by our subsidiary Get It Now, LLC. Get It Now operates under a retail model which generates installment credit sales through a retail transaction. As of December 31, 2005, we operated 21 company-owned stores within Wisconsin, all of which operate under the name Get It Now.

Financial Services Operations

We offer financial services products, such as short term, secured and unsecured loans, bill paying, debit cards, check cashing and money transfer services under the trade name The Cash AdvantEdge. As of December 31, 2005, we offered some or all of these financial services products in 40 Rent-A-Center store locations in Idaho, Montana, Nevada, Oregon, Utah and Washington. We expect to offer such financial services products in 140 to 200 Rent-A-Center store locations by the end of 2006. Stores offering financial services products in addition to traditional rent-to-own products generally require one to two additional employees. The financial services business is managed by our executive management team at the home office.

Our financial services business operates in a highly competitive industry. Similar financial services products are offered by large regional or national entities, smaller independent outlets, and pawnshops. Competitive factors include location, service, maximum loan amount, repayment options and fees.

Trademarks

We own various registered trademarks, including Rent-A-Center®, Renters Choice®, and Get It Now®. We have submitted a trademark application for The Cash AdvantEdge in connection with our financial services business. The products held for rent also bear trademarks and service marks held by their respective manufacturers.

Employees

As of March 3, 2006, we had approximately 15,480 employees, of whom 404 are assigned to our headquarters and the remainder are directly involved in the management and operation of our stores and service centers. The employees of the ColorTyme franchisees are not employed by us. While we have experienced limited union activity in the past, none of our employees are covered by a collective bargaining agreement.

We believe relationships with our employees are generally good. In connection with the settlement in December 2002 of a class action matter alleging discriminatory, gender-based employment practices, we entered into a four-year consent decree, which can be extended by the court for an additional one year upon a showing of good cause. Under the terms of the consent decree, we augmented our human resources department and our internal employee complaint procedures, enhanced our gender anti-discrimination training for all employees, and hired a consultant mutually acceptable to the parties to advise us on employment matters. We provide certain reports to the EEOC regarding our compliance with the consent decree, as well as our efforts to recruit, hire and promote qualified women. We continue to take steps to improve opportunities for women. We believe that we are in compliance in all material respects with our obligations under the consent decree.

Government Regulation

Rental Purchase Transactions

State Regulation

Currently 47 states, the District of Columbia and Puerto Rico have legislation regulating rental purchase transactions. We believe this existing legislation is generally favorable to us, as it defines and clarifies the various disclosures, procedures and transaction structures related to the rent-to-own business with which we must comply. With some variations in individual states, most related state legislation requires the lessor to make prescribed disclosures to customers about the rental purchase agreement and transaction, and provides

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time periods during which customers may reinstate agreements despite having failed to make a timely payment. Some state rental purchase laws prescribe grace periods for non-payment, prohibit or limit certain types of collection or other practices, and limit certain fees that may be charged. Nine states limit the total rental payments that can be charged. These limitations, however, generally do not become applicable unless the total rental payments required under an agreement exceed 2.0 times to 2.4 times of the disclosed cash price or the retail value of the rental product.

Minnesota, which has a rental purchase statute, and New Jersey and Wisconsin, which do not have rental purchase statutes, have had court decisions which treat rental purchase transactions as credit sales subject to consumer lending restrictions. In response, we have developed and utilized a separate rental agreement in Minnesota which does not provide customers with an option to purchase rented merchandise. In New Jersey, we have provided increased disclosures and longer grace periods in our rental purchase agreements. In Wisconsin, our Get It Now customers are provided an opportunity to purchase our merchandise through an installment sale transaction. We operate four stores in Minnesota and 43 stores in New Jersey. Get It Now, our subsidiary, operates 21 stores in Wisconsin.

North Carolina has no rental purchase legislation. However, the retail installment sales statute in North Carolina recognizes that rental purchase transactions which provide for more than a nominal purchase price at the end of the agreed rental period are not credit sales under such statute. We operate 111 stores in North Carolina.

Federal Legislation

To date, no comprehensive federal legislation has been enacted regulating or otherwise impacting the rental purchase transaction. We do, however, comply with the Federal Trade Commission recommendations for disclosure in rental purchase transactions.

From time to time, we have supported legislation introduced in Congress that would regulate the rental purchase transaction. Currently, there are two bills pending in Congress that would regulate the rental purchase transaction, both of which are similar in substance to the generally favorable state laws in effect. While both beneficial and adverse legislation may be introduced in Congress in the future, any adverse federal legislation, if enacted, could have a material and adverse effect on us.

There can be no assurance that new or revised rental purchase laws will not be enacted or, if enacted, that the laws would not have a material and adverse effect on us.

Financial Services

Thirty-four states and the District of Columbia provide safe harbor regulations for short term consumer lending, and two additional states, Wisconsin and New Mexico, permit short term consumer lending by licensed lenders. Safe harbor regulations typically set maximum fees, size and length of the loans. Fourteen states prohibit or limit short term consumer lending through small loan rate caps or state usury ceilings, including New York, New Jersey, Pennsylvania, Georgia, and Texas. In addition, our financial services business is subject to federal statutes and regulations such as the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Gramm-Leach-Bliley Act, the Fair Debt Collection Practices Act, and similar state laws.

There can be no assurance that new or revised financial services laws will not be enacted or, if enacted, that the laws would not have a material and adverse effect on us.

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Item 1A. Risk Factors.

You should carefully consider the risks described below before making an investment decision. We believe these are all the material risks currently facing our business. Our business, financial condition or results of operations could be materially adversely affected by these risks. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. You should also refer to the other information included or incorporated by reference in this report, including our financial statements and related notes.

We may not be able to successfully implement our growth strategy, which could cause our future earnings to grow more slowly or even decrease.

As part of our growth strategy, we intend to increase our total number of rent-to-own stores in both existing markets and new markets through a combination of new store openings and store acquisitions. We increased our store base by 241 stores in 2003, and 227 stores in 2004. In 2005, however, we decreased our store base by 115 stores, as part of our critical evaluation of all stores and in anticipation of continued store growth. This growth strategy is subject to various risks, including uncertainties regarding our ability to open new rent-to-own stores and our ability to acquire additional rent-to-own stores on favorable terms. We may not be able to continue to identify profitable new store locations or underperforming competitors as we currently anticipate.

Our continued growth also depends on our ability to increase sales in our existing rent-to-own stores. Our same store sales increased by 3.0% for 2003 and decreased by 3.6% and 2.3% in 2004 and 2005, respectively. As a result of new store openings in existing markets and because mature stores will represent an increasing proportion of our store base over time, our same store revenues in future periods may be lower than historical levels.

We also plan to grow through expansion into the financial services business. We face risks associated with integrating this new business into our existing operations. In addition, the financial services industry is highly competitive and regulated by federal, state and local laws.

Our growth strategy could place a significant demand on our management and our financial and operational resources. If we are unable to implement our growth strategy, our earnings may grow more slowly or even decrease.

If we fail to effectively manage the growth and integration of our new rent-to-own stores, our financial results may be adversely affected.

The addition of new rent-to-own stores, both through store openings and through acquisitions, requires the integration of our management philosophies and personnel, standardization of training programs, realization of operating efficiencies and effective coordination of sales and marketing and financial reporting efforts. In addition, acquisitions in general are subject to a number of special risks, including adverse short-term effects on our reported operating results, diversion of management's attention and unanticipated problems or legal liabilities. Further, a newly opened rent-to-own store generally does not attain positive cash flow during its first year of operations.

There are legal proceedings pending against us seeking material damages. The costs we incur in defending ourselves or associated with settling any of these proceedings, as well as a material final judgment or decree against us, could materially adversely affect our financial condition by requiring the payment of the settlement amount, a judgment or the posting of a bond.

Some lawsuits against us involve claims that our rental agreements constitute installment sales contracts, violate state usury laws or violate other state laws enacted to protect consumers. We are also defending a class action lawsuit alleging we violated the securities laws and lawsuits alleging we violated state wage and hour laws. Because of the uncertainties associated with litigation, we cannot estimate for you our ultimate liability for these matters, if any. Significant settlement amounts or final judgments could materially and adversely

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affect our liquidity. The failure to pay any judgment would be a default under our senior credit facilities and the indenture governing our outstanding subordinated notes.

Our debt agreements impose restrictions on us which may limit or prohibit us from engaging in certain transactions. If a default were to occur, our lenders could accelerate the amounts of debt outstanding, and holders of our secured indebtedness could force us to sell our assets to satisfy all or a part of what is owed.

Covenants under our senior credit facilities and the indenture governing our outstanding subordinated notes restrict our ability to pay dividends, engage in various operational matters, as well as require us to maintain specified financial ratios and satisfy specified financial tests. Our ability to meet these financial ratios and tests may be affected by events beyond our control. These restrictions could limit our ability to obtain future financing, make needed capital expenditures or other investments, repurchase our outstanding debt or equity, withstand a future downturn in our business or in the economy, dispose of operations, engage in mergers, acquire additional stores or otherwise conduct necessary corporate activities. Various transactions that we may view as important opportunities, such as specified acquisitions, are also subject to the consent of lenders under the senior credit facilities, which may be withheld or granted subject to conditions specified at the time that may affect the attractiveness or viability of the transaction.

If a default were to occur, the lenders under our senior credit facilities could accelerate the amounts outstanding under the credit facilities, and our other lenders could declare immediately due and payable all amounts borrowed under other instruments that contain certain provisions for cross-acceleration or cross-default. In addition, the lenders under these agreements could terminate their commitments to lend to us. If the lenders under these agreements accelerate the repayment of borrowings, we may not have sufficient liquid assets at that time to repay the amounts then outstanding under our indebtedness or be able to find additional alternative financing. Even if we could obtain additional alternative financing, the terms of the financing may not be favorable or acceptable to us.

The existing indebtedness under our senior credit facilities is secured by substantially all of our assets. Should a default or acceleration of this indebtedness occur, the holders of this indebtedness could sell the assets to satisfy all or a part of what is owed. Our senior credit facilities also contain certain provisions prohibiting the modification of our outstanding subordinated notes, as well as limiting the ability to refinance such notes.

A change of control could accelerate our obligation to pay our outstanding indebtedness, and we may not have sufficient liquid assets to repay these amounts.

Under our senior credit facilities, an event of default would result if a third party became the beneficial owner of 35.0% or more of our voting stock or upon certain changes in the constitution of our Board of Directors. As of December 31, 2005, we were required to make principal payments under our senior credit facilities of \$3.5 million in 2006, \$3.5 million in 2007, \$3.5 million in 2008, \$168.0 million in 2009 and \$166.3 million after 2009. These payments reduce our cash flow.

Under the indenture governing our outstanding subordinated notes, in the event that a change in control occurs, we may be required to offer to purchase all of our outstanding subordinated notes at 101% of their original aggregate principal amount, plus accrued interest to the date of repurchase. A change in control also would result in an event of default under our senior credit facilities, which would allow our lenders to accelerate indebtedness owed to them.

If the lenders under our debt instruments accelerate these obligations, we may not have sufficient liquid assets to repay amounts outstanding under these agreements.

Rent-to-own transactions are regulated by law in most states. Any adverse change in these laws or the passage of adverse new laws could expose us to litigation or require us to alter our business practices.

As is the case with most businesses, we are subject to various governmental regulations, including specifically in our case regulations regarding rent-to-own transactions. There are currently 47 states that have

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passed laws regulating rental purchase transactions and another state that has a retail installment sales statute that excludes rent-to-own transactions from its coverage if certain criteria are met. These laws generally require certain contractual and advertising disclosures. They also provide varying levels of substantive consumer protection, such as requiring a grace period for late fees and contract reinstatement rights in the event the rental purchase agreement is terminated. The rental purchase laws of nine states limit the total amount of rentals that may be charged over the life of a rental purchase agreement. Several states also effectively regulate rental purchase transactions under other consumer protection statutes. We are currently subject to litigation alleging that we have violated some of these statutory provisions.

Although there is currently no comprehensive federal legislation regulating rental-purchase transactions, adverse federal legislation may be enacted in the future. From time to time, legislation has been introduced in Congress seeking to regulate our business. In addition, various legislatures in the states where we currently do business may adopt new legislation or amend existing legislation that could require us to alter our business practices.

Financial services transactions are regulated by federal law as well as the laws of certain states. Any adverse changes in these laws or the passage of adverse new laws with respect to the financial services business could slow our growth opportunities, expose us to litigation or alter our business practices in a manner that we may deem to be unacceptable.

Our financial services business is subject to federal statutes and regulations such as the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Gramm-Leach-Bliley Act, the Fair Debt Collection Practices Act, and similar state laws. In addition, thirty-four states and the District of Columbia provide safe harbor regulations for short term consumer lending, and two additional states permit short term consumer lending by licensed dealers. Safe harbor regulations typically set maximum fees, size and length of the loans. Congress and/or the various legislatures in the states where we currently intend to offer financial services products may adopt new legislation or amend existing legislation with respect to our financial services business that could require us to alter our business practices in a manner that we may deem to be unacceptable, which could slow our growth opportunities.

Our business depends on a limited number of key personnel, with whom we do not have employment agreements. The loss of any one of these individuals could disrupt our business.

Our continued success is highly dependent upon the personal efforts and abilities of our senior management, including Mark E. Speese, our Chairman of the Board and Chief Executive Officer and Mitchell E. Fadel, our President and Chief Operating Officer. We do not have employment contracts with or maintain key-person insurance on the lives of any of these officers and the loss of any one of them could disrupt our business.

Our organizational documents and debt instruments contain provisions that may prevent or deter another group from paying a premium over the market price to our stockholders to acquire our stock.

Our organizational documents contain provisions that classify our board of directors, authorize our board of directors to issue blank check preferred stock and establish advance notice requirements on our stockholders for director nominations and actions to be taken at annual meetings of the stockholders. In addition, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law relating to business combinations. Our senior credit facilities and the indenture governing our subordinated notes each contain various change of control provisions which, in the event of a change of control, would cause a default under those provisions. These provisions and arrangements could delay, deter or prevent a merger, consolidation, tender offer or other business combination or change of control involving us that could include a premium over the market price of our common stock that some or a majority of our stockholders might consider to be in their best interests.

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We are a holding company and are dependent on the operations and funds of our subsidiaries.

We are a holding company, with no revenue generating operations and no assets other than our ownership interests in our direct and indirect subsidiaries. Accordingly, we are dependent on the cash flow generated by our direct and indirect operating subsidiaries and must rely on dividends or other intercompany transfers from our operating subsidiaries to generate the funds necessary to meet our obligations, including the obligations under our senior credit facilities and our outstanding subordinated notes. The ability of our subsidiaries to pay dividends or make other payments to us is subject to applicable state laws. Should one or more of our subsidiaries be unable to pay dividends or make distributions, our ability to meet our ongoing obligations could be materially and adversely impacted.

Our stock price is volatile, and you may not be able to recover your investment if our stock price declines.

The price of our common stock has been volatile and can be expected to be significantly affected by factors such as:

quarterly variations in our results of operations, which may be impacted by, among other things, changes in same store sales, when and how many rent-to-own stores we acquire or open, and the rate at which we add financial services to our existing rent-to-own stores;

quarterly variations in our competitors' results of operations;

changes in earnings estimates or buy/sell recommendations by financial analysts;

the stock price performance of comparable companies; and

general market conditions or market conditions specific to particular industries.

Failure to achieve and maintain effective internal controls could have a material adverse effect on our business and stock price.

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our brand and operating results could be harmed. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

While we continue to evaluate and improve our internal controls, we cannot be certain that these measures will ensure that we implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations.

We have completed documenting and testing our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires annual management assessments of the effectiveness of our internal control over financial reporting and a report by our independent registered public accounting firm addressing these assessments. For the year ended December 31, 2005, our management has determined that our internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Please refer to management's annual report on internal control over financial reporting, and the report by Grant Thornton LLP, which appear later in this report. If we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Failure to achieve and maintain an effective internal control environment could cause investors to lose confidence in our reported financial information, which could have a material adverse effect on our stock price.

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Item 1B. *Unresolved Staff Comments.*

None.

Item 2. *Properties.*

We lease space for all of our stores and service center locations, as well as our corporate and regional offices, under operating leases expiring at various times through 2013. Most of our store leases are five year leases and contain renewal options for additional periods ranging from three to five years at rental rates adjusted according to agreed-upon formulas. Store sizes range from approximately 1,900 to 18,500 square feet, and average approximately 4,600 square feet. Approximately 75% of each store's space is generally used for showroom space and 25% for offices and storage space. Our headquarters, including Get It Now and ColorTyme, are each located at 5700 Tennyson Parkway, Plano, Texas, and consists of approximately 115,307 square feet.

In December 2005, we acquired approximately 15 acres of land located in Plano, Texas, on which we intend to build a new corporate headquarters facility. The purchase price for the land was approximately \$4.2 million. Building costs are expected to be in the range of \$20.0-\$25.0 million, with construction beginning in January 2006. Building costs will be paid on a percentage of completion basis throughout the construction period, and the building is expected to be completed by the end of 2006. We intend to finance this project from cash flow generated from operations. Our remaining lease obligation on our existing location is approximately \$6.2 million. We anticipate subleasing some or all of the space at our current location to offset the remaining lease obligation. Additionally, we have adjusted the remaining life on the assets which will be abandoned upon our move to the new facility.

We believe that suitable store space generally is available for lease and we would be able to relocate any of our stores without significant difficulty should we be unable to renew a particular lease. We also expect additional space is readily available at competitive rates to open new stores. Under various federal and state laws, lessees may be liable for environmental problems at leased sites even if they did not create, contribute to, or know of the problem. We are not aware of and have not been notified of any material violations of federal, state or local environmental protection or health and safety laws, but cannot guarantee that we will not incur material costs or liabilities under these laws in the future.

Item 3. *Legal Proceedings.*

From time to time, we, along with our subsidiaries, are party to various legal proceedings arising in the ordinary course of business. Except as described below, we are not currently a party to any material litigation. The ultimate outcome of our litigation is uncertain and the amount of any loss we may incur, if any, cannot in our judgment be reasonably estimated. Accordingly, other than with respect to the settlement of the *Pucci/Chess* matter (which was funded in February 2006), the prospective settlement of the *Rose/Madrigal* matter discussed below as well as anticipated legal fees and expenses for our other litigation matters, no provision has been made in our consolidated financial statements for any such loss.

Colon v. Thorn Americas, Inc. The plaintiff filed this class action in November 1997 in New York state court. This matter was assumed by us in connection with the Thorn Americas acquisition. The plaintiff acknowledges that rent-to-own transactions in New York are subject to the provisions of New York's Rental Purchase Statute but contends the Rental Purchase Statute does not provide us immunity from suit for other statutory violations. The plaintiff alleges we have a duty to disclose effective interest under New York consumer protection laws, and seeks damages and injunctive relief for failure to do so. This suit also alleges violations relating to excessive and unconscionable pricing, late fees, harassment, undisclosed charges, and the ease of use and accuracy of payment records. In the prayer for relief, the plaintiff requests class certification, injunctive relief requiring us to cease certain marketing practices and price our rental purchase contracts in

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certain ways, unspecified compensatory and punitive damages, rescission of the class members contracts, an order placing in trust all moneys received by us in connection with the rental of merchandise during the class period, treble damages, attorney's fees, filing fees and costs of suit, pre- and post-judgment interest, and any further relief granted by the court. The plaintiff has not alleged a specific monetary amount with respect to the request for damages.

The proposed class includes all New York residents who were party to our rent-to-own contracts from November 26, 1994. In November 2000, following interlocutory appeal by both parties from the denial of cross-motions for summary judgment, we obtained a favorable ruling from the Appellate Division of the State of New York, dismissing the plaintiff's claims based on the alleged failure to disclose an effective interest rate. The plaintiff's other claims were not dismissed. The plaintiff moved to certify a state-wide class in December 2000. The plaintiff's class certification motion was heard by the court on November 7, 2001 and, on September 12, 2002, the court issued an opinion denying in part and granting in part the plaintiff's requested certification. The opinion grants certification as to all of the plaintiff's claims except the plaintiff's pricing claims pursuant to the Rental Purchase Statute, as to which certification was denied. The parties have differing views as to the effect of the court's opinion, and accordingly, the court granted the parties permission to submit competing orders as to the effect of the opinion on the plaintiff's specific claims. Both proposed orders were submitted to the court on March 27, 2003, and on May 30, 2003, the court held a hearing regarding such orders. No clarifying order has yet been entered by the court.

From June 2003 until May 2005, there was no activity in this case. On May 18, 2005, we filed a motion to dismiss the plaintiff's claim and to decertify the class, based upon the plaintiff's failure to schedule her claim in this matter in her earlier voluntary bankruptcy proceeding. The plaintiff opposed our motion and asked the court to grant it an opportunity to find a substitute class representative in the event the court determined Ms. Colon was no longer adequate. On January 17, 2006, the court issued an order denying our motion, but noted that no motion to intervene to add additional class representatives had been filed. A conference with the court has been scheduled for March 14, 2006. If the court ultimately enters a final certification order, we intend to pursue an interlocutory appeal of such certification order.

We believe these claims are without merit and will continue to vigorously defend ourselves in this case. However, we cannot assure you that we will be found to have no liability in this matter.

Terry Walker, et. al. v. Rent-A-Center, Inc., et. al. On January 4, 2002, a putative class action was filed against us and certain of our current and former officers and directors by Terry Walker in federal court in Texarkana, Texas. The complaint alleged that the defendants violated Sections 10(b) and/or Section 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by issuing false and misleading statements and omitting material facts regarding our financial performance and prospects for the third and fourth quarters of 2001. The complaint purported to be brought on behalf of all purchasers of our common stock from April 25, 2001 through October 8, 2001 and sought damages in unspecified amounts. Similar complaints were consolidated by the court with the *Walker* matter in October 2002.

On November 25, 2002, the lead plaintiffs in the *Walker* matter filed an amended consolidated complaint which added certain of our outside directors as defendants to the Exchange Act claims. The amended complaint also added additional claims that we, and certain of our current and former officers and directors, violated various provisions of the Securities Act as a result of alleged misrepresentations and omissions in connection with an offering in May 2001 and also added the managing underwriters in that offering as defendants.

On February 7, 2003, we, along with certain officer and director defendants, filed a motion to dismiss the matter as well as a motion to transfer venue. In addition, our outside directors named in the matter separately filed a motion to dismiss the Securities Act claims on statute of limitations grounds. On February 19, 2003, the underwriter defendants also filed a motion to dismiss the matter. The plaintiffs filed response briefs to these motions, to which we replied on May 21, 2003. A hearing was held by the court on June 26, 2003 to hear each of these motions.

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On September 30, 2003, the court granted our motion to dismiss without prejudice, dismissed without prejudice the outside directors' and underwriters' separate motions to dismiss and denied our motion to transfer venue. In its order on the motions to dismiss, the court granted the lead plaintiffs leave to replead the case within certain parameters.

On July 7, 2004, the plaintiffs again repled their claims by filing a third amended consolidated complaint, raising allegations of similar violations against the same parties generally based upon alleged facts not previously asserted. We, along with certain officer and director defendants and the underwriter defendants, filed motions to dismiss the third amended consolidated complaint on August 23, 2004. A hearing on the motions was held on April 14, 2005. On July 25, 2005, the court ruled on these motions, dismissing with prejudice the claims against our outside directors as well as the underwriter defendants, but denying our motion to dismiss. In evaluating this motion to dismiss, the court was required to view the pleadings in the light most favorable to the plaintiffs and to take the plaintiffs' allegations as true. On August 18, 2005, we filed a motion to certify the dismissal order for an interlocutory appeal, which was denied on November 14, 2005. Discovery in this matter has now commenced. A hearing on class certification is scheduled for June 22, 2006.

We continue to believe the plaintiffs' claims in this matter are without merit and intend to vigorously defend ourselves as this matter progresses. However, we cannot assure you that we will be found to have no liability in this matter.

California Attorney General Inquiry. During the second quarter of 2004, we received an inquiry from the California Attorney General regarding our business practices in California with respect to our cash prices and our membership program. We met with representatives of the Attorney General's office during the first quarter and fourth quarter of 2005, and provided additional information with respect to our membership program as requested. We are continuing to discuss these issues with the Attorney General's office.

State Wage and Hour Class Actions

We recently settled a material action pending against us in Oregon, and are currently subject to various material actions pending against us in the states of California and Washington, all of which allege we violated the wage and hour laws of such states.

Rob Pucci, et. al. v. Rent-A-Center, Inc.; Jeremy Chess et. al. v. Rent-A-Center, Inc. et. al.; Clemmons et. al. v. Rent-A-Center, Inc., et. al. On August 20, 2001, the putative class action entitled *Rob Pucci, et. al. v. Rent-A-Center, Inc.* was filed in state court in Multnomah County, Oregon alleging we violated various provisions of Oregon state law regarding overtime, lunch and work breaks, that we failed to pay all wages due to our Oregon employees, and various contract claims that we promised but failed to pay overtime. *Pucci* sought to represent a class of all present and former executive assistants, inside/outside managers and account managers employed by us within the six year period prior to the filing of the complaint as to the contract claims, and three years as to the statutory claims, and sought class certification, payments for all unpaid wages under Oregon law, statutory and civil penalties, costs and disbursements, pre-and post-judgment interest in the amount of 9% per annum and attorneys fees.

On July 25, 2002, the plaintiffs filed a motion for class certification and on July 31, 2002, we filed our motion for summary judgment. On January 15, 2003, the court orally granted our motion for summary judgment in part, ruling that the plaintiffs were prevented from recovering overtime payments at the rate of time and a half, but stated that the plaintiffs may recover straight-time to the extent plaintiffs could prove purported class members worked in excess of forty hours in a work week but were not paid for such time worked. The court denied our motion for summary judgment on the remaining claims.

On October 10, 2003, the court issued an opinion letter stating that it would certify a class and not permit an interlocutory appeal, and issued its written order to that effect on December 9, 2003.

On March 17, 2005, *Pucci* class members Jeremy Chess and Chad Clemmons filed an amended class action complaint entitled *Jeremy Chess et al. v. Rent-A-Center, Inc. et al.*, alleging similar claims as the plaintiffs in *Pucci* and seeking unspecified statutory and contractual damages and penalties, as well as injunctive relief. The *Chess* plaintiffs sought to represent a class of all present and former executive assistants,

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inside/outside managers and account managers employed by us within the six year period prior to the filing of the complaint as to the contract claims, and three years as to the statutory claims. On April 15, 2005, we filed pleadings removing the case to the federal court for the District of Oregon under the Class Action Fairness Act of 2005. The *Chess* plaintiffs were represented by the same attorneys as the *Pucci* plaintiffs.

On June 23, 2005, we reached an agreement in principle to settle the claims in *Pucci* and *Chess*. Under the settlement, we agreed to pay \$1.75 million to settle all class claims, including payments to the class and its representatives, the plaintiffs' attorneys' fees and administrative costs, subject to adjustment based upon the size of the class. The final class included approximately 777 current and former account managers, inside/outside managers, and executive assistant managers that were employed by us in Oregon. In connection therewith, the plaintiffs' counsel in the *Pucci* and *Chess* matters filed a new class action complaint in Federal court entitled *Clemmons et al v. Rent-A-Center Inc., et al*, alleging substantially similar claims and seeking similar damages as in *Pucci* and *Chess* through the date of filing. The parties used the *Clemmons* case to consolidate the *Pucci* and *Chess* claims, and facilitate final approval, administration and distribution of the settlement. Notice of the settlement was mailed to class members on or about November 15, 2005 and no class member objected to the settlement or sought exclusion from the class. Accordingly, at December 31, 2005, \$1.9 million was reserved with respect to this matter covering the anticipated settlement and our attorneys' fees. On January 20, 2006, the *Pucci* and *Clemmons* courts approved the final settlement, entered a final judgment and dismissed the respective cases. We funded the settlement in February 2006.

Jeremy Burdusis, et al. v. Rent-A-Center, Inc., et al./ Israel French, et al. v. Rent-A-Center, Inc. These matters pending in Los Angeles, California were filed on October 23, 2001, and October 30, 2001, respectively, and allege similar violations of the wage and hour laws of California as those in *Pucci*. The same law firm in *Pucci* is seeking to represent the purported class in *Burdusis*. The *Burdusis* and *French* proceedings are pending before the same judge in California. On March 24, 2003, the *Burdusis* court denied the plaintiffs' motion for class certification in that case, which we view as a favorable development in that proceeding. On April 25, 2003, the plaintiffs in *Burdusis* filed a notice of appeal of that ruling, and on May 8, 2003, the *Burdusis* court, at our request, stayed further proceedings in *Burdusis* and *French* pending the resolution on appeal of the court's denial of class certification in *Burdusis*. In June 2004, the *Burdusis* plaintiffs filed their appellate brief. Our response brief was filed in September 2004, and the *Burdusis* plaintiffs filed their reply in October 2004. On February 9, 2005, the California Court of Appeals reversed and remanded the trial court's denial of class certification in *Burdusis* and directed the trial court to reconsider its ruling in light of two other recent appellate court decisions, including the opinions of the California Supreme Court in *Sav-On Drugs Stores, Inc. v. Superior Court*, and of the California appeals court in *Bell v. Farmers Insurance Exchange*. After remand, the plaintiffs filed a motion with the trial court seeking to remove from the case the trial court judge who previously denied their motion for class certification. The trial court denied the motion. In response, plaintiffs filed a petition for writ of mandate with the California Court of Appeals requesting review of the trial court's decision. The California Court of Appeals heard oral arguments in this matter on August 29, 2005, and ruled against the plaintiffs, denying the requested relief. The case is now being returned to the trial court as previously ordered.

On October 30, 2003, the plaintiffs' counsel in *Burdusis* and *French* filed a new non-class lawsuit in Orange County, California entitled *Kris Corso, et al. v. Rent-A-Center, Inc.* The plaintiffs' counsel later amended this complaint to add additional plaintiffs, totaling approximately 339 individuals. The claims made are substantially the same as those in *Burdusis*. On January 16, 2004, we filed a demurrer to the complaint, arguing, among other things, that the plaintiffs in *Corso* were misjoined. On February 19, 2004, the court granted our demurrer on the misjoinder argument, with leave for the plaintiffs to replead. On March 8, 2004, the plaintiffs filed an amended complaint in *Corso*, increasing the number of plaintiffs to approximately 400. The claims in the amended complaint are substantially the same as those in *Burdusis*. We filed a demurrer with respect to the amended complaint on April 12, 2004, which the court granted on May 6, 2004. However, the court allowed the plaintiffs to again replead the action on a representative basis, which they did on May 26, 2004. We subsequently filed a demurrer with respect to the newly repleaded action, which the court granted on August 12, 2004. The court subsequently stayed the *Corso* matter pending the outcome of the *Burdusis* matter. On March 16, 2005, the court lifted the stay and on April 12, 2005, we answered the amended

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complaint. Discovery is now proceeding. On January 30, 2006, the *Corso* Court heard a motion to coordinate *Corso* with the *Burdusis* and *French* actions. The *Corso* court recommended that *Corso* be coordinated with the other actions before the judge in the *Burdusis* and *French* matters. The Judicial Council has yet to act on the recommendation.

We believe the claims asserted in *Burdusis*, *French* and *Corso* are without merit and we intend to vigorously oppose each of these cases. We cannot assure you, however, that we will be found to have no liability in these matters. As of December 31, 2005, we operated 150 stores in California.

Kevin Rose, et al. v. Rent-A-Center, Inc. et al. This matter pending in Clark County, Washington was filed on June 26, 2001, and alleges similar violations of the wage and hour laws of Washington as those in *Pucci*. The same law firm who represented the class in *Pucci* sought to represent the purported class in this matter. On May 14, 2003, the *Rose* court denied the plaintiffs' motion for class certification in that case. On June 3, 2003, the plaintiffs in *Rose* filed a notice of appeal, which was subsequently denied. Following the denial by the Court of Appeals, the plaintiffs counsel filed 14 county-wide putative class actions in Washington with substantially the same claims as in *Rose*. In April 2005, the plaintiffs' counsel filed another putative county-wide lawsuit and subsequently the plaintiffs' counsel filed another putative state-wide lawsuit in federal court in Washington, bringing the total to 16. The purported classes in the county-wide class actions ranged from approximately 20 individuals to approximately 100 individuals.

In November 2005, we reached an agreement in principle to settle for \$1.25 million all of the pending lawsuits and related matters brought by the plaintiffs' counsel in Washington on an agreed state-wide class basis. In connection therewith, the parties agreed to seek class settlement in the Superior Court of Yakima County, Washington, where one of the putative county-wide class actions, *Madrigal et al. v. Rent-A-Center*, is pending. On January 13, 2006, the court in *Madrigal* preliminarily approved the class settlement. The class consists of approximately 1,300 class members, and notice of settlement has now been sent. Objections to the settlement are due March 15, 2006, and a final approval hearing before the court is scheduled for April 21, 2006. Accordingly, at December 31, 2005, approximately \$1.3 million was reserved to fund the prospective settlement as well as our attorneys' fees.

While we believe that the terms of the prospective settlement are fair, there can be no assurance that the settlement, if completed, will be finally approved by the court in its present form.

Item 4. *Submission of Matters to a Vote of Security Holders.*

None.

Table of Contents**PART II****Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***

Our common stock has been listed on the Nasdaq Stock Market® under the symbol RCII since January 25, 1995, the date we commenced our initial public offering. The following table sets forth, for the periods indicated, the high and low sales price per share of the common stock as reported.

2005	High	Low
Fourth Quarter	\$ 20.360	\$ 14.900
Third Quarter	24.360	17.910
Second Quarter	27.750	22.360
First Quarter	27.890	24.080

2004	High	Low
Fourth Quarter	\$ 26.890	\$ 22.000
Third Quarter	31.600	24.700
Second Quarter	33.930	27.630
First Quarter	33.342	27.030

As of March 8, 2006, there were approximately 94 record holders of our common stock.

We have not paid any cash dividends on our common stock since the time of our initial public offering. Any change in our dividend policy will be made at the discretion of our Board of Directors and will depend on a number of factors, including future earnings, capital requirements, contractual restrictions, financial condition, future prospects and any other factors our Board of Directors may deem relevant.

Cash dividend payments are subject to the restrictions in our senior credit facilities and the indenture governing our subordinated notes. These restrictions would not currently prohibit the payment of cash dividends. Please see the section entitled *Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Senior Credit Facilities* on page 38 of this report for further discussion of such restrictions.

Under our common stock repurchase program, we are authorized to repurchase up to \$400.0 million in aggregate purchase price of our common stock. As of December 31, 2005, we had repurchased \$356.1 million in aggregate purchase price of our common stock under our stock repurchase program. In the fourth quarter of 2005, we made the following repurchases of our common stock:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (including fees)
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(including
fees)

October 1 through October 31	0	\$	0.0000	0	\$	78,358,403
November 1 through November 30	1,816,100	\$	18.9807	1,816,100	\$	43,887,581
December 1 through December 31	0	\$	0.0000	0	\$	43,887,581
Total	1,816,100	\$	18.9807	1,816,100	\$	43,887,581

Table of Contents**Item 6. Selected Financial Data.**

The selected financial data presented below for the five years ended December 31, 2005 have been derived from our consolidated financial statements as audited by Grant Thornton LLP, independent registered public accounting firm. All prices and amounts have been adjusted to reflect the 5-for-2 split of our common stock effected in August 2003. The historical financial data are qualified in their entirety by, and should be read in conjunction with, the financial statements and the notes thereto, the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations and other financial information included in this report.

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
Consolidated					
Statements of Earnings					
Revenues					
Store					
Rentals and fees	\$ 2,084,757	\$ 2,071,866	\$ 1,998,952	\$ 1,828,534	\$ 1,650,851
Merchandise sales	177,292	166,594	152,984	115,478	94,733
Installment sales	26,139	24,304	22,203	6,137	
Other	7,903	3,568	3,083	2,589	3,476
Franchise					
Merchandise sales	37,794	41,398	45,057	51,514	53,584
Royalty income and fees	5,222	5,525	5,871	5,792	5,884
Total revenue	2,339,107	2,313,255	2,228,150	2,010,044	1,808,528
Operating expenses					
Direct store expenses					
Cost of rentals and fees	452,583	450,035	432,696	383,400	343,197
Cost of merchandise sold	129,624	119,098	112,283	84,628	72,539
Cost of installment sales	10,889	10,512	10,639	3,776	
Salaries and other expenses	1,358,760 ⁽¹⁾	1,277,926	1,180,115	1,070,265	1,019,402
Franchise cost of merchandise sold	36,319	39,472	43,248	49,185	51,251
	1,988,175	1,897,043	1,778,981	1,591,254	1,486,389
General and administrative expenses	82,290	75,481	66,635	63,296	55,359
Amortization of intangibles	11,705 ⁽²⁾	10,780	12,512	5,045	30,194
Class action litigation settlement (reversion)	(8,000) ⁽³⁾	47,000 ⁽⁶⁾			52,000 ⁽⁸⁾
Restructuring charge	15,166 ⁽⁴⁾				

Total operating expenses	2,089,336	2,030,304	1,858,128	1,659,595	1,623,942
Operating profit	249,771	282,951	370,022	350,449	184,586
Income from sale of charged off accounts		(7,924) ⁽⁷⁾			
Finance charges from refinancing		4,173	35,260		
Interest expense, net	40,703	35,323	43,932	62,006	59,780
Earnings before income taxes	209,068	251,379	290,830	288,443	124,806
Income tax expense	73,330 ⁽⁵⁾	95,524	109,334	116,270	58,589

Table of Contents**Item 6. Selected Financial Data Continued**

	Year Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands, except per share data)				
NET EARNINGS	135,738	155,855	181,496	172,173	66,217
Preferred dividends				10,212	15,408
Net earnings allocable to common stockholders	\$ 135,738	\$ 155,855	\$ 181,496	\$ 161,961	\$ 50,809
Basic earnings per common share	\$ 1.86	\$ 1.99	\$ 2.16	\$ 2.20	\$ 0.79
Diluted earnings per common share	\$ 1.83	\$ 1.94	\$ 2.08	\$ 1.89	\$ 0.71

Consolidated Balance Sheet Data

Rental merchandise, net	\$ 750,680	\$ 759,111	\$ 680,700	\$ 631,724	\$ 653,701
Intangible assets, net	929,326	922,404	797,434	743,852	711,096
Total assets	1,948,664	1,967,788	1,831,302	1,626,652	1,630,315
Total debt	724,050	708,250	698,000	521,330	702,506
Total liabilities ⁽⁹⁾	1,125,232	1,173,517	1,036,472	784,252	1,224,937
Stockholders equity	823,432	794,271	794,830	842,400	405,378

Operating Data

Stores open at end of period	2,760	2,875	2,648	2,407	2,281
Comparable store revenue growth (decrease) ⁽¹⁰⁾	(2.3)%	(3.6)%	3.0%	6.0%	8.0%
Weighted average number of stores	2,844	2,788	2,560	2,325	2,235
Franchise stores open at end of period	296	313	329	318	342

- (1) Includes the effects of \$5.2 million in charges recorded in the third and fourth quarters of 2005 as a result of Hurricanes Katrina, Rita and Wilma. These charges were primarily related to the disposal of inventory and fixed assets.
- (2) Includes the effects of \$3.7 million in goodwill impairment charges recorded in the third quarter of 2005 as result of Hurricane Katrina.
- (3) Includes the effect of a pre-tax legal reversion of \$8.0 million recorded in the first quarter of 2005 associated with the settlement of a class action lawsuit in the state of California.

- (4) Includes the effects of a \$15.2 million pre-tax restructuring expense as part of the store consolidation plan announced September 6, 2005.
- (5) Includes the effects of a \$2.0 million tax audit reserve credit associated with the examination and favorable resolution of our 1998 and 1999 federal tax returns and a \$3.3 million state tax reserve credit due to a change in estimate related to potential loss exposures.
- (6) Includes the effects of a pre-tax legal settlement charge of \$47.0 million recorded in the third quarter of 2004 associated with the settlement of a class action lawsuit in the state of California.
- (7) Includes the effects of \$7.9 million in pre-tax income associated with the 2004 sale of previously charged off accounts.
- (8) Includes the effects of a pre-tax legal settlement charge of \$52.0 million associated with the 2001 settlement of class action lawsuits in the states of Missouri, Illinois, and Tennessee.
- (9) In accordance with the adoption of SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, total liabilities also includes redeemable convertible voting preferred stock.
- (10) Comparable store revenue for each period presented includes revenues only of stores open throughout the full period and the comparable prior period.

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Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations.*

Overview

We are the largest rent-to-own operator in the United States with an approximate 33% market share based on store count. At December 31, 2005, we operated 2,760 company-owned stores nationwide and in Canada and Puerto Rico, including 21 stores in Wisconsin operated by our subsidiary Get It Now, LLC under the name Get It Now and seven stores located in Canada operated by our subsidiary Rent-A-Centre, Ltd., under the name Rent-A-Centre. Another of our subsidiaries, ColorTyme, is a national franchisor of rent-to-own stores. At December 31, 2005, ColorTyme had 296 franchised stores in 38 states, 288 of which operated under the ColorTyme name and eight stores of which operated under the Rent-A-Center name.

Our stores generally offer high quality durable products such as major consumer electronics, appliances, computers, and furniture and accessories under flexible rental purchase agreements that generally allow the customer to obtain ownership of the merchandise at the conclusion of an agreed-upon rental period. These rental purchase agreements are designed to appeal to a wide variety of customers by allowing them to obtain merchandise that they might otherwise be unable to obtain due to insufficient cash resources or a lack of access to credit. These agreements also cater to customers who only have a temporary need, or who simply desire to rent rather than purchase the merchandise. Rental payments are made generally on a weekly basis and, together with applicable fees, constitute our primary revenue source.

Our expenses primarily relate to merchandise costs and the operations of our stores, including salaries and benefits for our employees, occupancy expense for our leased real estate, advertising expenses, lost, damaged, or stolen merchandise, fixed asset depreciation, and corporate and other expenses.

In 2005, we began offering financial services products, such as short term secured and unsecured loans, bill paying, debit cards, check cashing and money transfer services in our existing rent-to-own stores under the trade name The Cash AdvantEdge. As of December 31, 2005, we offered some or all of these financial services products in 40 Rent-A-Center store locations in Idaho, Montana, Nevada, Oregon, Utah and Washington. We expect to offer such financial services products in 140 to 200 Rent-A-Center store locations by the end of 2006.

We plan to continue growing through selective and opportunistic acquisitions of existing rent-to-own stores, and development of new rent-to-own stores, as well as offering financial services products designed to appeal to our customer demographic.

We have pursued an aggressive growth strategy since 1993. We have sought to acquire underperforming rent-to-own stores to which we could apply our operating model as well as open new stores. As a result, the acquired stores have generally experienced more significant revenue growth during the initial periods following their acquisition than in subsequent periods. Typically, a newly opened rent-to-own store is profitable on a monthly basis in the ninth to twelfth month after its initial opening. Historically, a typical store has achieved cumulative break-even profitability in 18 to 24 months after its initial opening. Total financing requirements of a typical new store approximate \$500,000, with roughly 75% of that amount relating to the purchase of rental merchandise inventory. A newly opened store historically has achieved results consistent with other stores that have been operating within the system for greater than two years by the end of its third year of operation. As a result, our quarterly earnings are impacted by how many new stores we opened during a particular quarter and the quarters preceding it. Because of significant growth since our formation, our historical results of operations and period-to-period comparisons of such results and other financial data, including the rate of earnings growth, may not be meaningful or indicative of future results.

In addition, we strategically open or acquire stores near market areas served by existing stores (cannibalize) to enhance service levels, gain incremental sales and increase market penetration. This planned cannibalization may negatively impact our same store revenue and cause us to grow at a slower rate. There can be no assurance that we will open any new rent-to-own stores in the future, or as to the number, location or profitability thereof.

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The following discussion focuses on our results of operations, and issues related to our liquidity and capital resources. You should read this discussion in conjunction with the consolidated financial statements and notes thereto included elsewhere in this report.

Forward-Looking Statements

The statements, other than statements of historical facts, included in this report are forward-looking statements. Forward-looking statements generally can be identified by the use of forward-looking terminology, such as may, will, would, expect, intend, could, estimate, should, anticipate or believe. We believe the expectations reflected in forward-looking statements are accurate. However, we cannot assure you that such expectations will occur. Our actual future performance could differ materially from such statements. Factors that could cause or contribute to such differences include, but are not limited to:

- uncertainties regarding our ability to open new rent-to-own stores;
- our ability to acquire additional rent-to-own stores on favorable terms;
- our ability to enhance the performance of these acquired stores;
- our ability to control store level costs;
- our ability to identify and successfully market products and services that appeal to our customer demographic;
- our ability to identify and successfully enter into new lines of business offering products and services that appeal to our customer demographic, including our financial services products;
- the results of our litigation;
- the passage of legislation adversely affecting the rent-to-own or financial services industries;
- interest rates;
- our ability to enter into new and collect on our rental purchase agreements;
- our ability to enter into new and collect on our short term loans;
- economic pressures affecting the disposable income available to our targeted consumers, such as high fuel and utility costs;
- changes in our effective tax rate;
- our ability to maintain an effective system of internal controls;
- changes in the number of share-based compensation grants, methods used to value future share-based payments and changes in estimated forfeiture rates with respect to share-based compensation;
- changes in our stock price and the number of shares of common stock that we may or may not repurchase; and
- the other risks detailed from time to time in our SEC reports.

Additional factors that could cause our actual results to differ materially from our expectations are discussed under the section entitled Risk Factors and elsewhere in this report. You should not unduly rely on these forward-looking

statements, which speak only as of the date of this report. Except as required by law, we are not obligated to publicly release any revisions to these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events.

Critical Accounting Policies Involving Critical Estimates, Uncertainties or Assessments in Our Financial Statements

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported

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amounts of assets and liabilities, disclosure of contingent losses and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. In applying accounting principles, we must often make individual estimates and assumptions regarding expected outcomes or uncertainties. Our estimates, judgments and assumptions are continually evaluated based on available information and experience. Because of the use of estimates inherent in the financial reporting process, actual results could differ from those estimates. We believe the following are areas where the degree of judgment and complexity in determining amounts recorded in our consolidated financial statements make the accounting policies critical.

Self-Insurance Liabilities. We have self-insured retentions with respect to losses under our workers' compensation, general liability, and auto liability insurance policies. We establish reserves for our liabilities associated with these losses by obtaining forecasts for the ultimate expected losses and estimating amounts needed to pay losses within our self-insured retentions.

We make assumptions on our liabilities within our self-insured retentions using actuarial loss forecasts, which are prepared using methods and assumptions in accordance with standard actuarial practice, and third party claim administrator loss estimates which are based on known facts surrounding individual claims. During 2005, each quarter we reevaluated our estimate of liability within our self-insured retentions, including our assumptions related to our loss forecasts and estimates, using actuarial loss forecasts updated during the quarter and currently valued third party claim administrator loss estimates. We evaluate the adequacy of our accruals by comparing amounts accrued on our balance sheet for anticipated losses to our updated actuarial loss forecasts and third party claim administrator loss estimates, and make adjustments to our accruals as needed based upon such review.

Over the previous 10 years, our loss exposure has increased, primarily as a result of our growth. We instituted procedures to manage our loss exposure through a greater focus on the risk management function, a transitional duty program for injured workers, ongoing safety and accident prevention training, and various programs designed to minimize losses and improve our loss experience in our store locations.

As of December 31, 2005, the net amount accrued for losses within our self-insured retentions was \$97.0 million, as compared to \$87.2 million at December 31, 2004. The increase in the net amount accrued for the 2005 period is a result of an estimate for new claims expected for the current policy period, which incorporates our store growth, increased number of employees, increases in health care costs, and the net effect of prior period claims which have closed or for which additional development or changes in estimates have occurred.

Litigation Reserves. We are the subject of litigation in the ordinary course of our business. Our litigation involves, among other things, actions relating to claims that our rental purchase agreements constitute installment sales contracts, violate state usury laws or violate other state laws to protect consumers, claims asserting violations of wage and hour laws in our employment practices, as well as claims we violated the federal securities laws. In preparing our financial statements at a given point in time, we account for these contingencies pursuant to the provisions of SFAS No. 5, which requires that we accrue for losses that are both probable and reasonably estimable.

Each quarter, we make estimates of our probable liabilities, if reasonably estimable, and record such amounts in our consolidated financial statements. These amounts represent our best estimate, or may be the minimum range of probable loss when no single best estimate is determinable. We, together with our counsel, monitor developments related to these legal matters and, when appropriate, adjustments are made to reflect current facts and circumstances. As of December 31, 2005, we had accrued \$4.5 million relating to our outstanding litigation, of which \$1.9 million was related to the settlement of the *Pucci/ Chess* matter (which was funded in February 2006), approximately \$1.3 million related to the prospective settlement of the *Rose/ Madrigal* matters, and an additional \$1.3 million for anticipated legal fees and expenses with respect to our other outstanding litigation, as compared to \$49.0 million for the year ended December 31, 2004, of which we had accrued \$47.0 million in connection with the settlement of the *Griego/ Carrillo* matter, and an additional \$2.0 million for probable litigation costs with respect to our other outstanding litigation.

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The ultimate outcome of our litigation is uncertain, and the amount of loss we may incur, if any, cannot in our judgment be reasonably estimated. Additional developments in our litigation or other adverse or positive developments or rulings in our litigation, could affect our assumptions and thus, our accrual.

Income Tax Reserves. We are subject to federal, state, local and foreign income taxes. We estimate our liabilities for income tax exposure by evaluating our income tax reserves each quarter based on the information available to us, and establishing reserves in accordance with the criteria for accrual under SFAS No. 5. In estimating this liability, we evaluate a number of factors in ascertaining whether we may have to pay additional taxes and interest when all examinations by taxing authorities are concluded. The actual amount accrued as a liability is based on an evaluation of the underlying facts and circumstances, a thorough research of the technical merits of our arguments, and an assessment of the chances of us prevailing in our arguments. We consult with external tax advisers in researching our conclusions. At December 31, 2005, we had accrued \$4.9 million relating to our contingent liabilities for income taxes, as compared to \$7.7 million at December 31, 2004. The decrease in the amount accrued for the 2005 period primarily relates to the reversal of a \$3.3 million state tax reserve in connection with a change in estimate as well as a \$2.0 million tax audit reserve associated with the favorable resolution of our 1998 and 1999 federal tax returns offset slightly by our normal tax accruals.

If we make changes to our accruals in any of these areas in accordance with the policies described above, these changes would impact our earnings. Increases to our accruals would reduce earnings and similarly, reductions to our accruals would increase our earnings. A pre-tax change of \$1.1 million in our estimates would result in a corresponding \$0.01 change in our earnings per common share.

Based on an assessment of our accounting policies and the underlying judgments and uncertainties affecting the application of those policies, we believe that our consolidated financial statements fairly present in all material respects the financial condition, results of operations and cash flows of our company as of, and for, the periods presented in this report. However, we do not suggest that other general risk factors, such as those discussed elsewhere in this report as well as changes in our growth objectives or performance of new or acquired stores, could not adversely impact our consolidated financial position, results of operations and cash flows in future periods.

Significant Accounting Policies

Our significant accounting policies are summarized below and in Note A to our consolidated financial statements included elsewhere herein.

Revenue. Merchandise is rented to customers pursuant to rental-purchase agreements which provide for weekly, semi-monthly or monthly rental terms with non-refundable rental payments. Generally, the customer has the right to acquire title either through a purchase option or through payment of all required rentals. Rental revenue and fees are recognized over the rental term as payments are received and merchandise sales revenue is recognized when the customer exercises their purchase option and pays the cash price due. Revenue for the total amount of the rental purchase agreement is not accrued because the customer can terminate the rental agreement at any time and we cannot enforce collection for non-payment of rents. Because Get It Now makes retail sales on an installment credit basis, Get It Now's revenue is recognized at the time of such retail sale, as is the cost of the merchandise sold, net of a provision for uncollectible accounts. The revenue from our financial services is recorded differently depending on the type of transaction. Fees collected on loans are recognized ratably over the term of the loan. For money orders, wire transfers, check cashing and other customer service type transactions, fee revenue is recognized at the time of the transactions.

Franchise Revenue. Revenue from the sale of rental merchandise is recognized upon shipment of the merchandise to the franchisee. Franchise fee revenue is recognized upon completion of substantially all services and satisfaction of all material conditions required under the terms of the franchise agreement.

Depreciation of Rental Merchandise. Depreciation of rental merchandise is included in the cost of rentals and fees on our statement of earnings. We depreciate our rental merchandise using the income forecasting method. Under the income forecasting method, merchandise held for rent is not depreciated and

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merchandise on rent is depreciated in the proportion of rents received to total rents provided in the rental contract, which is an activity-based method similar to the units of production method. On computers that are 24 months old or older and which have become idle, depreciation is recognized using the straight-line method for a period of at least six months, generally not to exceed an aggregate depreciation period of 36 months. The purpose is to better reflect the depreciable life of a computer in our stores and to encourage the sale of older computers.

Cost of Merchandise Sold. Cost of merchandise sold represents the book value net of accumulated depreciation of rental merchandise at time of sale.

Salaries and Other Expenses. Salaries and other expenses include all salaries and wages paid to store level employees, together with market managers' salaries, travel and occupancy, including any related benefits and taxes, as well as all store level general and administrative expenses and selling, advertising, insurance, occupancy, delivery, fixed asset depreciation and other operating expenses.

General and Administrative Expenses. General and administrative expenses include all corporate overhead expenses related to our headquarters such as salaries, taxes and benefits, occupancy, administrative and other operating expenses.

Results of Operations

The following table sets forth, for the periods indicated, historical Consolidated Statements of Earnings data as a percentage of total store and franchise revenues.

	Year Ended December 31,			Year Ended December 31,		
	2005	2004	2003	2005	2004	2003
	(Company-owned stores only)			(Franchise operations only)		
Revenues						
Rentals and fees	90.8%	91.4%	91.8%	%	%	%
Merchandise Sales	8.9	8.4	8.0	87.9	88.2	88.5
Other/ Royalty income and fees	0.3	0.2	0.2	12.1	11.8	11.5
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Operating Expenses						
Direct store expenses						
Cost of rentals and fees	19.7%	19.9%	19.9%	%	%	%
Cost of merchandise sold	6.1	5.7	5.6	84.4	84.1	84.9
Salaries and other expenses	59.2	56.4	54.2			
	85.0	82.0	79.7	84.4	84.1	84.9
General and administrative expenses	3.5	3.2	3.1	6.6	6.3	4.1
Amortization of intangibles	0.5	0.5	0.1	0.7	0.6	0.6
Class action litigation (reversion)	(0.3)					
Restructuring charge	0.7	2.1				
Total operating expenses	89.4	87.8	82.9	91.7	91.0	89.6
Operating profit	10.6	12.2	17.1	8.3	9.0	10.4
Interest, net and other income	1.8	1.4	3.7	(1.0)	(0.9)	(1.1)
Earnings before income taxes	8.8%	10.8%	13.4%	9.3%	9.9%	11.5%

Overview of 2005 Results

Total revenue for the year ended December 31, 2005 increased slightly, while net earnings decreased from the prior year primarily due to a decrease in same store sales, the impact of expenses related to our store

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consolidation plan and an increase in our salaries and other expenses, some of which related to expenses incurred as a result of Hurricanes Katrina, Rita and Wilma. We generated \$187.9 million in operating cash flow, with \$57.6 million in cash on hand at December 31, 2005. Same store revenues for the twelve month period ended December 31, 2005 decreased 2.3%, compared to a decrease of 3.6% for the twelve month period ended December 31, 2004. In addition, we repurchased 5,900,700 shares of our common stock for an aggregate of \$118.4 million.

Store Consolidation Plan

On September 6, 2005, we announced our plan to close up to 162 stores by December 31, 2005. The decision to close these stores was based on management's analysis and evaluation of the markets in which we operate, including our market share, operating results, competitive positioning and growth potential for the affected stores. The 162 stores included 114 stores that we intended to close and merge with our existing stores and up to 48 additional stores that we intended to sell, merge with a potential acquisition or close by December 31, 2005. As of December 31, 2005, we had merged 113 of the 114 stores identified to be merged with existing locations, sold 35 and merged one of the additional 48 stores on the plan.

We estimated that we would incur restructuring expenses in the range of \$12.1 million to \$25.1 million, to be recorded in the third and fourth quarters of the fiscal year ending December 31, 2005, based on the closing date of the stores. During the year ended December 31, 2005, we recorded restructuring charges of \$15.2 million. The following table presents the original range of estimated charges, the charges recorded in the fiscal year ending December 31, 2005, the estimated range of remaining charges to be recorded in the fiscal year ending December 31, 2006 and the remaining accrual as of December 31, 2005:

	Closing Plan Estimate	Expense Recognized During 2005	Estimated Remaining Charges for 2006
(In thousands)			
Lease obligations	\$ 8,661 - \$13,047	\$ 9,261	\$ 0 - \$3,786
Fixed asset disposals	2,630 - 4,211	3,333	0 - 878
Net proceeds from stores sold		(2,250)	
Other costs ⁽¹⁾	830 - 7,875	4,822	0 - 3,053
Total	\$ 12,121 - \$25,133	\$ 15,166	\$ 0 - \$7,717

The following table shows the changes in the accrual balance from September 30, 2005 to December 31, 2005, relating to our store consolidation plan.

	September 30, 2005 Balance	Charges to Expense	Cash (Payments) Receipts or Asset Write-Offs	December 31, 2005 Balance
(In thousands)				
Lease obligations	\$ 5,341	\$ 2,759	\$ (2,736)	\$ 5,364
Fixed asset disposals		1,544	(1,544)	
Net proceeds from stores sold		(2,250)	2,250	
Other costs ⁽¹⁾	658	86	(653)	91

Total	\$	5,999	\$	2,139	\$	(2,683)	\$	5,455
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(1) Goodwill impairment charges are the primary component of other costs. Additional costs include inventory disposals and the removal of signs and various assets from vacated locations.

We expect the total estimated cash outlay in connection with the store closing plan to be between \$9.0 million to \$13.7 million. The total amount of cash used in the store closing plan during 2005 was approximately \$4.0 million. Therefore, we expect to use approximately \$5.0 million to \$9.7 million of cash on hand for future payments primarily related to the satisfaction of lease obligations for closed stores.

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Table of Contents**Effects of Hurricanes Katrina, Rita and Wilma.**

During the last six months of 2005, we recorded pre-tax expenses of approximately \$8.9 million related to the damage caused by Hurricanes Katrina, Rita and Wilma. These costs relate primarily to goodwill impairment of approximately \$3.7 million and a combined loss of approximately \$5.2 million for inventory and fixed assets written off.

Comparison of the Years ended December 31, 2005 and 2004

Store Revenue. Total store revenue increased by \$29.8 million, or 1.3%, to \$2,296.1 million for 2005 from \$2,266.3 million for 2004. The increase in total store revenue was primarily attributable to approximately \$69.1 million in incremental revenue from new stores and acquisitions, net of stores sold, during 2005 as compared to 2004, offset by a decrease in same store sales of 2.3%.

Same store revenues represent those revenues earned in 2,043 stores that were operated by us for each of the entire years ending December 31, 2005 and 2004. Same store revenues decreased by \$39.3 million, or 2.3% in 2005 as compared to 2004. This decrease in same store revenues was primarily attributable to a decrease in the average number of customers on a per store basis during 2005 as compared to 2004.

Franchise Revenue. Total franchise revenue decreased by \$3.9 million, or 8.3%, to \$43.0 million for 2005 from \$46.9 million in 2004. This decrease was primarily attributable to a decrease in merchandise sales to franchise locations as a result of 15 fewer franchised locations operating, on a weighted average basis, during 2005 as compared to 2004. The number of franchised locations operating in 2005 declined primarily as a result of the purchase of 54 franchised locations by other Rent-A-Center subsidiaries.

Cost of Rentals and Fees. Cost of rentals and fees consists of depreciation of rental merchandise and the costs associated with our membership programs which began in 2004. Cost of rentals and fees for the year ended December 31, 2005, increased by \$2.6 million, or 0.6%, to \$452.6 million for the year ended December 31, 2005 as compared to \$450.0 million in 2004. This increase is a result of an increase in store rental revenue in 2005 compared to 2004. Depreciation of rental merchandise expressed as a percentage of store rentals and fees revenue was constant at 21.7% for 2005 and 2004.

Cost of Merchandise Sold. Cost of merchandise sold increased by \$10.5 million, or 8.8%, to \$129.6 million for 2005 from \$119.1 million in 2004. This increase was a result of an increase in the number of items sold in 2005 as compared to 2004. The gross profit percent of merchandise sales decreased to 26.9% for 2005 from 28.5% in 2004. This percentage decrease was primarily attributable to a decrease in the average purchase price on merchandise sales during 2005 as compared to 2004.

Salaries and Other Expenses. Salaries and other expenses increased by \$80.8 million, or 6.3% to \$1,358.7 million for the year ended December 31, 2005 as compared to \$1,277.9 million in 2004. The increase was primarily the result of an increase in salaries and wages and occupancy costs, higher fuel expenses relating to product deliveries and utility costs, as well as the impact of inventory and fixed assets written-off due to Hurricanes Katrina, Rita and Wilma. Salaries and other expenses expressed as a percentage of total store revenue increased to 59.2% for the year ended December 31, 2005 from 56.4% in 2004. This percentage increase was primarily attributable to the decrease in same store sales during 2005 as compared to 2004.

Franchise Cost of Merchandise Sold. Franchise cost of merchandise sold decreased by \$3.2 million, or 8.0%, to \$36.3 million for 2005 from \$39.5 in 2004. This decrease was primarily attributable to a decrease in merchandise sales to franchise locations as a result of 15 fewer franchised locations operating, on a weighted average basis, during 2005 as compared to 2004. The number of franchised locations operating in 2005 declined primarily as a result of the purchase of 54 franchised locations by other Rent-A-Center subsidiaries.

General and Administrative Expenses. General and administrative expenses increased by \$6.8 million, or 9.0%, to \$82.3 million for the year ended December 31, 2005, as compared to \$75.5 million in 2004. General and administrative expenses expressed as a percent of total revenue increased to 3.5% in 2005 from 3.3% in 2004. These increases are primarily attributable to additional personnel and related expansion at our

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corporate office to support current and future growth, including our plans to expand into complimentary lines of business in our rent-to-own stores.

Amortization of Intangibles. Amortization of intangibles increased by \$925,000, or 8.6%, to \$11.7 million for 2005 from \$10.8 million in 2004. This increase was primarily attributable to the impairment charges recorded in connection with our store closing plan and stores that closed due to Hurricane Katrina offset by completed customer relationship amortization associated with previous acquisitions, such as the Rent Way, Rainbow and Rent-Rite acquisitions.

Operating Profit. Operating profit decreased by \$33.2 million, or 11.7%, to \$249.8 million for the year ended December 31, 2005 as compared to \$283.0 million in 2004. Operating profit as a percentage of total revenue decreased to 10.7% for the year ended December 31, 2005 from 12.2% in 2004. These decreases were primarily attributable to the decrease in same store sales and the increase in salaries and other expenses during 2005 versus 2004 as discussed above.

Income Tax Expense. Income tax expense decreased by \$22.2 million, or 23.2%, to \$73.3 million for the year ended December 31, 2005 as compared to \$95.5 million in 2004. This decrease is primarily attributable to a decrease in earnings before taxes for 2005 as compared to 2004, in addition to a decrease in our overall effective tax rate to 35.07% for 2005 as compared to 38.00% for 2004. The rate decrease was the result of the reversal of a \$3.3 million state tax reserve in connection with a change in estimate related to potential loss exposures and a \$2.0 million tax audit reserve associated with the examination and favorable resolution of our 1998 and 1999 federal tax returns.

Net Earnings. Net earnings decreased by \$20.1 million, or 12.9%, to \$135.7 million for the year ended December 31, 2005 as compared to \$155.8 million in 2004. This decrease was primarily attributable to the decrease in same store sales, the impact of expenses related to our store consolidation plan and the increase in salaries and other expenses during 2005 versus 2004 as discussed above, offset by a pre-tax litigation reversion of \$8.0 million and the tax credits discussed above.

Comparison of the Years ended December 31, 2004 and 2003

Store Revenue. Total store revenue increased by \$89.1 million, or 4.1%, to \$2,266.3 million for 2004 from \$2,177.2 million for 2003. The increase in total store revenue was primarily attributable to approximately \$155.8 million in incremental revenue from new stores and acquisitions, net of stores sold, during 2004 as compared to 2003, offset by a decrease in same store sales of 3.6%.

Same store revenues represent those revenues earned in 1,937 stores that were operated by us for each of the entire years ending December 31, 2004 and 2003. Same store revenues decreased by \$60.9 million, or 3.6% in 2004 as compared to 2003. This decrease in same store revenues was primarily attributable to a decrease in the average number of customers on a per store basis during 2004 as compared to 2003.

Franchise Revenue. Total franchise revenue decreased by \$4.0 million, or 7.9%, to \$46.9 million for 2004 from \$50.9 million in 2003. This decrease was primarily attributable to a decrease in merchandise sales to franchise locations as a result of 16 fewer franchised locations operating by the end of 2004 as compared to 2003. The number of franchised locations operating in 2004 declined primarily as a result of fewer new franchise stores together with the purchase of 27 franchised locations by other Rent-A-Center subsidiaries.

Cost of Rentals and Fees. Cost of rentals and fees consists of depreciation of rental merchandise and the costs associated with our membership programs which began in 2004. Depreciation of rental merchandise, which accounts for 99.2% of the cost of rentals and fees for the year ended December 31, 2004, increased by \$13.9 million, or 3.2%, to \$446.6 million for the year ended December 31, 2004 as compared to \$432.7 million in 2003. This increase is a result of an increase in store rental revenue in 2004 compared to 2003. Depreciation of rental merchandise expressed as a percentage of store rentals and fees revenue was constant at 21.6% for 2004 and 2003.

Cost of Merchandise Sold. Cost of merchandise sold increased by \$6.8 million, or 6.1%, to \$119.1 million for 2004 from \$112.3 million in 2003. This increase was a result of an increase in the number of items sold

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in 2004 as compared to 2003. The gross profit percent of merchandise sales increased to 28.5% for 2004 from 26.6% in 2003. This percentage increase was primarily attributable to an increase in the average purchase price on merchandise sales during 2004 as compared to 2003.

Salaries and Other Expenses. Salaries and other expenses increased by \$97.8 million, or 8.3% to \$1,277.9 million for the year ended December 31, 2004 as compared to \$1,180.1 million in 2003. The increase was primarily the result of an increase in salaries and wages and occupancy costs due to an increased number of stores in the 2004 period. For the year ending December 31, 2004, there were 228 more stores, on a weighted average basis, operating during the year as compared to 2003. Salaries and other expenses expressed as a percentage of total store revenue increased to 56.4% for the year ended December 31, 2004 from 54.2% in 2003. This increase was primarily attributable to the decrease in same store sales coupled with an increase in salaries and other expenses of \$104.5 million during 2004 compared to 2003 resulting from an increase in our store base, which was offset by a decrease of approximately \$6.7 million in salaries and other expense incurred by our mature stores.

Franchise Cost of Merchandise Sold. Franchise cost of merchandise sold decreased by \$3.7 million, or 8.7%, to \$39.5 million for 2004 from \$43.2 in 2003. This decrease was primarily attributable to a decrease in merchandise sales to franchise locations as a result of 16 fewer franchised locations operating by the end of 2004 as compared to 2003. The number of franchised locations operating in 2004 declined primarily as a result of fewer new franchise stores together with the purchase of 27 franchised locations by other Rent-A-Center subsidiaries.

General and Administrative Expenses. General and administrative increased by \$8.9 million, or 13.3%, to \$75.5 million for the year ended December 31, 2004, as compared to \$66.6 million in 2003. General and administrative expenses expressed as a percent of total revenue increased to 3.3% in 2004 from 3.0% in 2003. These increases are primarily attributable to the operation of the Rainbow Rentals and Rent Rite headquarters during the integration and transition period pursuant to those acquisitions, expansion at our corporate office to support current and future store growth as well as the impact of the decrease in our same stores sales for 2004.

Amortization of Intangibles. Amortization of intangibles decreased by \$1.7 million, or 13.8%, to \$10.8 million for 2004 from \$12.5 million in 2003. This decrease was primarily attributable to the completed amortization of certain intangibles, particularly the \$7.9 million in customer relationships associated with the 2003 acquisition of 295 stores from Rent-Way. The decrease due to the completion of amortization of certain intangibles was offset by the addition of customer relationship and non-compete amortization related to the Rainbow Rentals and Rent Rite acquisitions in May 2004.

Operating Profit. Operating profit decreased by \$87.0 million, or 23.5%, to \$283.0 million for the year ended December 31, 2004 as compared to \$370.0 million in 2003. Excluding the pre-tax litigation charges of \$47.0 million recorded in 2004, operating profit decreased \$40.0 million, or 10.8%, to \$330.0 million for the year ended December 31, 2004 as compared to \$370.0 million in 2003. Operating profit as a percentage of total revenue decreased to 14.3% for the year ended December 31, 2004 before the pre-tax litigation charge of \$47.0 million, from 16.6% for the year ended December 31, 2003. These decreases, excluding the pre-tax litigation charge, were primarily attributable to the decrease in same store sales during 2004 versus 2003 and the increase in salaries and other expenses as discussed above. For the year ended December 31, 2004, there were 228 more stores, on a weighted average basis, operating during the year as compared to 2003, many of which are not yet performing at the level of a mature store.

Financing Costs. In 2004, we incurred \$4.2 million in charges related to the refinancing of our senior debt in July 2004. During 2003, we announced and commenced a program to recapitalize a portion of our financial structure in a series of transactions. Please see Note G in the notes to consolidated financial statements included in this report. In connection with the recapitalization in 2003, we recorded \$35.3 million in financing charges. These charges primarily consisted of senior subordinated note premiums of approximately \$18.7 million, senior subordinated note issue costs and loan origination fees written-off of approximately \$11.9 million and other bank charges and fees of approximately \$4.7 million.

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Income Tax Expense. Income tax expense decreased by \$13.8 million, or 12.6%, to \$95.5 million for the year ended December 31, 2004 as compared to \$109.3 million in 2003. This decrease is primarily attributable to a decrease in earnings before taxes for 2004 as compared to 2003, offset by a slight increase in our overall effective tax rate to 38.0% for 2004 as compared to 37.6% for 2003.

Net Earnings. Including the litigation charge adjustments noted above, net earnings decreased by \$25.6 million, or 14.1%, to \$155.9 million for the year ended December 31, 2004 as compared to \$181.5 million in 2003. Excluding the after tax effects of the \$47.0 million litigation charge, \$4.2 million refinance charge and \$7.9 million in other income from the sale of charged off accounts recorded in 2004, net earnings decreased by \$20.5 million, or 10.1%, to \$182.7 million for the year ended December 31, 2004 from \$203.2 million before the after tax effects of the \$35.3 million in recapitalization charges recorded in 2003. This decrease is primarily attributable to the operating profit decrease mentioned above, offset by lower interest expense during 2004 as compared to 2003.

Quarterly Results

The following table contains certain unaudited historical financial information for the quarters indicated. All prices and amounts have been adjusted to reflect the 5-for-2 split of our common stock effected in August 2003.

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
(In thousands, except per share data)				
Year ended December 31, 2005				
Revenues	\$601,809	\$580,578	\$573,507	\$583,213
Operating profit	85,992	72,988	30,980 ⁽²⁾	59,811
Net earnings	47,669 ⁽¹⁾	41,742	11,277	35,050 ⁽³⁾
Basic earnings per common share	\$ 0.64	\$ 0.56	\$ 0.15	\$ 0.50
Diluted earnings per common share	\$ 0.63	\$ 0.55	\$ 0.15	\$ 0.50
Year ended December 31, 2004				
Revenues	\$585,380	\$572,985	\$569,607	\$585,283
Operating profit	92,659	90,223	24,344 ⁽⁴⁾	75,725
Net earnings	52,209	51,194	5,573	46,879
Basic earnings per common share	\$ 0.65	\$ 0.64	\$ 0.07	\$ 0.63
Diluted earnings per common share	\$ 0.63	\$ 0.62	\$ 0.07	\$ 0.61
Year ended December 31, 2003				
Revenues	\$566,406	\$553,260	\$549,825	\$558,659
Operating profit	96,291	97,238	87,502	88,991
Net earnings	50,959	35,300	43,738	51,499
Basic earnings per common share	\$ 0.58	\$ 0.40	\$ 0.54	\$ 0.64
Diluted earnings per common share	\$ 0.57	\$ 0.39	\$ 0.52	\$ 0.62

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	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
	(As a percentage of revenues)			
Year ended December 31, 2005				
Revenues	100.0%	100.0%	100.0%	100.0%
Operating profit	14.3	12.6	5.4 ₍₂₎	10.3
Net earnings	7.9 ₍₁₎	7.2	2.0	6.0 ₍₃₎
Year ended December 31, 2004				
Revenues	100.0%	100.0%	100.0%	100.0%
Operating profit	15.8	15.7	4.3 ₍₄₎	12.9
Net earnings	8.9	8.9	1.0	8.0
Year ended December 31, 2003				
Revenues	100.0%	100.0%	100.0%	100.0%
Operating profit	17.0	17.6	15.9	15.9
Net earnings	9.0	6.4	8.0	9.2

- (1) Includes the effects of a pre-tax legal reversion of \$8.0 million associated with the settlement of a class action lawsuit in the state of California and a \$2.0 million tax audit reserve credit associated with the examination and favorable resolution of our 1998 and 1999 federal tax returns.
- (2) Includes the effects of a \$13.0 million pre-tax restructuring expense as part of our store consolidation plan, \$7.7 million in pre-tax expenses related to the damage caused by Hurricanes Katrina and Rita.
- (3) Includes the effects of a \$2.1 million pre-tax restructuring expense as part of our store consolidation plan, \$1.1 million in pre-tax expenses related to the damage caused by Hurricanes Katrina, Rita and Wilma and a \$3.3 million state tax reserve credit due to a change in estimate related to potential loss exposures.
- (4) Includes the effects of a pre-tax legal settlement charge of \$47.0 million associated with the settlement of a class action lawsuit in the state of California.

Liquidity and Capital Resources

For the year ended December 31, 2005, we generated approximately \$187.9 million in operating cash flow. In addition to funding operating expenses, we used approximately \$60.2 million for capital expenditures, approximately \$38.3 million in acquisitions of existing rent-to-own stores, and approximately \$118.4 million in stock repurchases. We ended the year with approximately \$57.6 million in cash and cash equivalents.

Cash provided by operating activities decreased by \$143.1 million to \$187.9 million in 2005 from \$331.0 million in 2004. This decrease is attributable to a decrease in net earnings, changes in deferred income taxes resulting from the reversal of the effect that the Job Creation and Workers Assistance Act of 2002 had on our cash flow as discussed under *Deferred Taxes* below and changes in accrued liabilities. The change in our accrued liabilities is primarily due to the litigation settlement accrual of \$47.0 million recorded in the third quarter of 2004 and then paid in 2005.

Cash used in investing activities decreased by \$136.5 million to \$96.0 million in 2005 from \$232.5 million in 2004. This decrease is primarily attributable to the acquisition of Rent Rite and Rainbow Rentals in May 2004 as well as a decrease in property assets purchased during 2005 as compared to 2004.

Cash used in financing activities decreased by \$90.6 million to \$93.1 million in 2005 from \$183.7 million in 2004. This decrease is primarily related to decrease in stock repurchases in 2005 as compared to 2004.

Liquidity Requirements. Our primary liquidity requirements are for debt service, rental merchandise purchases, capital expenditures, and implementation of our growth strategies, including store expansion and investment in our

financial services business. Our primary sources of liquidity have been cash provided by operations, borrowings and sales of debt and equity securities. In the future, to provide any additional funds necessary for the continued pursuit of our operating and growth strategies, we may incur from time to time additional short or long-term bank indebtedness and may issue, in public or private transactions, equity and debt securities. The availability and attractiveness of any outside sources of financing will depend on a number

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of factors, some of which relate to our financial condition and performance, and some of which are beyond our control, such as prevailing interest rates and general economic conditions. There can be no assurance that additional financing will be available, or if available, that it will be on terms we find acceptable.

We believe that the cash flow generated from operations, together with amounts available under our senior credit facilities, will be sufficient to fund our debt service requirements, rental merchandise purchases, capital expenditures, and our store expansion programs during 2006. Our revolving credit facilities, including our \$10.0 million line of credit at Intrust Bank, provide us with revolving loans in an aggregate principal amount not exceeding \$260.0 million, of which \$110.5 million was available at March 8, 2006. At March 8, 2006, we had \$91.0 million in cash. To the extent we have available cash that is not necessary to fund the items listed above, we intend to repurchase additional shares of our common stock, repurchase some of our outstanding subordinated notes, as well as make additional payments to service our existing debt. While our operating cash flow has been strong and we expect this strength to continue, our liquidity could be negatively impacted if we do not remain as profitable as we expect.

If a change in control occurs, we may be required to offer to repurchase all of our outstanding subordinated notes at 101% of their principal amount, plus accrued interest to the date of repurchase. Our senior credit facility restricts our ability to repurchase the subordinated notes, including in the event of a change in control. In addition, a change in control would result in an event of default under our senior credit facilities, which would allow our lenders to accelerate the indebtedness owed to them. In the event a change in control occurs, we cannot be sure we would have enough funds to immediately pay our accelerated senior credit facility obligations and all of the subordinated notes, or that we would be able to obtain financing to do so on favorable terms, if at all.

Litigation. In November 2005, we reached an agreement in principle to settle all of the pending lawsuits and related matters in Washington brought by the plaintiffs' counsel in the *Rose/ Madrigal* matters on an agreed state-wide class basis for \$1.25 million. These matters alleged violations of various provisions of Washington state law regarding overtime, lunch and work breaks, failure to pay wages due to our Washington employees, and various labor related matters. In January 2006, the court in *Rose/ Madrigal* preliminarily approved the class settlement. The final approval hearing before the court is scheduled for April 21, 2006. To account for this prospective settlement, as well as our own attorneys' fees, we accrued an aggregate of \$1.3 million as of December 31, 2005.

While we believe that the terms of this settlement are fair, there can be no assurance that the settlement, if completed, will be approved by the court in its present form. We believe that the cash flow generated from operations will be sufficient to fund the prospective settlement without adversely affecting our liquidity.

Additional settlements or judgments against us on our existing litigation could affect our liquidity. Please refer to Note M of our consolidated financial statements included herein.

Deferred Taxes. On March 9, 2002, President Bush signed into law the Job Creation and Worker Assistance Act of 2002, which provides for accelerated tax depreciation deductions for qualifying assets placed in service between September 11, 2001 and September 10, 2004. Under these provisions, 30% of the basis of qualifying property is deductible in the year the property is placed in service, with the remaining 70% of the basis depreciated under the normal tax depreciation rules. For assets placed in service between May 6, 2003 and December 31, 2004, the Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the percent of the basis of qualifying property deductible in the year the property is placed in service from 30% to 50%. Accordingly, our cash flow benefited from the resulting lower cash tax obligations in those prior years. We estimate that our operating cash flow, on a net cumulative basis, from the accelerated depreciation deductions on rental merchandise increased by approximately \$85.3 million through 2004. The associated deferred tax liabilities are expected to reverse over a three year period which began in 2005. Approximately \$67.0 million, or 79%, reversed in 2005. We expect that \$15.2 million, or 18%, will reverse in 2006 and the remaining \$3.1 million will reverse in 2007, which will result in additional cash taxes and a corresponding decrease in our deferred tax liabilities discussed above.

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Rental Merchandise Purchases. We purchased \$655.6 million, \$654.3 million and \$612.3 million of rental merchandise during the years 2005, 2004 and 2003, respectively.

Capital Expenditures. We make capital expenditures in order to maintain our existing operations as well as for new capital assets in new and acquired stores. We spent \$60.2 million, \$72.1 million and \$56.0 million on capital expenditures in the years 2005, 2004 and 2003, respectively, and expect to spend approximately \$82.0 million in 2006, which includes amounts we intend to spend with respect to expanding our financial services business and our new corporate headquarters facility as discussed below.

In December 2005, we acquired approximately 15 acres of land located in Plano, Texas, on which we intend to build a new corporate headquarters facility. The purchase price for the land was approximately \$4.2 million. Building costs are expected to be in the range of \$20.0-\$25.0 million, and construction began in January 2006. Building costs will be paid on a percentage of completion basis throughout the construction period, and the building is expected to be completed by the end of 2006. We intend to finance this project from cash flow generated from operations. Our remaining lease obligation on our existing location is approximately \$6.2 million. We anticipate subleasing some or all of the space at our current location to offset the remaining lease obligation. Additionally, we have adjusted the remaining life on the assets which will be abandoned upon our move to the new facility.

Acquisitions and New Store Openings. During 2005, we continued our strategy of increasing our rent-to-own store base through opening new stores, as well as through opportunistic acquisitions. We spent approximately \$38.3 million in cash acquiring stores and accounts for the year ended December 31, 2005. It is our intention to increase the number of stores we operate by an average of approximately 5% per year over the next several years.

During 2005, we acquired 44 stores, accounts from 39 additional locations, opened 67 new stores, and closed 226 stores. Of the closed stores, 170 were merged with existing store locations, 13 stores were closed due to Hurricane Katrina and 43 stores were sold. The acquired stores and accounts were the result of 38 separate transactions for an aggregate price of approximately \$38.3 million, of which \$3.6 million will be paid at the conclusion of an escrow period.

The table below summarizes the store growth activity for the year ended December 31, 2005, 2004 and 2003.

	2005	2004	2003
Stores at beginning of period	2,875	2,648	2,407
New store openings	67	94	101
Acquired stores remaining open	44	191	160
Closed stores			
Merged with existing stores	170	48	20
Sold or closed with no surviving store	56	10	
Stores at end of period	2,760	2,875	2,648
Acquired stores closed and accounts merged with existing stores	39	111	220
Total approximate purchase price of acquisitions	\$ 38.3 million	\$ 195.2 million ⁽¹⁾	\$ 126.1 million

⁽¹⁾ The total purchase price includes non-cash consideration of approximately \$23.8 million in common stock issued and approximately \$6.1 million in fair value assigned to the stock options assumed in connection with the acquisition of Rent Rite, Inc.

The profitability of our rent-to-own stores tends to grow at a slower rate approximately five years from the time we open or acquire them. As a result, in order for us to show improvements in our profitability, it is important for us to continue to open stores in new locations or acquire underperforming stores on favorable terms. There can be no assurance we will be able to acquire or open new stores at the rates we expect, or at all.

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We cannot assure you the stores we do acquire or open will be profitable at the same levels as our current stores, or at all.

Senior Credit Facilities. Our \$600.0 million senior credit facilities consist of a \$350.0 million term loan and a \$250.0 million revolving credit facility. The full amount of the revolving credit facility may be used for the issuance of letters of credit, of which \$107.5 million had been utilized as of March 8, 2006. As of March 8, 2006, \$110.5 million was available under our revolving facility. The revolving credit facility expires in July 2009 and the term loan expires in 2010.

The table below shows the scheduled maturity dates of our senior term debt outstanding at December 31, 2005.

Year Ending December 31,

	(In thousands)
2006	\$ 3,500
2007	3,500
2008	3,500
2009	168,000
2010	166,250
Thereafter	
	\$ 344,750

Borrowings under our senior credit facilities bear interest at varying rates equal to the Eurodollar rate plus 1.00% to 2.00%, or the prime rate plus up to 1.00%, at our election. The weighted average Eurodollar rate on our outstanding debt was 4.49% at December 31, 2005. None of our outstanding borrowings at December 31, 2005 utilized the prime rate option. The margins on the Eurodollar rate and on the prime rate may fluctuate dependent upon an increase or decrease in our consolidated leverage ratio as defined by a pricing grid included in our credit agreement. For the year ended December 31, 2005, the average effective rate on outstanding borrowings under the senior credit facilities was 6.29%. We have not entered into any interest rate protection agreements with respect to term loans under the new senior credit facility. A commitment fee equal to 0.20% to 0.50% of the unused portion of the revolving credit facility is payable quarterly. As of March 8, 2006, the total amount outstanding on our revolving credit facility of \$32.0 million bears interest at the Eurodollar Rate. The weighted average Eurodollar rate on our outstanding debt was 4.53% at March 8, 2006.

We utilize our revolving credit facility for the issuance of letters of credit, as well as to manage normal fluctuations in operational cash flow caused by the timing of cash receipts. In that regard, we may from time to time draw funds under the revolving credit facility for general corporate purposes. The funds drawn on individual occasions have varied in amounts of up to \$50.0 million, with total amounts outstanding ranging from \$10.0 million up to \$88.0 million. The amounts drawn are generally outstanding for a short period of time and are generally paid down as cash is received from our operating activities.

Our senior credit facilities are secured by a security interest in substantially all of our tangible and intangible assets, including intellectual property. Our senior credit facilities are also secured by a pledge of the capital stock of our U.S. subsidiaries, and a portion of the capital stock of our international subsidiaries.

Our senior credit facilities contain, without limitation, covenants that generally limit our ability to:

incur additional debt (including subordinated debt) in excess of \$50 million at any one time outstanding;

repurchase our capital stock and 7¹/₂% notes and pay cash dividends (subject to a restricted payments basket for which \$113.1 million was available for use as of December 31, 2005);

incur liens or other encumbrances;

merge, consolidate or sell substantially all our property or business;
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sell assets, other than inventory in the ordinary course of business;

make investments or acquisitions unless we meet financial tests and other requirements;

make capital expenditures; or

enter into an unrelated line of business.

Our senior credit facilities require us to comply with several financial covenants, including a maximum consolidated leverage ratio, a minimum consolidated interest coverage ratio and a minimum fixed charge coverage ratio. The table below shows the required and actual ratios under our credit facilities calculated as at December 31, 2005:

	Required Ratio		Actual Ratio
Maximum consolidated leverage ratio	No greater than	2.75:1	2.34:1
Minimum consolidated interest coverage ratio	No less than	4.0:1	6.42:1
Minimum fixed charge coverage ratio	No less than	1.50:1	1.84:1

Events of default under our senior credit facilities include customary events, such as a cross-acceleration provision in the event that we default on other debt. In addition, an event of default under the senior credit facilities would occur if there is a change of control. This is defined to include the case where a third party becomes the beneficial owner of 35% or more of our voting stock or certain changes in our Board of Directors occurs. An event of default would also occur if one or more judgments were entered against us of \$20.0 million or more and such judgments were not satisfied or bonded pending appeal within 30 days after entry.

7¹/₂% Senior Subordinated Notes. On May 6, 2003, we issued \$300.0 million in senior subordinated notes due 2010, bearing interest at 7¹/₂%, pursuant to an indenture dated May 6, 2003, among Rent-A-Center, Inc., its subsidiary guarantors and The Bank of New York, as trustee. The proceeds of this offering were used to fund the repurchase and redemption of our then outstanding 11% senior subordinated notes.

The 2003 indenture contains covenants that limit our ability to:

incur additional debt;

sell assets or our subsidiaries;

grant liens to third parties;

pay cash dividends or repurchase stock (subject to a restricted payments basket for which \$116.6 million was available for use as of December 31, 2005); and

engage in a merger or sell substantially all of our assets.

Events of default under the 2003 indenture include customary events, such as a cross-acceleration provision in the event that we default in the payment of other debt due at maturity or upon acceleration for default in an amount exceeding \$50.0 million, as well as in the event a judgment is entered against us in excess of \$50.0 million that is not discharged, bonded or insured.

The 7¹/₂% notes may be redeemed on or after May 1, 2006, at our option, in whole or in part, at a premium declining from 103.75%. The 7¹/₂% notes also require that upon the occurrence of a change of control (as defined in the 2003 indenture), the holders of the notes have the right to require us to repurchase the notes at a price equal to 101% of the original aggregate principal amount, together with accrued and unpaid interest, if any, to the date of repurchase. This would trigger an event of default under our new senior credit facilities. We are not required to maintain any financial ratios under the 2003 indenture.

Store Leases. We lease space for all of our stores and service center locations, as well as our corporate and regional offices under operating leases expiring at various times through 2013. Most of our store leases are five year leases and contain renewal options for additional periods ranging from three to five years at rental rates adjusted according to agreed-upon formulas.

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ColorTyme Guarantee. ColorTyme is a party to an agreement with Wells Fargo Foothill, Inc., which provides \$50.0 million in aggregate financing to qualifying franchisees of ColorTyme generally of up to five times their average monthly revenues. Under the Wells Fargo agreement, upon an event of default by the franchisee under agreements governing this financing and upon the occurrence of certain other events, Wells Fargo can assign the loans and the collateral securing such loans to ColorTyme, with ColorTyme paying the outstanding debt to Wells Fargo and then succeeding to the rights of Wells Fargo under the debt agreements, including the right to foreclose on the collateral. The Wells Fargo agreement expires in October 2006. Although we believe we will be able to renew our existing agreement or find other financing arrangements, we cannot assure you that we will not need to fund the foregoing guarantee upon the expiration of the existing agreement. An additional \$20.0 million of financing is provided by Texas Capital Bank, National Association under an agreement similar to the Wells Fargo financing. Rent-A-Center East guarantees the obligations of ColorTyme under each of these agreements, not considering the effects of any amounts that could be recovered under collateralization provisions, up to a maximum amount of \$70.0 million, of which \$30.3 million was outstanding as of December 31, 2005. Mark E. Speese, Rent-A-Center's Chairman of the Board and Chief Executive Officer, is a passive investor in Texas Capital Bank, owning less than 1% of its outstanding equity.

Stock Split. On July 28, 2003, we announced that our Board of Directors had approved a 5 for 2 stock split of our common stock to be paid in the form of a stock dividend. Each common stockholder of record on August 15, 2003 received 1.5 additional shares of common stock for each share of common stock held on that date. No fractional shares were issued in connection with the stock dividend. Each stockholder who would otherwise have received a fractional share received an additional share of common stock. The distribution date for the stock dividend was August 29, 2003. The effect of the stock split has been recognized retroactively in all share data in the consolidated financial statements and management's discussion and analysis, unless otherwise noted.

Contractual Cash Commitments. The table below summarizes debt, lease and other minimum cash obligations outstanding as of December 31, 2005:

Contractual Cash Obligations	Total	Payments Due by Period			
		2006	2007-2008	2009-2010	Thereafter
(In thousands)					
Senior Credit Facilities (including current portion)	\$ 424,050 ⁽¹⁾	\$ 7,800	\$ 7,000	\$ 409,250	\$ 0
7 1/2% Senior Subordinated Notes ⁽²⁾	401,250	22,500	45,000	333,750	0
Operating Leases	466,435	149,976	220,515	93,234	2,710
Total	\$ 1,291,735	\$ 180,276	\$ 272,515	\$ 836,234	\$ 2,710

⁽¹⁾ Includes amounts due under the Intrust line of credit. Amount referenced does not include the interest on our senior credit facilities. Our senior credit facilities bear interest at varying rates equal to the Eurodollar rate plus 1.00% to 2.00%. The weighted average Eurodollar rate on our outstanding debt at December 31, 2005 was 4.49%.

⁽²⁾ Includes interest payments of \$11.25 million on each of May 1 and November 1 of each year.

Repurchases of Outstanding Securities. On October 24, 2003, we announced that our Board of Directors had authorized a common stock repurchase program, permitting us to purchase, from time to time, in the open market and privately negotiated transactions, up to an aggregate of \$100.0 million of our common stock. Over a period of time, our Board of Directors increased the authorization for stock repurchases under our new common stock repurchase program to \$400.0 million. As of December 31, 2005, we had purchased a total of 14,426,000 shares of our common

stock for an aggregate of \$356.1 million under this common stock repurchase program, of which 1,816,100 shares were repurchased in the fourth quarter of 2005 for approximately \$34.5 million. Please see *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities* on page 22 of this report.

Economic Conditions. Although our performance has not suffered in previous economic downturns, we cannot assure you that demand for our products, particularly in higher price ranges, will not significantly

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decrease in the event of a prolonged recession. Reductions in our targeted customers' monthly disposable income, such as those we believe may have been caused by the nationwide increases in fuel and energy costs, could adversely impact our results of operations.

Store Consolidation Plan. We expect the total estimated cash outlay in connection with our store consolidation plan to be between \$9.0 million to \$13.7 million. The total amount of cash used in the store consolidation plan during 2005 was approximately \$4.0 million. Therefore, we expect to use approximately \$5.0 million to \$9.7 million of cash on hand for future payments primarily related to the satisfaction of lease obligations for closed stores. Please see **Store Consolidation Plan** in the Notes to Consolidated Financial Statements for more information on our store consolidation plan.

Seasonality. Our revenue mix is moderately seasonal, with the first quarter of each fiscal year generally providing higher merchandise sales than any other quarter during a fiscal year, primarily related to federal income tax refunds. Generally, our customers will more frequently exercise their early purchase option on their existing rental purchase agreements or purchase pre-leased merchandise off the showroom floor during the first quarter of each fiscal year. We expect this trend to continue in future periods. Furthermore, we tend to experience slower growth in the number of rental purchase agreements on rent in the third quarter of each fiscal year when compared to other quarters throughout the year. As a result, we would expect revenues for the third quarter of each fiscal year to remain relatively flat with the prior quarter. We expect this trend to continue in future periods unless we add significantly to our store base during the third quarter of future fiscal years as a result of new store openings or opportunistic acquisitions.

Effect of New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) enacted SFAS 123R, which replaces SFAS 123, and supersedes APB 25. SFAS 123R requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statement of earnings. The accounting provisions of SFAS 123R are effective for fiscal years beginning after June 15, 2005.

We are required to adopt SFAS 123R in the first quarter of 2006. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. See the *Stock-Based Compensation* section shown in Note A to our consolidated financial statements included elsewhere in this report for the pro forma net earnings and earnings per share amounts for 2005 and 2004 as if we had used a fair-value-based method under SFAS 123 to measure compensation expense for employee stock incentive awards. The actual effects of SFAS 123R will depend on numerous factors, including the amounts of share-based payments granted in the future, the method used to value future share-based payments to our employees and estimated forfeiture rates. We will be adopting SFAS 123R under the prospective method and estimate recognizing additional pre-tax compensation expense of approximately \$0.04 and \$0.03 per diluted share for the years ended December 31, 2006 and 2007, respectively, based on the number of options outstanding at December 31, 2005, and assuming that we continue to issue stock options under the Plan consistent with our current policy and procedures. The decrease in the estimated expense under SFAS 123R, as compared to the pro forma expense shown in the Stock-Based Compensation table in the notes to our consolidated financial statements, is primarily due to methods of calculation that are permitted under SFAS 123R versus the methods under SFAS 123.

SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, whereas current accounting rules prescribe that the benefits be reported as an operating cash flow. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Total cash flow will remain unchanged from what would have been reported under prior accounting rules.

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Item 7A. *Quantitative and Qualitative Disclosure about Market Risk.*

Interest Rate Sensitivity

As of December 31, 2005, we had \$300.0 million in subordinated notes outstanding at a fixed interest rate of 7¹/₂%, \$344.8 million in term loans and \$75.0 million in revolving credit outstanding at interest rates indexed to the Eurodollar rate and \$4.3 million outstanding on our line of credit at interest rates discounted from prime. The fair value of the subordinated notes is estimated based on discounted cash flow analysis using interest rates currently offered for loans with similar terms to borrowers of similar credit quality. The fair value of the 7¹/₂% subordinated notes at December 31, 2005 was \$291.0 million. As of December 31, 2005, we have not entered into any interest rate swap agreements with respect to term loans under our senior credit facilities.

Market Risk

Market risk is the potential change in an instrument's value caused by fluctuations in interest rates. Our primary market risk exposure is fluctuations in interest rates. Monitoring and managing this risk is a continual process carried out by the Board of Directors and senior management. We manage our market risk based on an ongoing assessment of trends in interest rates and economic developments, giving consideration to possible effects on both total return and reported earnings.

Interest Rate Risk

We hold long-term debt with variable interest rates indexed to prime or Eurodollar rate that exposes us to the risk of increased interest costs if interest rates rise. Based on our overall interest rate exposure at December 31, 2005, a hypothetical 1.0% increase or decrease in interest rates would have the effect of causing a \$4.3 million additional pre-tax charge or credit to our statement of earnings than would otherwise occur if interest rates remained unchanged.

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Item 8. *Financial Statements and Supplementary Data.*

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Rent-A-Center, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Rent-A-Center, Inc. and Subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of earnings, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Rent-A-Center, Inc. and Subsidiaries as of December 31, 2005 and 2004, and the consolidated results of their operations and their consolidated cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Rent-A-Center, Inc. and Subsidiaries' internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Our report dated March 10, 2006, included on page 45 of this report expressed an unqualified opinion on management's assessment that Rent-A-Center, Inc. and Subsidiaries' internal control over financial reporting as of December 31, 2005, was effective based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and management's assessment thereof.

/s/ Grant Thornton LLP

Dallas, Texas

March 10, 2006

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Rent-A-Center, Inc. and Subsidiaries

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting, that Rent-A-Center, Inc. and Subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established by COSO. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the December 31, 2005 and 2004 consolidated balance sheets and the related consolidated statements of earnings, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005 of the Company and our report dated March 10, 2006, expressed an unqualified opinion.

/s/ Grant Thornton LLP

Dallas, Texas

March 10, 2006

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**MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING**

Management of the Company, including the Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended. The Company's internal control system was designed to provide reasonable assurance to management and our board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

All internal control systems, no matter how well designed, have inherent limitations. A system of internal control may become inadequate over time because of changes in conditions, or deterioration in the degree of compliance with the policies or procedures. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on this assessment, management has concluded that, as of December 31, 2005, the Company's internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles based on such criteria.

Grant Thornton LLP, our independent registered public accounting firm, has issued an audit report on our assessment of internal control over financial reporting. This report appears on page 45.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS

	Year Ended December 31,		
	2005	2004	2003
	(In thousands, except per share data)		
Revenues			
Store			
Rentals and fees	\$ 2,084,757	\$ 2,071,866	\$ 1,998,952
Merchandise sales	177,292	166,594	152,984
Installment sales	26,139	24,304	22,203
Other	7,903	3,568	3,083
Franchise			
Merchandise sales	37,794	41,398	45,057
Royalty income and fees	5,222	5,525	5,871
	2,339,107	2,313,255	2,228,150
Operating expenses			
Direct store expenses			
Cost of rentals and fees	452,583	450,035	432,696
Cost of merchandise sold	129,624	119,098	112,283
Cost of installment sales	10,889	10,512	10,639
Salaries and other expenses	1,358,760	1,277,926	1,180,115
Franchise cost of merchandise sold	36,319	39,472	43,248
	1,988,175	1,897,043	1,778,981
General and administrative expenses	82,290	75,481	66,635
Amortization of intangibles	11,705	10,780	12,512
Class action litigation settlement (reversion)	(8,000)	47,000	
Restructuring charge	15,166		
Total operating expenses	2,089,336	2,030,304	1,858,128
Operating profit	249,771	282,951	370,022
Income from sale of charged off accounts		(7,924)	
Finance charges from refinancing		4,173	35,260
Interest expense	46,195	40,960	48,577
Interest income	(5,492)	(5,637)	(4,645)
Earnings before income taxes	209,068	251,379	290,830
Income tax expense	73,330	95,524	109,334
NET EARNINGS	135,738	155,855	181,496
Preferred dividends			
Net earnings allocable to common stockholders	\$ 135,738	\$ 155,855	\$ 181,496

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Basic earnings per common share	\$	1.86	\$	1.99	\$	2.16
Diluted earnings per common share	\$	1.83	\$	1.94	\$	2.08

See accompanying notes to consolidated financial statements.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2005	2004
	(In thousands, except share data)	
ASSETS		
Cash and cash equivalents	\$ 57,627	\$ 58,825
Accounts receivable, net	20,403	16,269
Prepaid expenses and other assets	38,524	65,050
Rental merchandise, net		
On rent	588,978	596,447
Held for rent	161,702	162,664
Merchandise held for installment sale	2,200	1,311
Property assets, net	149,904	144,818
Goodwill, net	925,960	913,415
Other intangible assets, net	3,366	8,989
	\$ 1,948,664	\$ 1,967,788
LIABILITIES		
Accounts payable trade	\$ 88,147	\$ 94,399
Accrued liabilities	191,831	207,835
Deferred income taxes	121,204	163,031
Senior debt	424,050	408,250
Subordinated notes payable, net of discount	300,000	300,000
Redeemable convertible voting preferred stock		2
	1,125,232	1,173,517
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock, \$.01 par value; 250,000,000 shares authorized; 102,988,126 and 102,297,937 shares issued in 2005 and 2004, respectively	1,030	1,023
Additional paid-in capital	630,308	618,486
Retained earnings	901,493	765,785
Treasury stock, 33,801,099 and 27,900,399 shares at cost in 2005 and 2004, respectively	(709,399)	(591,023)
	823,432	794,271
	\$ 1,948,664	\$ 1,967,788

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RENT-A-CENTER, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
For the three years ended December 31, 2005
(In thousands)

	Common Stock		Additional	Retained	Treasury	Accumulated	
	Shares	Amount	Paid-In Capital	Earnings	Stock	Comprehensive Income (Loss)	Total
Balance at January 1, 2003	98,845	\$ 395	\$ 532,675	\$ 428,621	\$ (115,565)	\$ (3,726)	\$ 842,400
Net earnings				181,496			181,496
Other comprehensive income:							
Gains on interest rate swaps, net of tax of \$3,986						6,504	6,504
Reclassification adjustment for gains included in net earnings, net of tax of \$1,702						(2,778)	(2,778)
Other comprehensive income						3,726	3,726
Comprehensive income							185,222
Purchase of treasury stock (9,528 shares)					(273,175)		(273,175)
Issuance of stock options for services			28				28
Effect of 5-for-2 stock split		605	(451)	(154)			
Exercise of stock options	2,303	12	29,771				29,783
Tax benefits related to exercise of stock options			10,605				10,605
Other				(33)			(33)
Balance at December 31, 2003	101,148	1,012	572,628	609,930	(388,740)		794,830
Net earnings				155,855			155,855
Purchase of treasury stock (7,690 shares)					(210,520)		(210,520)

Issuance of treasury shares for acquisition (815 shares)			15,617		8,237		23,854
Conversion of stock options for acquisition			6,123				6,123
Exercise of stock options	1,150	11	16,604				16,615
Tax benefits related to exercise of stock options			7,514				7,514
Balance at December 31, 2004	102,298	1,023	618,486	765,785	(591,023)		794,271
Net earnings				135,738			135,738
Purchase of treasury stock (5,901 shares)			(146)		(118,376)		(118,522)
Conversion of preferred stock to common			2				2
Exercise of stock options	690	7	9,512				9,519
Tax benefits related to exercise of stock options			2,469				2,469
Other			(15)	(30)			(45)
Balance at December 31, 2005	102,988	\$ 1,030	\$ 630,308	\$ 901,493	\$ (709,399)	\$	\$ 823,432

See accompanying notes to consolidated financial statements.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
Cash flows from operating activities			
Net earnings	\$ 135,738	\$ 155,855	\$ 181,496
Adjustments to reconcile net earnings to net cash provided by operating activities			
Depreciation of rental merchandise	444,682	446,578	432,696
Depreciation of property assets	53,382	48,566	43,384
Amortization of intangibles	16,236	10,780	12,512
Amortization of financing fees	1,600	690	844
Deferred income taxes	(41,827)	30,113	46,776
Financing charges from recapitalization		4,173	23,329
Changes in operating assets and liabilities, net of effects of acquisitions			
Rental merchandise	(427,907)	(456,316)	(424,397)
Accounts receivable	(4,134)	(1,320)	(9,027)
Prepaid expenses and other assets	30,106	(12,286)	(8,752)
Accounts payable trade	(6,252)	21,691	18,647
Accrued liabilities and other	(13,727)	82,506	24,904
Net cash provided by operating activities	187,897	331,030	342,412
Cash flows from investing activities			
Purchase of property assets	(60,230)	(72,096)	(55,987)
Proceeds from sale of property assets	2,513	4,824	809
Acquisitions of businesses	(38,321)	(165,219)	(126,119)
Net cash used in investing activities	(96,038)	(232,491)	(181,297)
Cash flows from financing activities			
Purchase of treasury stock	(118,376)	(210,520)	(273,175)
Exercise of stock options	9,519	16,615	29,783
Issuance of subordinated notes			300,000
Payment of refinancing fees			(17,049)
Proceeds from debt	257,285	442,940	400,000
Repurchase of senior subordinated notes, including premium			(290,956)
Repayments of debt	(241,485)	(432,690)	(251,500)
Net cash used in financing activities	(93,057)	(183,655)	(102,897)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,198)	(85,116)	58,218

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Cash and cash equivalents at beginning of year	58,825	143,941	85,723
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Cash and cash equivalents at end of year	\$ 57,627	\$ 58,825	\$ 143,941
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Supplemental cash flow information

Cash paid during the year for:

Interest	\$ 43,933	\$ 38,789	\$ 56,401
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Income taxes	\$ 97,190	\$ 75,712	\$ 68,805
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See accompanying notes to consolidated financial statements.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note A Summary of Accounting Policies and Nature of Operations

A summary of the significant accounting policies applied in the preparation of the accompanying consolidated financial statements follows:

Principles of Consolidation and Nature of Operations

These financial statements include the accounts of Rent-A-Center, Inc. (Rent-A-Center) and its direct and indirect wholly-owned subsidiaries (collectively, the Company). All significant intercompany accounts and transactions have been eliminated. At December 31, 2005, the Company operated 2,760 company-owned stores nationwide and in Puerto Rico and Canada, including 21 stores in Wisconsin operated by a subsidiary, Get It Now, LLC, under the name Get It Now, and seven stores in Canada operated by a subsidiary, Rent-A-Centre Canada, Ltd., under the name Rent-A-Centre. The Company s primary operating segment consists of renting household durable goods to customers on a rent-to-own basis. Get It Now offers merchandise on an installment sales basis in Wisconsin.

ColorTyme, Inc. (ColorTyme), an indirect wholly-owned subsidiary of Rent-A-Center, is a nationwide franchisor of 296 franchised rent-to-own stores operating in 38 states at December 31, 2005. These rent-to-own stores offer high quality durable products such as home electronics, appliances, computers, and furniture and accessories. ColorTyme s primary source of revenues is the sale of rental merchandise to its franchisees, who, in turn, offer the merchandise to the general public for rent or purchase under a rent-to-own program. The balance of ColorTyme s revenue is generated primarily from royalties based on franchisees monthly gross revenues.

Stock Split

On July 28, 2003, Rent-A-Center announced that its Board of Directors had approved a 5 for 2 stock split on its common stock to be paid in the form of a stock dividend. Each common stockholder of record on August 15, 2003 received 1.5 additional shares of common stock for each share of common stock held on that date. No fractional shares were issued in connection with the stock dividend. Each stockholder who would otherwise have received a fractional share received an additional share of common stock. The distribution date for the stock dividend was August 29, 2003. The effect of the stock split has been recognized retroactively in all share data in the consolidated financial statements unless otherwise noted.

Rental Merchandise

Rental merchandise is carried at cost, net of accumulated depreciation. Depreciation for all merchandise is provided using the income forecasting method, which is intended to match as closely as practicable the recognition of depreciation expense with the consumption of the rental merchandise, and assumes no salvage value. The consumption of rental merchandise occurs during periods of rental and directly coincides with the receipt of rental revenue over the rental-purchase agreement period, generally 7 to 36 months. Under the income forecasting method, merchandise held for rent is not depreciated and merchandise on rent is depreciated in the proportion of rents received to total rents provided in the rental contract, which is an activity-based method similar to the units of production method. On computers that are 24 months old or older and which have become idle, depreciation is recognized using the straight-line method for a period of at least six months, generally not to exceed an aggregate depreciation period of 36 months. The purpose is to better reflect the depreciable life of a computer in our stores and to encourage the sale of older computers.

Rental merchandise which is damaged and inoperable, or not returned by the customer after becoming delinquent on payments, is expensed when such impairment occurs. Any repairs made to rental merchandise are expensed at the time of the repair.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash Equivalents

For purposes of reporting cash flows, cash equivalents include all highly liquid investments with an original maturity of three months or less.

Revenue

Merchandise is rented to customers pursuant to rental-purchase agreements which provide for weekly, semi-monthly or monthly rental terms with non-refundable rental payments. Generally, the customer has the right to acquire title either through a purchase option or through payment of all required rentals. Rental revenue and fees are recognized over the rental term and merchandise sales revenue is recognized when the customer exercises its purchase option and pays the cash price due. Revenue for the total amount of the rental purchase agreement is not accrued because the customer can terminate the rental agreement at any time and the Company cannot enforce collection for non-payment of rents. ColorTyme's revenue from the sale of rental merchandise is recognized upon shipment of the merchandise to the franchisee. Franchise fee revenue is recognized upon completion of substantially all services and satisfaction of all material conditions required under the terms of the franchise agreement. Because Get It Now makes retail sales on an installment credit basis, Get It Now's revenue is recognized at the time of such retail sale, as is the cost of the merchandise sold, net of a provision for uncollectible accounts. The revenue from our financial services is recorded differently depending on the type of transaction. Fees collected on loans are recognized ratably over the term of the loan. For money orders, wire transfers, check cashing and other customer service type transactions, fee revenue is recognized at the time of the transactions.

Receivables and Allowance for Doubtful Accounts

Get It Now sells merchandise through installment sales transactions. The installment note generally consists of the sales price of the merchandise purchased and any additional fees for services the customer has chosen, less the customer's down payment. No interest is accrued and interest income is recognized each time a customer makes a payment, generally on a monthly basis. The Company's financial services business extends short term secured and unsecured loans. The loans are funded with the Company's cash from operations. The amount and length of the loan may vary depending on applicable state law. The Company has established an allowance for doubtful accounts for Get It Now's installment notes and loan receivables associated with the Company's financial services business. The Company's policy for determining the allowance is based on historical loss experience generally, as well as the results of management's review and analysis of the payment and collection of the installment notes and trade receivables within the previous quarter. Management believes that the Company's allowances are adequate to absorb any known or probable losses. The Company's policy is to charge off installment notes that are 90 days or more past due and loan receivables that are 30 days or more past due. Charge-offs are applied as a reduction to the allowance for doubtful accounts and any recoveries of previously charged off balances are applied as an increase to the allowance for doubtful accounts.

The majority of ColorTyme's accounts receivable relate to amounts due from franchisees. Credit is extended based on an evaluation of a customer's financial condition and collateral is generally not required. Accounts receivable are due within 30 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts that are outstanding longer than the contractual payment terms are considered past due. ColorTyme determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, ColorTyme's previous loss history, the franchisee's current ability to pay its obligation to ColorTyme, and the condition of the general economy and the industry as a whole. ColorTyme writes off accounts receivable that are 120 days or more past due, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property Assets and Related Depreciation

Furniture, equipment and vehicles are stated at cost less accumulated depreciation. Depreciation is provided over the estimated useful lives of the respective assets (generally five years) by the straight-line method. Leasehold improvements are amortized over the useful life of the asset or the initial term of the applicable leases by the straight-line method, whichever is shorter. The Company incurs repair and maintenance expenses on its vehicles and equipment. These amounts are expensed when incurred, unless such repairs significantly extend the life of the asset, in which case the Company amortizes the cost of the repairs for the remaining life of the asset utilizing the straight-line method.

Intangible Assets and Amortization

Goodwill is the cost in excess of the fair value of net assets of acquired businesses. Goodwill is evaluated at least annually for impairment, in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Intangible assets that have finite useful lives are amortized over their estimated useful lives.

Under SFAS No. 142, the Company is required to test all existing goodwill for impairment. In December of each year, we use a discounted cash flow approach to test goodwill for impairment. There were no impairment charges in 2005, 2004 or 2003 for goodwill based on this test. However, in 2005, as a result of our store consolidation plan and Hurricane Katrina, the Company recorded an impairment charge of approximately \$4.5 million and \$3.7 million, respectively.

Accounting for Impairment of Long-Lived Assets

The Company evaluates all long-lived assets, including intangible assets, excluding goodwill and rental merchandise, for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. Impairment is recognized when the carrying amounts of such assets cannot be recovered by the undiscounted net cash flows they will generate.

Derivative Instruments and Hedging Activities

The Company is not currently a party to any interest rate swap agreements. Under the Company's previous credit facility, the Company entered into interest-rate swap agreements in order to manage its exposure to fluctuations in interest rates by decreasing the volatility of earnings and cash flows associated with changes in the applicable rates. The interest-rate swaps were derivative instruments related to forecasted transactions and hedged future cash flows. The effective portion of any gains or losses were included in accumulated other comprehensive income (loss) until earnings were affected by the variability of cash flows. Any ineffective portion was recognized into earnings. The cash flows of the interest-rate swaps offset cash flows attributable to fluctuations in the cash flows of the previous floating-rate senior credit facility. If it became probable a forecasted transaction would no longer occur, the interest-rate swaps were carried on the balance sheet at fair value, and gains or losses that were deferred in accumulated other comprehensive income (loss) were recognized immediately into earnings.

Changes in the fair value of the effective cash flow hedges were recorded in accumulated other comprehensive income (loss). The effective portion that had been deferred in accumulated other comprehensive income (loss) was reclassified to earnings when the hedged items impacted earnings.

The interest-rate swaps were based on the same index as their respective underlying debt. The interest-rate swaps were effective in achieving offsetting cash flows attributable to the fluctuations in the cash flows of the hedged risk, and no amount was required to be reclassified from accumulated other comprehensive income (loss) into earnings for hedge ineffectiveness during the year ended December 31, 2003. The interest-rate swap resulted in an increase of interest expense of \$4.5 million for the year ended December 31, 2003. In May 2003, the Company extinguished the remaining interest rate swap in connection with its recapitalization

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

program. The accumulated loss in other comprehensive income of approximately \$3.7 million was recognized immediately into earnings and is included in the finance charge of \$35.3 million on the statement of earnings for 2003.

Income Taxes

The Company records deferred taxes for temporary differences between the tax and financial reporting bases of assets and liabilities at the rate expected to be in effect when taxes become payable.

Earnings Per Common Share

Basic earnings per common share are based upon the weighted average number of common shares outstanding during each period presented. Diluted earnings per common share are based upon the weighted average number of common shares outstanding during the period, plus, if dilutive, the assumed exercise of stock options and the assumed conversion of convertible securities at the beginning of the year, or for the period outstanding during the year for current year issuances.

Advertising Costs

Costs incurred for producing and communicating advertising are expensed when incurred. Advertising expense was \$67.1 million, \$62.7 million, and \$67.8 million in 2005, 2004 and 2003, respectively.

Stock-Based Compensation

The Company maintains a long-term incentive plan for the benefit of certain employees, consultants and directors, which is described more fully in Note N. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net earnings, as all options granted under those plans had an exercise price equal to the quoted market price of the underlying common stock on the date of grant.

The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of the Financial Accounting Standards Board (FASB) Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	Year Ended December 31,		
	2005	2004	2003
	(In thousands, except per share data)		
Net earnings allocable to common stockholders			
As reported	\$ 135,738	\$ 155,855	\$ 181,496
Deduct: Total stock-based employee compensation under fair value based method for all awards, net of related tax benefit	9,152	9,868	15,687
Pro forma	\$ 126,586	\$ 145,987	\$ 165,809
Basic earnings per common share			
As reported	\$ 1.86	\$ 1.99	\$ 2.16
Pro forma	\$ 1.73	\$ 1.87	\$ 1.97
Diluted earnings per common share			
As reported	\$ 1.83	\$ 1.94	\$ 2.08
Pro forma	\$ 1.71	\$ 1.82	\$ 1.90

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For all periods prior to April 1, 2004, the fair value of these options was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of 55.0%, risk-free interest rates of 2.9% and 3.7% and expected lives of four years in 2004 and seven years in 2003, respectively, and no dividend yield. For options granted on or after April 1, 2004, the fair value of the options was estimated at the date of grant using the binomial method pricing model with the following weighted average assumptions: expected volatility of 46.1%, a risk-free interest rate of 3.6%, no dividend yield and an expected life of four years. Had the Company changed from using the Black-Scholes option pricing model to a binomial method pricing model effective January 1, 2003 rather than April 1, 2004, the impact would not have been significant.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent losses and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. In applying accounting principles, the Company must often make individual estimates and assumptions regarding expected outcomes or uncertainties. The Company's estimates, judgments and assumptions are continually evaluated based on available information and experience. Because of the use of estimates inherent in the financial reporting process, actual results could differ from those estimates. The Company believes that self-insurance liabilities, litigation and tax reserves are areas where the degree of judgment and complexity in determining amounts recorded in its consolidated financial statements make the accounting policies critical. Please see the Critical Accounting Policies Involving Critical Estimates, Uncertainties or Assessment in Our Financial Statements section on page 26 of this report.

Other Income

In December 2004, the Company sold to certain qualified buyers its right to collect outstanding amounts due, as well as its interest in the merchandise rented, pursuant to delinquent rental purchase agreements that have been charged off in the ordinary course of business. The accounts ranged from approximately one to five years old. The Company sold such accounts for approximately \$7.9 million and recorded such amount as other income in its consolidated statement of earnings.

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) enacted SFAS 123R, which replaces SFAS 123, and supersedes APB 25. SFAS 123R requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statement of earnings. The accounting provisions of SFAS 123R are effective for fiscal years beginning after June 15, 2005.

The Company is required to adopt SFAS 123R in the first quarter of 2006. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. See the *Stock-Based Compensation* section shown above for the pro forma net earnings and earnings per share amounts for 2005 and 2004 as if the Company had used a fair-value-based method under SFAS 123 to measure compensation expense for employee stock incentive awards. The actual effects of SFAS 123R will depend on numerous factors, including the amounts of share-based payments granted in the future, the method used to value future share-based payments to the Company's employees and estimated forfeiture rates. The Company will be adopting SFAS 123R under the prospective method and estimates recognizing additional pre-tax compensation expense of approximately \$0.04 and \$0.03 per diluted share, for the years ended December 31, 2006 and 2007, respectively, based on the number of options outstanding at December 31, 2005, and assuming

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

that the Company continues to issue stock options under the Plan consistent with its current policy and procedures. The decrease in the estimated expense under SFAS 123R, as compared to the pro forma expense shown in the Stock-Based Compensation table earlier, is primarily due to methods of calculation that are permitted under SFAS 123R versus the methods under SFAS 123.

SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, whereas current accounting rules prescribe that the benefits be reported as an operating cash flow. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Total cash flow will remain unchanged from what would have been reported under prior accounting rules.

Note B Receivables and Allowance for Doubtful Accounts

Receivables consist of the following:

	At December 31,	
	2005	2004
	(In thousands)	
Installment sales receivable	\$ 18,356	\$ 16,919
Financial service loans receivable	2,757	
Trade receivables	2,607	1,956
Total	23,720	18,875
Less allowance for doubtful accounts	(3,317)	(2,606)
Net receivables	\$ 20,403	\$ 16,269

Changes in the Company's allowance for doubtful accounts are as follows:

	At December 31,		
	2005	2004	2003
	(In thousands)		
Beginning balance	\$ 2,606	\$ 1,918	\$ 1,420
Bad debt expense	1,581	1,101	753
Addition from acquisition	114		
Accounts written off	(1,271)	(744)	(312)
Recoveries	287	331	57
Ending balance	\$ 3,317	\$ 2,606	\$ 1,918

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note C Merchandise Inventory**Rental Merchandise**

	December 31,	
	2005	2004
	(In thousands)	
On rent		
Cost	\$ 984,301	\$ 999,265
Less accumulated depreciation	395,323	402,818
Net book value, on rent	\$ 588,978	\$ 596,447
Held for rent		
Cost	\$ 210,865	\$ 208,339
Less accumulated depreciation	49,163	45,675
Net book value, held for rent	\$ 161,702	\$ 162,664

Reconciliation of Merchandise Inventory

	December 31,		
	2005	2004	2003
	(In thousands)		
Beginning merchandise value	\$ 760,422	\$ 682,367	\$ 631,724
Inventory additions through acquisitions	9,233	68,317	58,942
Purchases	655,553	654,261	612,276
Depreciation of rental merchandise	(444,682)	(446,578)	(432,696)
Cost of good sold	(140,513)	(129,610)	(122,922)
Skips and stolens	(56,341)	(54,797)	(50,216)
Other inventory deletions ⁽¹⁾	(30,792)	(13,538)	(14,741)
Ending merchandise value	\$ 752,880	\$ 760,422	\$ 682,367

⁽¹⁾ Other inventory deletions include loss/damage waiver claims and unrepairable and missing merchandise, as well as acquisition charge-offs. 2005 inventory deletions also include \$4.5 million in write-offs associated with Hurricanes Katrina, Rita and Wilma, as well as \$6.6 million associated with the sale of 35 stores pursuant to our store consolidation plan during the fourth quarter.

Note D Property Assets

	December 31,	
	2005	2004
	(In thousands)	
Furniture and equipment	\$ 149,998	\$ 175,735
Transportation equipment	13,713	21,984
Building and leasehold improvements	145,133	147,418
Land and land improvements	4,248	
Construction in progress	11,118	1,988
	324,210	347,125
Less accumulated depreciation	174,306	202,307
	\$ 149,904	\$ 144,818

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note E Intangible Assets and Acquisitions

Intangibles consist of the following (in thousands):

	December 31, 2005			December 31, 2004		
	Avg. Life (years)	Gross Carrying Amount	Accumulated Amortization	Avg. Life (years)	Gross Carrying Amount	Accumulated Amortization
Amortizable intangible assets						
Franchise network	10	\$ 3,000	\$ 2,850	10	\$ 3,000	\$ 2,550
Non-compete agreements	3	6,040	4,423	3	5,902	3,197
Customer relationships	1.5	32,934	31,335	1.5	30,644	24,810
Total		41,974	38,608		39,546	30,557
Intangible assets not subject to amortization						
Goodwill		1,025,112	99,152		1,012,577	99,162
Total intangibles		\$ 1,067,086	\$ 137,760		\$ 1,052,123	\$ 129,719

Aggregate Amortization Expense

Year ended December 31, 2005 ⁽¹⁾	\$ 16,236
Year ended December 31, 2004	\$ 10,780
Year ended December 31, 2003	\$ 12,512

Supplemental information regarding intangible assets and amortization.

Estimated amortization expense, assuming current intangible balances and no new acquisitions, for each of the years ending December 31, is as follows:

	Estimated Amortization Expense
	(In thousands)
2006	\$ 3,167
2007	191
2008	8
2009	
Total	\$ 3,366

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

	2005	2004
	(In thousands)	
Balance as of January 1,	\$ 913,415	\$ 788,059
Additions from acquisitions	25,947	112,209
Goodwill impairment ⁽¹⁾	(8,198)	
Post purchase price allocation adjustments	(5,204)	13,147
Balance as of December 31,	\$ 925,960	\$ 913,415

The post purchase price allocation adjustments in 2005 of approximately \$5.2 million are primarily attributable to the tax benefit associated with certain items recorded as goodwill that were deductible for tax purposes. The post purchase price allocation adjustments in 2004 of approximately \$13.1 million are primarily attributable to inventory charge-offs for unrentable or missing merchandise acquired in acquisitions, reserves

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

put into place for lease buyouts for acquired stores which were closed post acquisition in compliance with executive management's pre-acquisition plans, and the severance pay for the employees involved in the planned reduction in workforce inherited from some of the acquired companies.

- (1) Goodwill impairment of approximately \$4.5 million was included in our restructuring charges relating to our store consolidation plan and \$3.7 million relating to Hurricane Katrina was included in amortization expense.

Acquisitions

The following table provides information concerning the acquisitions made during the years ended December 31, 2005, 2004 and 2003:

	Year Ended December 31,		
	2005	2004	2003
	(Dollar amounts in thousands)		
Number of stores acquired remaining open	44	191	160
Number of stores acquired that were merged with existing stores	39	111	220
Number of transactions	38	48	39
Total purchase price	\$ 38,321	\$ 195,196 ⁽¹⁾	\$ 126,119
Amounts allocated to:			
Goodwill	\$ 25,947	\$ 112,209	\$ 48,445
Non-compete agreements	33	389	4,515
Customer relationships	2,282	9,991	9,938
Property assets	751	4,203	4,166
Rental merchandise	9,233	68,317	58,942
Other assets	75	87	113

- (1) The total purchase price includes non-cash consideration of approximately \$23.8 million in common stock issued and approximately \$6.1 million in fair value assigned to the stock options assumed in connection with the acquisition of Rent Rite, Inc.

Rent-Way, Inc. On February 8, 2003, the Company completed the acquisition of substantially all of the assets of 295 rent-to-own stores from Rent-Way, Inc. for an aggregate purchase price of \$100.4 million in cash. Of the aggregate purchase price, the Company held back \$10.0 million to pay for various indemnified liabilities and expenses, if any, of which \$5.0 million was remitted in the second quarter of 2003 and \$5.0 million was remitted in August 2004. The Company funded the acquisition entirely from cash on hand. Of the 295 stores, 176 were subsequently merged with the Company's existing store locations. The asset values are based upon the fair value assigned to the tangible and identifiable intangible assets acquired which are based upon the present value of future cash flows, historic longevity of like-kind customer base, historic profitability of like-kind customer base and the number of customer relationships acquired. The excess of purchase consideration over the fair value of tangible assets and identifiable intangible assets acquired was assigned to goodwill. The final purchase price allocation resulted in a \$4.0 million decrease in the value assigned to customer relationships and a \$4.0 million increase in the value placed on the non-compete agreement as compared to the Company's original estimates as disclosed in its 2002 Annual Report on

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Form 10-K. The table below summarizes the allocation of the purchase price based on the fair values of the assets acquired:

	Fair Values
	(In thousands)
Inventory	\$ 50,100
Property assets	4,300
Customer relationships	7,900
Non-compete agreement	4,300
Goodwill	33,800
 Total assets acquired	 \$ 100,400

Rent Rite, Inc. On May 7, 2004, the Company completed the acquisition of Rent Rite, Inc. d/b/a Rent Rite Rental Purchase for an aggregate purchase price of \$59.9 million. Rent Rite operated 90 stores in 11 states, of which 26 stores were merged with the Company's existing store locations. Approximately 40% of the consideration was paid with 815,592 shares of the Company's common stock, with the remaining portion consisting of cash, the assumption of Rent Rite's stock options and retirement of Rent Rite's outstanding debt. The common stock paid as well as the assumption of stock options were recorded at the fair value determined at the effective date of the purchase. The table below summarizes the allocation of the purchase price based on the fair values of the significant assets acquired:

	Fair Values
	(In thousands)
Rental merchandise	\$ 18,644
Property assets	1,262
Customer relationships	3,180
Non-compete agreements	242
Goodwill	36,568
 Total assets acquired	 \$ 59,896

Rainbow Rentals, Inc. On May 14, 2004, the Company completed the acquisition of Rainbow Rentals, Inc. for an aggregate purchase price of \$109.0 million. Rainbow Rentals operated 124 stores in 15 states, of which 29 stores were merged with the Company's existing store locations. The Company funded the acquisition entirely with cash on hand. The table below summarizes the allocation of the purchase price based on the fair values of the significant assets acquired:

	Fair Values
	(In thousands)
Rental merchandise	\$ 41,337
Property assets	2,864
Customer relationships	4,553

Non-compete agreements	100
Goodwill	60,192
Total assets acquired	\$ 109,046

The Company entered into these transactions seeing them as opportunistic acquisitions that would allow the Company to expand its store base in conjunction with its strategic growth plans. The prices of the acquisitions were determined by evaluating the average monthly rental income of the acquired stores and applying a multiple to the total. Customer relationships acquired in these transactions are being amortized

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

utilizing the straight-line method over an 18 month period. The non-compete agreements in these transactions are being amortized using the straight-line method over the life of the agreements and, in accordance with SFAS 142, the goodwill associated with the acquisitions will not be amortized.

All acquisitions have been accounted for as purchases, and the operating results of the acquired stores and accounts have been included in the financial statements since their date of acquisition.

Note F Store Consolidation Plan

On September 6, 2005, the Company announced its plan to close up to 162 stores by December 31, 2005. The decision to close these stores was based on management's analysis and evaluation of the markets in which the Company operates, including its market share, operating results, competitive positioning and growth potential for the affected stores. The 162 stores included 114 stores that the company intended to close and merge with its existing stores and up to 48 additional stores that it intended to sell, merge with a potential acquisition or close by December 31, 2005. As of December 31, 2005, the Company had merged 113 of the 114 stores identified to be merged with existing locations, sold 35 and merged one of the additional 48 stores on the plan.

The Company estimated that it would incur restructuring expenses in the range of \$12.1 million to \$25.1 million, to be recorded in the third and fourth quarters of the fiscal year ending December 31, 2005, based on the closing date of the stores. During the year ended December 31, 2005, the Company recorded restructuring charges of \$15.2 million. The following table presents the original range of estimated charges, the charges recorded in the fiscal year ending December 31, 2005, the estimated range of remaining charges to be recorded in the fiscal year ending December 31, 2006 and the remaining accrual as of December 31, 2005:

	Closing Plan Estimate	Expense Recognized During 2005	Estimated Remaining Charges for 2006
	(In thousands)		
Lease obligations	\$ 8,661 - \$13,047	\$ 9,261	\$ 0 - \$3,786
Fixed asset disposals	2,630 - 4,211	3,333	0 - 878
Net proceeds from stores sold		(2,250)	
Other costs ⁽¹⁾	830 - 7,875	4,822	0 - 3,053
Total	\$12,121 - \$25,133	\$ 15,166	\$ 0 - \$7,717

The following table shows the changes in the accrual balance from September 30, 2005 to December 31, 2005, relating to our store consolidation plan.

	September 30, 2005 Balance	Charges to Expense	Cash (Payments) Receipts or Asset Write-Offs	December 31, 2005 Balance
	(In thousands)			
Lease obligations	\$ 5,341	\$ 2,759	\$ (2,736)	\$ 5,364
Fixed asset disposals		1,544	(1,544)	

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Net proceeds from stores sold		(2,250)	2,250	
Other costs ⁽¹⁾	658	86	(653)	91
Total	\$ 5,999	\$ 2,139	\$ (2,683)	\$ 5,455

⁽¹⁾ Goodwill impairment charges are the primary component of other costs. Additional costs include inventory disposals and the removal of signs and various assets from vacated locations.

The Company expects the total estimated cash outlay in connection with the store consolidation plan to be between \$9.0 million to \$13.7 million. The total amount of cash used in the store consolidation plan during

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2005 was approximately \$4.0 million. Therefore, the Company expects to use approximately \$5.0 million to \$9.7 million of cash on hand for future payments primarily related to the satisfaction of lease obligations for closed stores.

Note G Recapitalization

Recapitalization. In April 2003, the Company announced and commenced a program to recapitalize a portion of its financial structure in a series of transactions. The recapitalization consisted of the tender offer for all of Rent-A-Center East's \$272.25 million principal amount of senior subordinated notes, paying 11% interest, due 2008 (the 11% Notes), the redemption of the 11% Notes, the issuance of \$300.0 million principal amount of senior subordinated notes, paying 7¹/₂% interest, due 2010 (the 7¹/₂% Notes), the refinancing of its senior debt and the repurchase of shares of its common stock.

On May 6, 2003, the Company repurchased approximately \$183.0 million principal amount of 11% Notes pursuant to a debt tender offer announced on April 23, 2003. On August 15, 2003, the Company redeemed all of the remaining outstanding 11% Notes in accordance with the terms of the indenture governing the 11% Notes, at the applicable redemption price of 105.5% of the principal amount, plus accrued and unpaid interest to that date. The total aggregate redemption price for the 11% Notes was approximately \$93.75 million, including \$4.65 million in accrued interest and \$4.65 million in redemption premium. Proceeds from the offering of \$300 million in 7¹/₂% Notes were used to pay for the redemption.

On April 25, 2003, Rent-A-Center announced that it entered into an agreement with affiliates of Apollo Management (together Apollo) which provided for the repurchase of a number of shares of Rent-A-Center's common stock sufficient to reduce Apollo's aggregate record ownership to 19.00% after consummation of Rent-A-Center's planned tender offer at the price per share paid in the tender offer. On April 28, 2003, Rent-A-Center commenced a tender offer to purchase up to 2.2 million shares of Rent-A-Center's common stock (on a pre-split basis) pursuant to a modified Dutch Auction. On June 25, 2003, Rent-A-Center closed the tender offer and purchased 1,769,960 shares of Rent-A-Center's common stock (on a pre-split basis) at \$73 per share (on a pre-split basis) for approximately \$129.2 million. On July 11, 2003, Rent-A-Center closed the Apollo transaction and purchased 774,547 shares of Rent-A-Center's common stock (on a pre-split basis) at \$73 per share (on a pre-split basis) for approximately \$56.5 million. As contemplated by the Apollo agreement, Apollo also exchanged their shares of Series A preferred stock for shares of Series C preferred stock. As a result, no shares of Series A preferred stock remain outstanding. The terms of the Series A preferred stock and Series C preferred stock were substantially similar, except the Series C preferred stock did not have the right to directly elect any members of Rent-A-Center's Board of Directors. As of December 31, 2005, no shares of Series C preferred stock remained outstanding.

On May 6, 2003, Rent-A-Center issued \$300.0 million in 7¹/₂% Notes, the proceeds of which were used, in part, to fund the repurchase and redemption of the 11% Notes.

On May 28, 2003, the Company refinanced its then existing senior debt by entering into a new \$600.0 million senior credit facility, consisting then of a \$400.0 million term loan, a \$120.0 million revolving credit facility and an \$80.0 million additional term loan.

During the second and third quarter of 2003, the Company recorded an aggregate of \$35.3 million in non-recurring financing charges in connection with the foregoing recapitalization which consisted of senior subordinated note premiums of approximately \$18.7 million, senior subordinated note issue costs and loan origination fees of approximately \$11.9 million and other bank charges and fees of approximately \$4.7 million.

Note H Senior Credit Facilities

The Company's existing \$600.0 million senior credit facilities consist of a \$350.0 million term loan and a \$250.0 million revolving credit facility. In connection with the Company's refinancing in 2003, the Company

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recorded a \$4.2 million non-cash charge to write off the remaining unamortized balance of financing costs in the third quarter of 2004.

The senior credit facilities as of December 31, 2005 and 2004 are as follows:

		2005			2004		
	Facility Maturity	Maximum Facility	Amount Outstanding	Amount Available	Maximum Facility	Amount Outstanding	Amount Available
(In thousands)							
Senior Credit Facility:							
Term Loan	B	2010	\$ 350,000	\$ 344,750	\$ 350,000	\$ 348,250	\$
Revolver ⁽¹⁾		2009	250,000	75,000	250,000	60,000	84,435
			600,000	419,750	600,000	408,250	84,435
Other Indebtedness:							
Line of credit			10,000	4,300	10,000		10,000
Total Debt Facilities			\$ 610,000	\$ 424,050	\$ 610,000	\$ 408,250	\$ 94,435

⁽¹⁾ At December 31, 2005 and 2004, the amounts available under the Company's revolving facility were reduced by approximately \$107.5 million and \$105.6 million, respectively, for outstanding letters of credit used to support the Company's insurance obligations. The Company provides assurance to its insurance providers that if they are not able to draw funds from the Company for claims paid, they have the ability to draw against the Company's letters of credit. At that time, the Company would then owe the drawn amount to the financial institution providing the letter of credit. One of the Company's letters of credit is renewed automatically every year unless the Company notifies the institution not to renew. The other letter of credit expires in August 2006, but is automatically renewed each year for a one year period unless the institution notifies the Company no later than thirty days prior to the applicable expiration date that such institution does not elect to renew the letter of credit for such additional one year period.

Borrowings under the Company's senior credit facilities bear interest at varying rates equal to the Eurodollar rate plus 1.00% to 2.00%, or the prime rate plus up to 1.00%, at the Company's election. The weighted average Eurodollar rate on our outstanding debt was 4.49% at December 31, 2005. None of the Company's outstanding borrowings at December 31, 2005 utilized the prime rate option. The margins on the Eurodollar rate and on the prime rate may fluctuate dependent upon an increase or decrease in the Company's consolidated leverage ratio as defined by a pricing grid set forth in its credit agreement. For the year ended December 31, 2005, the average effective rate on outstanding borrowings under the senior credit facilities was 6.29%. The Company has not entered into any interest rate protection agreements with respect to term loans under the new senior credit facility. A commitment fee equal to 0.20% to 0.50% of the unused portion of the revolving credit facility is payable quarterly.

The Company's senior credit facilities contain, without limitation, covenants that generally limit its ability to: incur additional debt (including subordinated debt) in excess of \$50 million at any one time outstanding;

repurchase its capital stock and 7¹/₂% notes and pay cash dividends (subject to a restricted payments basket for which \$113.1 million was available for use as of December 31, 2005);

incur liens or other encumbrances;

merge, consolidate or sell substantially all its property or business;

sell assets, other than inventory in the ordinary course of business;

make investments or acquisitions unless it meets financial tests and other requirements;

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make capital expenditures; or

enter into an unrelated line of business.

The Company's senior credit facilities require it to comply with several financial covenants, including a maximum consolidated leverage ratio, a minimum consolidated interest coverage ratio and a minimum fixed charge coverage ratio. The table below shows the required and actual ratios under the Company's credit facilities calculated as at December 31, 2005:

	Required Ratio	Actual Ratio
Maximum consolidated leverage ratio	No greater than 2.75:1	2.34:1
Minimum consolidated interest coverage ratio	No less than 4.0:1	6.42:1
Minimum fixed charge coverage ratio	No less than 1.50:1	1.84:1

Events of default under the Company's senior credit facility include customary events, such as a cross-acceleration provision in the event that it defaults on other debt. In addition, an event of default under the senior credit facility would occur if there is a change of control. This is defined to include the case where a third party becomes the beneficial owner of 35% or more of Rent-A-Center's voting stock or certain changes in Rent-A-Center's Board of Directors occur. An event of default would also occur if one or more judgments were entered against the Company of \$20.0 million or more and such judgments were not satisfied or bonded pending appeal within 30 days after entry.

The following are scheduled maturities of the senior term debt at December 31, 2005:

Year Ending December 31,

	(In thousands)
2006	\$ 3,500
2007	3,500
2008	3,500
2009	168,000
2010	166,250
Thereafter	
	\$ 344,750

Note I Subordinated Notes Payable

11% Senior Subordinated Notes. In December 2001, Rent-A-Center East issued \$100.0 million of 11% senior subordinated notes, maturing on August 15, 2008, under an indenture dated as of December 19, 2001 among Rent-A-Center East, its subsidiary guarantors and The Bank of New York, as trustee. On May 2, 2002, Rent-A-Center East closed an exchange offer for, among other things, approximately \$175.0 million of senior subordinated notes issued by it under a previous indenture, such that, on that date, all senior subordinated notes were governed by the terms of the 2001 indenture. The 2001 indenture contained covenants that limited Rent-A-Center East's ability to, among other things, incur additional debt, grants liens to third parties, and pay dividends or repurchase stock. On May 6, 2003, Rent-A-Center East repurchased approximately \$183.0 million of its then outstanding 11% Notes. On August 15, 2003, Rent-A-Center East redeemed the remaining outstanding 11% Notes.

7¹/₂% Senior Subordinated Notes. On May 6, 2003, Rent-A-Center issued \$300.0 million in senior subordinated notes due 2010, bearing interest at 7¹/₂%, pursuant to an indenture dated May 6, 2003, among Rent-A-Center, Inc., its subsidiary guarantors (the "Subsidiary Guarantors") and The Bank of New York, as

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

trustee. The proceeds of this offering were used to fund the repurchase and redemption of the then outstanding 11% Notes.

The 2003 indenture contains covenants that limit Rent-A-Center's ability to:

incur additional debt;

sell assets or its subsidiaries;

grant liens to third parties;

pay cash dividends or repurchase stock (subject to a restricted payments basket for which \$116.6 million was available for use as of December 31, 2005); and

engage in a merger or sell substantially all of its assets.

Events of default under the 2003 indenture include customary events, such as a cross-acceleration provision in the event that the Company defaults in the payment of other debt due at maturity or upon acceleration for default in an amount exceeding \$50.0 million, as well as in the event a judgment is entered against the Company in excess of \$50.0 million that is not discharged, bonded or insured.

The 7¹/₂% Notes may be redeemed on or after May 1, 2006, at Rent-A-Center's option, in whole or in part, at a premium declining from 103.75%. The 7¹/₂% Notes also require that upon the occurrence of a change of control (as defined in the 2003 indenture), the holders of the notes have the right to require Rent-A-Center to repurchase the notes at a price equal to 101% of the original aggregate principal amount, together with accrued and unpaid interest, if any, to the date of repurchase. This would trigger an event of default under the Company's senior credit facilities.

Rent-A-Center and the Subsidiary Guarantors have fully, jointly and severally, and unconditionally guaranteed the obligations of Rent-A-Center with respect to the 7¹/₂% Notes. Rent-A-Center has no independent assets or operations, and each Subsidiary Guarantor is 100% owned directly or indirectly by Rent-A-Center. The only direct or indirect subsidiaries of Rent-A-Center that are not guarantors are minor subsidiaries. There are no restrictions on the ability of any of the Subsidiary Guarantors to transfer funds to Rent-A-Center in the form of loans, advances or dividends, except as provided by applicable law.

Note J Accrued Liabilities

	December 31,	
	2005	2004
	(In thousands)	
Taxes other than income	\$ 27,967	\$ 27,190
Accrued insurance costs	97,326	87,647
Accrued compensation	28,882	23,653
Accrued restructuring costs	5,455	
Accrued interest payable	5,224	4,605
Accrued litigation costs	4,476	48,975
Accrued other	22,501	15,765
	\$ 191,831	\$ 207,835

Note K Redeemable Convertible Voting Preferred Stock

In August 1998, Rent-A-Center issued \$260.0 million of redeemable convertible voting preferred stock with a \$.01 par value. In connection with such issuance, Rent-A-Center entered into a registration rights

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agreement with affiliates of Apollo which, among other things, granted them two rights to request that their shares be registered, and a registration rights agreement with an affiliate of Bear Stearns, which granted them the right to participate in any company-initiated registration of shares, subject to certain exceptions. In May 2002, Apollo exercised one of their two rights to request that their shares be registered and an affiliate of Bear Stearns elected to participate in such registration. In connection therewith, Apollo and the affiliate of Bear Stearns converted 97,197 shares of Rent-A-Center's preferred stock held by them into 3,500,000 shares (on a pre-split basis) of Rent-A-Center's common stock, which they sold in the May 2002 public offering that was the subject of Apollo's request. Rent-A-Center did not receive any of the proceeds from this offering.

On August 5, 2002, the first date in which Rent-A-Center had the right to optionally redeem the shares of preferred stock, the holders of Rent-A-Center's preferred stock converted all but two shares of Rent-A-Center's preferred stock held by them into 7,281,548 shares of Rent-A-Center's common stock (on a pre-split basis). As a result, the dividend on Rent-A-Center's preferred stock was substantially eliminated.

Rent-A-Center's preferred stock was convertible, at any time, into shares of Rent-A-Center's common stock at a conversion price equal to \$11.174 per share, and had a liquidation preference of \$1,000 per share, plus all accrued and unpaid dividends. No distributions were permitted to holders of common stock until the holders of the preferred stock had received the liquidation preference. Dividends accrued on a quarterly basis, at the rate of \$37.50 per annum, per share. During 2002, Rent-A-Center accounted for shares of preferred stock distributed as dividends in-kind at the greater of the stated value or the value of the common stock obtainable upon conversion on the payment date. During 2002, Rent-A-Center paid approximately \$8.2 million in preferred dividends by issuing 8,151 shares of preferred stock. During 2004 and 2003, Rent-A-Center paid all preferred stock dividends in cash.

In May 2005, Apollo sold all of the remaining shares of Rent-A-Center common stock held by them in a public offering which closed on May 31, 2005. Rent-A-Center did not receive any of the proceeds from the sale of the shares by Apollo. In connection with such sale, Apollo converted the two issued and outstanding shares of Rent-A-Center Series C preferred stock into 180 shares of common stock, all of which were sold in the public offering. As a result of the conversion, no shares of Rent-A-Center Series C preferred stock remain outstanding. In addition, as a result of the sale by Apollo of all of the shares of Rent-A-Center common stock held by them, the stockholders agreement with Apollo terminated pursuant to its terms.

Note L Income Taxes

The income tax provision reconciled to the tax computed at the statutory Federal rate is:

	Year Ended December 31,		
	2005	2004	2003
Tax at statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit (expense)	(0.3)% ⁽¹⁾	2.5%	2.3%
Effect of foreign operations, net of foreign tax credits	0.1%	0.1%	0.1%
Other, net	0.3%	0.4%	0.2%
Total	35.1%	38.0%	37.6%

(1) Includes the effects of a \$3.3 million state tax reserve due to a change in estimate related to potential loss exposures.

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The components of the income tax provision are as follows:

	Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
Current expense			
Federal	\$ 108,667	\$ 60,996	\$ 53,615
State	5,073	1,844	9,382
Foreign	1,417	2,571	2,232
Total current	115,157	65,411	65,229
Deferred expense			
Federal	(35,728)	22,307	43,349
State	(6,099)	7,806	756
Total deferred	(41,827)	30,113	44,105
Total	\$ 73,330	\$ 95,524	\$ 109,334

Deferred tax assets (liabilities) consist of the following:

	December 31,	
	2005	2004
	(In thousands)	
Deferred tax assets		
State net operating loss carryforwards	\$ 2,101	\$ 2,101
Accrued expenses	8,058	12,968
Property assets	14,693	15,479
Foreign tax credit carryforwards	827	1,501
	25,679	32,049
Valuation allowance	(827)	(1,501)
Deferred tax liabilities		
Rental merchandise	(130,019)	(191,960)
Intangible assets	(16,037)	(1,619)
	(146,056)	(193,579)
Net deferred taxes	\$ (121,204)	\$ (163,031)

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Note M Commitments and Contingencies

The Company leases its office, service center and store facilities and most delivery vehicles. The office space and certain of the store leases contain escalation clauses for increased taxes and operating expenses. Rental expense was \$194.3 million, \$179.6 million and \$154.4 million for 2005, 2004, and 2003, respectively. Future minimum rental payments under operating leases with remaining non-cancelable lease terms in excess of one year at December 31, 2005 are as follows:

Year Ending December 31,

	(In thousands)
2006	\$ 149,976
2007	123,725
2008	96,790
2009	64,299
2010	28,935
Thereafter	2,710
	\$ 466,435

From time to time, the Company is party to various legal proceedings arising in the ordinary course of business. Except as described below, the Company is not currently a party to any material litigation. The ultimate outcome of the Company's litigation is uncertain and the amount of any loss it may incur, if any, cannot in its judgment be reasonably estimated. Accordingly, other than with respect to the settlement of the *Pucci/Chess* matter, the prospective settlement of the *Rose/ Madrigal* matter discussed below as well as anticipated legal fees and expenses for its other litigation matters, no provision has been made in the Company's consolidated financial statements for any such loss.

Colon v. Thorn Americas, Inc. The plaintiff filed this class action in November 1997 in New York state court. This matter was assumed by the Company in connection with the Thorn Americas acquisition. The plaintiff acknowledges that rent-to-own transactions in New York are subject to the provisions of New York's Rental Purchase Statute but contends the Rental Purchase Statute does not provide the Company immunity from suit for other statutory violations. The plaintiff alleges the Company has a duty to disclose effective interest under New York consumer protection laws, and seeks damages and injunctive relief for failure to do so. This suit also alleges violations relating to excessive and unconscionable pricing, late fees, harassment, undisclosed charges, and the ease of use and accuracy of payment records. In the prayer for relief, the plaintiff requests class certification, injunctive relief requiring the Company to cease certain marketing practices and price its rental purchase contracts in certain ways, unspecified compensatory and punitive damages, rescission of the class members contracts, an order placing in trust all moneys received by the Company in connection with the rental of merchandise during the class period, treble damages, attorney's fees, filing fees and costs of suit, pre- and post-judgment interest, and any further relief granted by the court. The plaintiff has not alleged a specific monetary amount with respect to the request for damages.

The proposed class includes all New York residents who were party to the Company's rent-to-own contracts from November 26, 1994. In November 2000, following interlocutory appeal by both parties from the denial of cross-motions for summary judgment, the Company obtained a favorable ruling from the Appellate Division of the State of New York, dismissing the plaintiff's claims based on the alleged failure to disclose an effective interest rate. The plaintiff's other claims were not dismissed. The plaintiff moved to certify a state-wide class in December 2000. The plaintiff's class certification motion was heard by the court on November 7, 2001 and, on September 12, 2002, the court issued an opinion denying in part and granting in part the plaintiff's requested certification. The opinion grants

certification as to all of the plaintiff's claims except the plaintiff's pricing claims pursuant to the Rental Purchase Statute, as to which certification was denied. The parties have differing views as to the effect of the court's opinion, and accordingly, the court

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granted the parties permission to submit competing orders as to the effect of the opinion on the plaintiff's specific claims. Both proposed orders were submitted to the court on March 27, 2003, and on May 30, 2003, the court held a hearing regarding such orders. No clarifying order has yet been entered by the court.

From June 2003 until May 2005, there was no activity in this case. On May 18, 2005, the Company filed a motion to dismiss the plaintiff's claim and to decertify the class, based upon the plaintiff's failure to schedule her claim in this matter in her earlier voluntary bankruptcy proceeding. The plaintiff opposed the Company's motion and asked the court for an opportunity to find a substitute class representative in the event the court determined Ms. Colon was no longer adequate. On January 17, 2006, the court issued an order denying the Company's motion, but noted that no motion to intervene to add additional class representatives had been filed. A conference with the court has been scheduled for March 14, 2006. If the court ultimately enters a final certification order, the Company intends to pursue an interlocutory appeal of such certification order.

The Company believes these claims are without merit and will continue to vigorously defend itself in this case. However, the Company cannot assure you that it will be found to have no liability in this matter.

Terry Walker, et. al. v. Rent-A-Center, Inc., et. al. On January 4, 2002, a putative class action was filed against the Company and certain of its current and former officers and directors by Terry Walker in federal court in Texarkana, Texas. The complaint alleged that the defendants violated Sections 10(b) and/or Section 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by issuing false and misleading statements and omitting material facts regarding the Company's financial performance and prospects for the third and fourth quarters of 2001. The complaint purported to be brought on behalf of all purchasers of the Company's common stock from April 25, 2001 through October 8, 2001 and sought damages in unspecified amounts. Similar complaints were consolidated by the court with the *Walker* matter in October 2002.

On November 25, 2002, the lead plaintiffs in the *Walker* matter filed an amended consolidated complaint which added certain of the Company's outside directors as defendants to the Exchange Act claims. The amended complaint also added additional claims that the Company, and certain of its current and former officers and directors, violated various provisions of the Securities Act as a result of alleged misrepresentations and omissions in connection with an offering in May 2001 and also added the managing underwriters in that offering as defendants.

On February 7, 2003, the Company, along with certain officer and director defendants, filed a motion to dismiss the matter as well as a motion to transfer venue. In addition, the Company's outside directors named in the matter separately filed a motion to dismiss the Securities Act claims on statute of limitations grounds. On February 19, 2003, the underwriter defendants also filed a motion to dismiss the matter. The plaintiffs filed response briefs to these motions, to which the Company replied on May 21, 2003. A hearing was held by the court on June 26, 2003 to hear each of these motions.

On September 30, 2003, the court granted the Company's motion to dismiss without prejudice, dismissed without prejudice the outside directors' and underwriters' separate motions to dismiss and denied the Company's motion to transfer venue. In its order on the motions to dismiss, the court granted the lead plaintiffs leave to replead the case within certain parameters.

On July 7, 2004, the plaintiffs again repleaded their claims by filing a third amended consolidated complaint, raising allegations of similar violations against the same parties generally based upon alleged facts not previously asserted. The Company, along with certain officer and director defendants and the underwriter defendants, filed motions to dismiss the third amended consolidated complaint on August 23, 2004. A hearing on the motions was held on April 14, 2005. On July 25, 2005, the court ruled on these motions, dismissing with prejudice the claims against the Company's outside directors as well as the underwriter defendants, but denying the Company's motion to dismiss. In evaluating this motion to dismiss, the court was required to view the pleadings in the light most favorable to the plaintiffs and to take the plaintiffs' allegations as true. On

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August 18, 2005, the Company filed a motion to certify the dismissal order for an interlocutory appeal, which was denied on November 14, 2005. Discovery in this matter has now commenced. A hearing on class certification is scheduled for June 22, 2006.

The Company continues to believe the plaintiffs' claims in this matter are without merit and intends to vigorously defend itself as this matter progresses. However, the Company cannot assure you that it will be found to have no liability in this matter.

California Attorney General Inquiry. During the second quarter of 2004, the Company received an inquiry from the California Attorney General regarding its business practices in California with respect to its cash prices and its membership program. The Company met with representatives of the Attorney General's office during the first quarter and fourth quarter of 2005, and provided additional information with respect to its membership program as requested. The Company is continuing to discuss these issues with the Attorney General's office.

State Wage and Hour Class Actions

The Company recently settled a material action pending against it in Oregon, and is currently subject to various material actions pending against it in the states of California and Washington, all of which allege it violated the wage and hour laws of such states.

Rob Pucci, et. al v. Rent-A-Center, Inc; Jeremy Chess et. al. v. Rent-A-Center, Inc. et. al.; Clemmons et. al. v. Rent-A-Center, Inc., et. al. On August 20, 2001, the putative class action entitled *Rob Pucci, et. al. v. Rent-A-Center, Inc.* was filed in state court in Multnomah County, Oregon alleging the Company violated various provisions of Oregon state law regarding overtime, lunch and work breaks, that it failed to pay all wages due to the Company's Oregon employees, and various contract claims that it promised but failed to pay overtime. *Pucci* sought to represent a class of all present and former executive assistants, inside/outside managers and account managers employed by the Company within the six year period prior to the filing of the complaint as to the contract claims, and three years as to the statutory claims, and sought class certification, payments for all unpaid wages under Oregon law, statutory and civil penalties, costs and disbursements, pre- and post-judgment interest in the amount of 9% per annum and attorneys fees.

On July 25, 2002, the plaintiffs filed a motion for class certification and on July 31, 2002, the Company filed its motion for summary judgment. On January 15, 2003, the court orally granted its motion for summary judgment in part, ruling that the plaintiffs were prevented from recovering overtime payments at the rate of time and a half, but stated that the plaintiffs may recover straight-time to the extent plaintiffs could prove purported class members worked in excess of forty hours in a work week but were not paid for such time worked. The court denied the Company's motion for summary judgment on the remaining claims.

On October 10, 2003, the court issued an opinion letter stating that it would certify a class and not permit an interlocutory appeal, and issued its written order to that effect on December 9, 2003.

On March 17, 2005, *Pucci* class members Jeremy Chess and Chad Clemmons filed an amended class action complaint entitled *Jeremy Chess et al. v. Rent-A-Center, Inc. et al*, alleging similar claims as the plaintiffs in *Pucci* and seeking unspecified statutory and contractual damages and penalties, as well as injunctive relief. The *Chess* plaintiffs sought to represent a class of all present and former executive assistants, inside/outside managers and account managers employed by the Company within the six year period prior to the filing of the complaint as to the contract claims, and three years as to the statutory claims. On April 15, 2005, the Company filed pleadings removing the case to the federal court for the District of Oregon under the Class Action Fairness Act of 2005. The *Chess* plaintiffs were represented by the same attorneys as the *Pucci* plaintiffs.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On June 23, 2005, the Company reached an agreement in principle to settle the claims in *Pucci* and *Chess*. Under the settlement, the Company agreed to pay \$1.75 million to settle all class claims, including payments to the class and its representatives, the plaintiffs' attorneys' fees and administrative costs, subject to adjustment based upon the size of the class. The final class included approximately 777 current and former account managers, inside/outside managers, and executive assistant managers that were employed by the Company in Oregon. In connection therewith, the plaintiffs' counsel in the *Pucci* and *Chess* matters filed a new class action complaint in Federal court entitled *Clemmons et al v. Rent-A-Center Inc., et al*, alleging substantially similar claims and seeking similar damages as in *Pucci* and *Chess* through the date of filing. The parties used the *Clemmons* case to consolidate the *Pucci* and *Chess* claims, and facilitate final approval, administration and distribution of the settlement. Notice of the settlement was mailed to class members on or about November 15, 2005 and no class member objected to the settlement or sought exclusion from the class. As a result of the prospective settlement, \$1.9 million was reserved with respect to this matter as of December 31, 2005, covering the anticipated settlement and our attorneys' fees. On January 20, 2006, the *Pucci* and *Clemmons* courts approved the final settlement, entered a final judgment and dismissed the respective cases. The Company funded the settlement in February 2006.

Jeremy Burdusis, et al. v. Rent-A-Center, Inc., et al./ Israel French, et al. v. Rent-A-Center, Inc. These matters pending in Los Angeles, California were filed on October 23, 2001, and October 30, 2001, respectively, and allege similar violations of the wage and hour laws of California as those in *Pucci*. The same law firm in *Pucci* is seeking to represent the purported class in *Burdusis*. The *Burdusis* and *French* proceedings are pending before the same judge in California. On March 24, 2003, the *Burdusis* court denied the plaintiffs' motion for class certification in that case, which the Company views as a favorable development in that proceeding. On April 25, 2003, the plaintiffs in *Burdusis* filed a notice of appeal of that ruling, and on May 8, 2003, the *Burdusis* court, at the Company's request, stayed further proceedings in *Burdusis* and *French* pending the resolution on appeal of the court's denial of class certification in *Burdusis*. In June 2004, the *Burdusis* plaintiffs filed their appellate brief. The Company's response brief was filed in September 2004, and the *Burdusis* plaintiffs filed their reply in October 2004. On February 9, 2005, the California Court of Appeals reversed and remanded the trial court's denial of class certification in *Burdusis* and directed the trial court to reconsider its ruling in light of two other recent appellate court decisions, including the opinions of the California Supreme Court in *Sav-On Drugs Stores, Inc. v. Superior Court*, and of the California appeals court in *Bell v. Farmers Insurance Exchange*. After remand, the plaintiffs filed a motion with the trial court seeking to remove from the case the trial court judge who previously denied their motion for class certification. The trial court denied the motion. In response, plaintiffs filed a petition for writ of mandate with the California Court of Appeals requesting review of the trial court's decision. The California Court of Appeals heard oral arguments in this matter on August 29, 2005, and ruled against the plaintiffs, denying the requested relief. The case is now being returned to the trial court as previously ordered.

On October 30, 2003, the plaintiffs' counsel in *Burdusis* and *French* filed a new non-class lawsuit in Orange County, California entitled *Kris Corso, et al. v. Rent-A-Center, Inc.* The plaintiffs' counsel later amended this complaint to add additional plaintiffs, totaling approximately 339 individuals. The claims made are substantially the same as those in *Burdusis*. On January 16, 2004, the Company filed a demurrer to the complaint, arguing, among other things, that the plaintiffs in *Corso* were misjoined. On February 19, 2004, the court granted the Company's demurrer on the misjoinder argument, with leave for the plaintiffs to replead. On March 8, 2004, the plaintiffs filed an amended complaint in *Corso*, increasing the number of plaintiffs to approximately 400. The claims in the amended complaint are substantially the same as those in *Burdusis*. The Company filed a demurrer with respect to the amended complaint on April 12, 2004, which the court granted on May 6, 2004. However, the court allowed the plaintiffs to again replead the action on a representative basis, which they did on May 26, 2004. The Company subsequently filed a demurrer with respect to the newly repleaded action, which the court granted on August 12, 2004. The court subsequently stayed the *Corso* matter pending the outcome of the *Burdusis* matter. On March 16, 2005, the court lifted the stay and on April 12, 2005, the

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company answered the amended complaint. Discovery is now proceeding. On January 30, 2006, the *Corso* Court heard a motion to coordinate *Corso* with the *Burdusis* and *French* actions. The *Corso* court recommended that *Corso* be coordinated with the other actions before the judge in the *Burdusis* and *French* matters. The Judicial Council has yet to act on the recommendation.

The Company believes the claims asserted in *Burdusis*, *French* and *Corso* are without merit and intends to vigorously oppose each of these cases. The Company cannot assure you, however, that it will be found to have no liability in these matters. As of December 31, 2005, the Company operated 150 stores in California.

Kevin Rose, et al. v. Rent-A-Center, Inc. et al. This matter pending in Clark County, Washington was filed on June 26, 2001, and alleges similar violations of the wage and hour laws of Washington as those in *Pucci*. The same law firm who represented the class in *Pucci* sought to represent the purported class in this matter. On May 14, 2003, the *Rose* court denied the plaintiffs' motion for class certification in that case. On June 3, 2003, the plaintiffs in *Rose* filed a notice of appeal, which was subsequently denied. Following the denial by the Court of Appeals, the plaintiffs counsel filed 14 county-wide putative class actions in Washington with substantially the same claims as in *Rose*. In April 2005, the plaintiffs' counsel filed another putative county-wide lawsuit and subsequently the plaintiffs' counsel filed another putative state-wide lawsuit in federal court in Washington, bringing the total to 16. The purported classes in the county-wide class actions ranged from approximately 20 individuals to approximately 100 individuals.

In November 2005, the Company reached an agreement in principle to settle for \$1.25 million all of the pending lawsuits and related matters brought by the plaintiffs' counsel in Washington on an agreed state-wide class basis. In connection therewith, the parties agreed to seek class settlement in the Superior Court of Yakima County, Washington, where one of the putative county-wide class actions, *Madrigal et al. v. Rent-A-Center*, is pending. On January 13, 2006, the court in *Madrigal* preliminarily approved the class settlement. The class consists of approximately 1,300 class members, and notice of settlement has now been sent. Objections to the settlement are due March 15, 2006, and a final approval hearing before the court is scheduled for April 21, 2006. Accordingly, at December 31, 2005, approximately \$1.3 million was reserved to fund the prospective settlement as well as the Company's attorneys' fees.

While the Company believes that the terms of the prospective settlement are fair, there can be no assurance that the settlement, if completed, will be finally approved by the court in its present form.

ColorTyme Guarantee. ColorTyme is a party to an agreement with Wells Fargo Foothill, Inc., who provides \$50.0 million in aggregate financing to qualifying franchisees of ColorTyme generally of up to five times their average monthly revenues. Under the Wells Fargo agreement, upon an event of default by the franchisee under agreements governing this financing and upon the occurrence of certain other events, Wells Fargo can assign the loans and the collateral securing such loans to ColorTyme, with ColorTyme paying the outstanding debt to Wells Fargo and then succeeding to the rights of Wells Fargo under the debt agreements, including the right to foreclose on the collateral. The Wells Fargo agreement expires in October 2006. Although the Company believes it will be able to renew its existing agreement or find other financing arrangements, there can be no assurance that it will not need to fund the foregoing guarantee upon the expiration of the existing agreement. An additional \$20.0 million of financing is provided by Texas Capital Bank, National Association under an agreement similar to the Wells Fargo financing. Rent-A-Center East guarantees the obligations of ColorTyme under each of these agreements, excluding the effects of any amounts that could be recovered under collateralization provisions, up to a maximum amount of \$70.0 million, of which \$30.3 million was outstanding as of December 31, 2005. Mark E. Speese, Rent-A-Center's Chairman of the Board and Chief Executive Officer, is a passive investor in Texas Capital Bank, owning less than 1% of its outstanding equity.

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RENT-A-CENTER, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note N Stock Based Compensation

Rent-A-Center's Amended and Restated Long-Term Incentive Plan (the "Plan") for the benefit of certain employees, consultants and directors provides the Board of Directors broad discretion in creating equity incentives. Under the Plan, 14,562,865 shares of Rent-A-Center's common stock have been reserved for issuance under stock options, stock appreciation rights or restricted stock grants. Options granted to the Company's employees under the Plan generally become exercisable over a period of one to four years from the date of grant and may be exercised up to a maximum of 10 years from the date of grant. Options granted to directors are immediately exercisable. There have been no grants of stock appreciation rights and all options have been granted with fixed prices. At December 31, 2005, there were 8,878,260 shares available for issuance under the Plan, of which 5,018,977 shares were allocated to options currently outstanding. However, pursuant to the terms of the Plan, when an optionee leaves the Company's employ, unvested options granted to that employee terminate and become available for re-issuance under the Plan. Vested options not exercised within 90 days from the date the optionee leaves the Company's employ terminate and become available for re-issuance under the Plan.

Information with respect to stock option activity related to the Plan is as follows:

At December 31,

	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	5,231,538	\$17.62	6,206,897	\$15.78	8,627,690	\$14.13
Granted	1,001,000	23.80	838,500	29.30	1,335,438	23.31
Exercised	(690,608)	13.78	(1,144,295)	14.51	(2,302,494)	12.94
Forfeited	(522,953)	-	-	-	-	-
Customer list, net	-	-	9,638	-	-	-
Minority interest	-	-	16,621	-	-	-
Company's share in excess of liabilities over assets in investees	-	-	4,825	-	-	-
	-	-	(1)	-	-	-

* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2C).

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

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

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 1 - General**

Internet Gold - Golden Lines Ltd. (hereinafter "the Company") was incorporated in Israel in 1992. From 1996, the Company has operated as a provider of internet services, tailored to meet the needs of residential and business subscribers, including internet access and related value-added services, as well as content through portals. The Company launched its international Telephone Service (ITS) under the brand "015" in august 2004. The license to provide ITS was granted for 20 years.

Internet Gold is a public company and its ordinary shares currently trade on the NASDAQ national market.

Note 2 - Reporting Principles and Accounting Policies**A. Basis of preparation of financial statements**

These financial statements are prepared in accordance with generally accepted accounting principles in Israel. See Note 21 for a reconciliation to generally accepted accounting principles in the United States.

B. Definitions

In these financial statements -

(1) The Company Internet Gold - Golden Lines Ltd.

(2) The Group - Internet Gold - Golden Lines Ltd. and its investee companies as specified in Annex A list of Group Companies.

(3) Subsidiary - A company, including a partnership or joint venture, the financial statements of which are fully consolidated, directly or indirectly, with the financial statements of the Company.

(4) Affiliated company - A company, other than a subsidiary and including a partnership or joint venture, the Company's investment in which is stated, directly or indirectly, under the equity basis.

(5) Investee company - A subsidiary or affiliated company

(6) Related party - As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel (hereinafter - the ICPAI).

(7) Interested party as defined in Paragraph (1) of the definition of an "interest party" in Section 1 of the Securities Law - 1968.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 2 - Reporting Principles and Accounting Policies****B. Definitions (cont'd)**

(8) Controlling shareholder - As defined in the Securities Regulations (Financial Statement Presentation of Transactions between a company and its controlling shareholder) - 1996.

(9) CPI - The Consumer Price Index as published by the Central Bureau of Statistics.

(10) Adjusted amount - the nominal historical amount adjusted in accordance with the provisions of Opinions 23 and 34 and Opinions 36 and 37.

(11) Reported amount - The adjusted amount as at the transition date (December 31, 2003), with the addition of amounts in nominal values that were added after the transition date and less amounts eliminated after the transition date.

(12) Adjusted financial reporting - Financial reporting based on the provisions of Opinions 23, 34, 36, 37 and 50.

(13) Nominal financial reporting - Financial reporting based on reported amounts.

C. Financial statements in reported New Israeli Shekels (NIS)

In October 2001, the Israel Accounting Standards Board published Accounting Standard No. 12, "Discontinuance of Adjustment of Financial Statements". Pursuant to this standard and in accordance with Accounting Standard No. 17 that was published in December 2002, the adjustment of financial statements was discontinued as of January 1, 2004. Up to December 31, 2003, the Company continued to prepare adjusted financial statements in accordance with Opinion No. 36 of the Institute of Certified Public Accountants in Israel. The adjusted amounts included in the financial statements as at December 31, 2003 constitute the starting point for the nominal financial report as of January 1, 2004. The Company has implemented the provisions of the standard and has accordingly discontinued the adjustments as of January 1, 2004.

1. In the past the Company prepared its financial statements on the basis of historical cost adjusted for the changes in the Consumer Price Index. The adjusted amounts that are included in the financial statements as at December 31, 2003 constitute the starting point for the nominal financial report as of January 1, 2004. Any additions made during the period are included according to their nominal values.

2. Amounts of non-monetary assets do not necessarily reflect their realizable value or updated economic value, but only the reported amounts of such assets.

3. The term "cost" in these financial statements means the reported amount of cost.

4. All the comparative data for prior periods is stated adjusted to the index at December 31, 2003.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 2 - Reporting Principles and Accounting Policies

C. Financial statements in reported New Israeli Shekels (NIS) (cont'd)

Balance sheets:

- a. Non-monetary items are stated at reported amounts.
- b. Monetary items are stated in the balance sheet at their nominal historical values as at balance sheet date.

Statement of operations:

- A. Income and expenses deriving from non-monetary items from provisions included in the balance sheet are derived from the difference between the reported amounts of the opening balance and the reported amounts of the closing balance.
- B. The other income and expense items (such as: sales, purchases, current manufacturing costs, etc.) are presented at their nominal values.

D. Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

E. Convenience translation

For the convenience of the reader, the reported NIS figures of December 31, 2004 have been presented in U.S. Dollars thousands, translated at the representative rate of exchange as of December 31, 2004 (NIS 4.308 = U.S. Dollar 1.00). The U.S. Dollar (hereinafter - \$) amounts presented in these financial statements should not be construed as representing amounts receivable or payable in U.S. Dollars or convertible into U.S. Dollars, unless otherwise indicated.

F. Principles of consolidation

The consolidated financial statements include those of the Company and all its subsidiary companies. All material intercompany transactions and balances have been eliminated in the consolidated financial statements.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 2 - Significant Accounting Policies (cont'd)****G. Exchange rate and Consumer Price Index data****1. Transactions in foreign currency**

Transactions denominated in foreign currency are recorded upon their initial recognition according to the exchange rate in effect on the date of the transaction. Exchange rate differences arising upon the settlement of monetary items or upon reporting the Company's monetary items at exchange rates that are different than those by which they were initially recorded during the period, or reported in previous financial statements, are charged to income or expenses.

2. Representative rates of exchange (as published by the Bank of Israel) and Consumer Price Indices (as published by the Israeli Central Bureau of Statistics) are as follows:

	Exchange rate of the \$	Consumer Price Index
As of December 31, 2002	4.737	182.01 points
As of December 31, 2003	4.379	178.58 points
As of December 31, 2004	4.308	180.74 points
Changes during the:		
Year ended December 31, 2002	7.27%	6.49%
Year ended December 31, 2003	(7.56%)	(1.88%)
Year ended December 31, 2004	(1.625%)	1.21%

H. Cash and cash equivalents

The Company considers as cash equivalents all highly-liquid investments, including short-term bank deposits with an original maturity of three months or less, which are not encumbered by a lien.

I. Allowance for doubtful accounts

The allowance for doubtful accounts represents management's estimate of the aged receivable balance considered uncollectible, based on past experience.

J. Investments

Investee companies

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

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Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 2 - Significant Accounting Policies (cont'd)****K. Property and equipment**

Property and equipment are stated at cost less depreciation.

Depreciation is calculated using the straight-line method, over the assets estimated useful lives.

Annual depreciation rates are as follows:

	%
Network equipment and computers	25 - 33
Motor vehicles	15
Furniture and office equipment	6 - 15
Leasehold improvements	10

The cost of maintenance and repairs is charged to expenses as incurred. The cost of significant renewals and improvements is added to the carrying amount of the respective asset.

L. Other assets**1. Special content web sites**

Certain costs relating to self construction of special content web-sites have been capitalized according to EITF-00-02 and amortized over a period of 18 months from completion of construction. Such capitalized costs are presented as part of other assets.

2. Rights of Use (ROU) of international fiber optic lines

The Company signed a long-term agreement with two of its suppliers (see Note 14F). The ROU purchase is presented in the financial statements as a capital lease. Amortization is computed by the straight-line method over the term of the agreement (15 years) subject to technological obsolescence effects.

3. Deferred charges

The Company defers costs incurred relating to the expansion of customer base by long-term contracts granting the customers incentives such as Routers, firewall, etc. The consideration in such long-term contracts is refundable. The Company amortizes such costs over the term of the agreement. The Company reflects long-term deferred charges net of current maturities that are presented as prepaid expenses.

In addition, the company granted the Ministry of Communication in Israel a guarantee related to the International telephoning services license. The commission regarding this guarantee is amortized over the term of the guarantee.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 2 - Significant Accounting Policies (cont'd)****M. Deferred income**

The deferred income in the consolidated financial statements is derived from Post Contract Customer Support ("PCS") and from advertising services. Those revenues are recognized ratably over the period that services are provided (see also Note 2N).

N. Revenue recognition**(1) Sales of products**

Revenues from sales of products are recognized upon the delivery to the customer and the transfer of the principal risks and rewards arising from ownership over the sold products.

Revenues from the electronic commerce and "after sale" activity are recognized as the services are performed or when the goods are delivered, as applicable.

(2) Revenues from services

Revenues from services are recognized proportionately over the period of the agreement or upon the performance of the service if it is certain that the economic benefits attributed to the performance of the service will be received.

Most of the Company's revenues from services are derived from Internet access. These revenues are recognized ratably over the period that services are provided. Other revenues include website hosting, advertising revenues and recently international telephony services. Revenues from website hosting are recognized as the services are performed. Advertising revenues are recognized on a straight-line over the term of the contract. Revenues from international carrier services are recognized according to minutes of traffic.

(3) Multiple element sale agreements

Revenues from sale agreements which do not include a general right of return and which include a number of elements such as: hardware, software and support agreements, are split into separate accounting units and are recognized separately with respect to each accounting unit. An element constitutes a separate accounting unit if, and only if, it has a separate value to the customer and there is reliable and objective evidence regarding the fair value of all the elements of the agreement/the fair value of undelivered elements. Elements that not split into an accounting unit due to non-fulfillment of the conditions specified above are grouped together under one accounting unit. Revenues from the various accounting units are recognized when the conditions for recognizing the revenues from the elements included in that same accounting unit according to their type have been fulfilled, and only up to the amount of the consideration that is not contingent upon the completion/execution of the other elements of the contract.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 2 - Significant Accounting Policies (cont'd)**N. Revenue recognition (cont'd)****(4) Revenues from the sale of software**

Revenues from the sale of software are recognized in accordance with American Statement of Position SOP 97-2 "Software Revenue Recognition" (as amended by SOP 98-9). According to the standard, revenues from the sale of software licenses are recognized when all the following conditions have been met: the software has been delivered to the customer, collection of the payment is probable, the amount of the contract has been or can be determined and there is objective and persuasive evidence of the contract and of the Company's ability to allocate the consideration between the elements of the contract.

O. Income taxes

Income taxes are provided on the basis of the liability method of accounting. Under the liability method, deferred tax assets and liabilities are recognized for the future tax consequences of differences between the carrying amounts of existing assets and liabilities and their respective tax bases, as well as tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years when these temporary differences are expected to be recovered or settled.

In the reporting period, the Company has reported profits and utilized a portion of the tax loss carryforward but, due to the uncertainty inherent in the intense competition in the market which has developed in recent months, the Company's management cannot be reasonably assured as to the Company's ability to further utilize the tax asset in the foreseeable future. Therefore, a valuation allowance has been provided to the full amount of these losses.

The Company believes that two of its subsidiaries will utilize their carryforward tax losses and therefore a deferred tax asset has been recorded in those subsidiaries (See Note 16B).

P. Financial instruments

The financial statements include disclosures relating to the fair value of financial instruments.

With regard to current financial assets and liabilities and long-term liabilities, there is no material difference between the value recorded in the Company's books of account and their fair value.

Q. Income (loss) per share

Income (loss) per share is computed based on the weighted average number of shares outstanding during each period not including share options granted, in accordance with Opinion No. 55 of the ICPAI.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 2 - Significant Accounting Policies (cont'd)****R. Impairment of assets**

In February 2003, the Israel Accounting Standards Board (hereinafter - IASB) published **Accounting Standard No. 15 - "Impairment of Assets"**. The Standard provides procedures which a company must apply in order to ensure that its assets in the consolidated balance sheet, are not presented at an amount which is in excess of their recoverable value, which is the higher of the net selling price or the present value of the estimated future cash flows expected to be derived from use and disposal of the asset. In addition, the Standard provides rules for presentation and disclosure with respect to assets whose value has declined.

The Standard applies to financial statements for periods beginning January 1, 2003. The Standard provides that in most cases the transition will be effected by means of the "from hereon" method.

According to the Standard, Internet Gold International Ltd., a wholly-owned subsidiary of the Company, has fully written off its investment in an Internet group in Greece (see Note 6A(3)). The impairment charges of NIS 2,609 in 2003 and NIS 1,555 in 2004 are presented as other expenses.

The adoption of the Standard had no impact on the operations of the former affiliated company as the client list was partially impaired prior to the release of the standard.

S. Segment reporting

Segment reporting is represented according to Accounting Standard No. 11 of the IASB.

T. Discontinued operation

Discontinued operations are presented in accordance with Accounting Standard No. 8 and are separated from the information regarding continuing operations.

U. Disclosure of effect of new accounting standards in the period prior to their implementation

In July 2004, the Israeli Accounting Standards Board published Accounting Standard No. 19, "Taxes on Income". The Standard provides that a liability for deferred taxes is to be recorded for all temporary differences subject to tax, except for a limited number of exceptions. In addition, a deferred tax asset is to be recorded for all temporary differences that may be deducted, losses for tax purposes and tax benefits not yet utilized, if it is anticipated that there will be taxable income against which they can be offset, except for a limited number of exceptions. The new Standard applies to financial statements for periods beginning on January 1, 2005. The Standard provides that it is to be implemented by means of a cumulative effect of a change in accounting method. In the Company's estimation, the impact of the Standard on its results of operations, financial position and cash flows will not be material.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 3 - Cash and Cash Equivalents**

The Company holds its available funds in US\$ dollar short-term deposits bearing interest rates ranging from 1% to 2%.

Note 4 - Trade Receivables, Net

Trade receivables consist of:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31,	December 31,	December 31,	December 31,
	2005	2005	2005	2005
	2004	2003	2004	2003
Open accounts and accrued revenues	43,750	29,050	29,102	19,165
Checks, debit orders and credit cards receivable	15,775	13,134	13,506	12,526
	59,525	42,184	42,608	31,691
Allowance for doubtful accounts	(6,843)	(6,615)	(4,885)	(5,090)
	52,682	35,569	37,723	26,601

Changes in the allowance for doubtful accounts were as follows:

	Consolidated	Company
Balance as of December 31, 2002	7,241	5,919
Additions charged to bad debt expenses	1,538	1,358
Write-downs charged against the allowance	(863)	(846)
Recoveries of amounts previously written off	(1,301)	(1,341)
Balance as of December 31, 2003	6,615	5,090
Additions charged to bad debt expenses	2,118	679
Write-downs charged against the allowance	(1,212)	(572)
Recoveries of amounts previously written off	(678)	(312)
Balance as of December 31, 2004	6,843	4,885

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 5 - Other Receivables**

Other receivables consist of:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Prepaid expenses	6,762	5,121	6,230	4,906
Related parties (see Note 17)	1,213	2,554	429	560
Other	973	5,094	749	5,073
	8,948	12,769	7,408	10,539

Note 6 - Investments in Investee Companies**A.** Data in respect of the Company's subsidiaries and affiliated is as follows:**(1) Gold Trade Ltd. (GT)**

GT, a wholly owned subsidiary, owns e-commerce activity, the P-1000 Mega-Mall, which was launched on June 30, 2000. At the end of 2002, GT has shifted its e-commerce activity to a tender site. As such, this activity is based on commission of about 7% of sales. The revenue is recorded on a net basis.

During December 2004, the Company acquired all of the shares of GT from a related party and from others.

The excess of consideration over the GT's value in the related party financial statement recorded as a capital reserve.

The excess of consideration over Gold Trade's value in Eurocom books was recorded as capital reserve.

As of December 31, 2004, Gold Trade had incurred losses of NIS 73.5 million (\$ 17.1 million). Most of Gold Trade losses were covered by capital infusions.

The Company recorded its share of GT's losses amounting to NIS 5.16 million in 2004 (NIS 5.28 million in 2003).

Regarding discontinuance of operations in 2004, see Note 20.

(2) MSN Israel Ltd. (MSN)

MSN Israel was established in April 2000, and is an independent company jointly owned by Internet Gold (50.1%) and The Microsoft Corporation (49.9%). This portal, with the same look and feel as MSN Worldwide, uniquely combines leading Israeli content and e-commerce providers and integrates with Microsoft's leading network services such as Messenger, Hotmail (in Hebrew), Passport and Web Communities offering local users access to the most advanced online Internet services in the world. This portal constitutes the first step toward realizing the vision of an

"everyday web" in Israel.

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 6 - Investments in Investee Companies (cont'd)

A. (cont'd)

(2) MSN Israel Ltd. (MSN) (cont'd)

The consolidated financial statements include those of MSN. The Company recorded its share of MSN's net income amounting to NIS 2.2 million in 2004 (net losses of NIS 2.4 million in 2003).

The Company has an obligation to finance losses of MSN Israel up to US\$ 10 million, therefore, the Company is recording 100% of MSN's losses and the recovery of the losses. The Company has already financed approximately \$ 8.8 million as of balance sheet date (including \$7.3 million accumulated deficit).

In November 2002, MSN exercised an option to obtain 50% of the portal "Start" for no immediate consideration but was obligated to pay royalties to the other shareholder at the amount of 20% of the revenues of "Start" for a period of 36 months. Minimum payments per month was of \$8 thousand. MSN sold its 50% share of Start to Gold Mind at the end of 2004 for no consideration.

(3) Internet Gold International Ltd. (IGI)

Established in January 2000 as a wholly owned subsidiary of Internet Gold, with a goal of becoming a regional Internet Group. IGI's strategy included acquiring and partnering with local Internet Service Providers, IT companies and Media Groups in emerging markets. Currently, IGI holds 15.2% in shares of an Internet Group in Greece (the investment, of US\$ 1 million, has been fully written off). The impairment charges of NIS 2,609 and NIS 1,550 for 2003 and 2004, respectively, are presented as other expenses. IGI operates an international ISP services to customers outside Israel. The investment is presented on a cost basis. The Company recorded its share of IGI's losses amounting to NIS 0.5 million in 2004 most of which was derived from the impairment (loss of NIS 1.6 million in 2003). The Company's investment in IGI is in the form of a nominal non-interest bearing capital note plus loans amounting to NIS 5.6 million.

(4) Gold Mind Ltd. (GM)

Established in January 2000 as a wholly owned subsidiary, the company is currently engaged in virtual magazine sales and sale of value-added services such as anti Virus and anti Spam. At the end of 2004 GM acquired 50% of the portal Start from the former shareholder (including a loan) and the remaining 50% from MSN. As of December 31, 2004, GM holds 100% from Start shares. The Company recorded its share of GM's profits amounting to NIS 6.2 million in 2004 (profits of NIS 5 million in 2003).

(5) Start Net Ltd. (Start)

Start is a wholly owned subsidiary, it owns portal content-web communities offering local users access to the most advanced online internet services in the world.

At the end of 2004 GM acquired 50% of the portal Start from the former shareholder (including a loan) and the remaining 50% from MSN.

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 6 - Investments in Investee Companies (cont'd)

	Consolidated		Company	
	As at December 31 2004	As at December 31 2003	As at December 31 2004	As at December 31 2003
B.				
Investments in subsidiaries				
Consists of the following:				
Cost of shares	-	-	24,046	55
Accumulated losses	-	-	(73,421)	(45,550)
Capital reserve from purchase of investee company	-	-	(15,709)	-
	-	-	(65,084)	(45,495)
Loans	-	-	81,905	53,782
	-	-		
	-	-	16,821	8,287

	Consolidated		Company	
	As at December 31 2004	As at December 31 2003	As at December 31 2004	As at December 31 2003
C. Investments in investee companies:				
Cost of shares	-	24,418	-	22,868
Accumulated losses	-	(30,574)	-	(30,574)
	-	(6,156)	-	(7,706)
Presented as investments in investee companies	-	1,550	16,821	8,287
Presented as part of long- term liabilities	-	7,706	-	7,706

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 7 - Property and Equipment, Net

Property and equipment consists of:

A. Consolidated

	Network equipment and computers	Furniture and office equipment	Motor vehicles ⁽¹⁾	Leasehold improvements	Total
Cost:					
As at					
December 31, 2003	74,518	18,359	7,426	9,681	109,984
Additions	18,346	4,170	-	1,299	23,815
Acquisition of					
Gold Trade	8,472	595	240	2,063	11,370
Disposals	(511)	(15)	(4,091)	(38)	(4,655)
As at					
December 31, 2004	100,825	23,109	3,575	13,005	140,514
Depreciation:					
As at					
December 31, 2003	58,181	9,907	4,944	7,792	80,824
Depreciation for					
the year	8,455	3,382	902	894	13,633
Acquisition of					
Gold Trade	6,772	533	188	1,752	9,245
Disposals	(500)	(15)	(3,218)	(38)	(3,771)
As at					
December 31, 2004	72,908	13,807	2,816	10,400	99,931
Property and equipment, net					
As at					
December 31, 2004	27,917	9,302	759	2,605	40,583
As at					
December 31, 2003	16,337	8,452	2,482	1,889	29,160

⁽¹⁾Includes cost of motor vehicles under financial lease agreements totaling NIS 3,536 as of December 31, 2004 (NIS 7,391 as of December 31, 2003). Liens have been placed on such vehicles, in favor of the lessor, (see also Note 14(E)).

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 7 - Property and Equipment, Net (cont'd)****B. Company**

	Network equipment and computers	Furniture and office equipment	Motor Vehicles⁽¹⁾	Leasehold improvements	Total
Cost:					
As at					
December 31, 2003	69,416	18,184	5,947	9,504	103,051
Additions	17,517	4,088	-	860	22,465
Disposals	(511)	(15)	(3,356)	(38)	(3,920)
As at					
December 31, 2004	86,422	22,257	2,591	10,326	121,596
Depreciation:					
As at					
December 31, 2003	54,563	9,866	4,133	7,693	76,255
Depreciation for the year	7,590	3,369	709	885	12,553
Disposals	(500)	(15)	(2,734)	(38)	(3,287)
As at					
December 31, 2004	61,653	13,220	2,108	8,540	85,521
Property and equipment, net					
As at					
December 31, 2004	24,769	9,037	483	1,786	36,075
As at					
December 31, 2003	14,853	8,318	1,814	1,811	26,796

⁽¹⁾Includes cost of motor vehicles under financial lease agreements totaling NIS 2,581 as of December 31, 2004 (NIS 5,938 as of December 31, 2003). Liens have been placed on such vehicles, in favor of the lessor.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 8 - Other Assets and Deferred Charges**

Consists of:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Web site construction for self use (see Note 2L (1))	7,029	5,888	219	219
Amortization of web sites	(5,925)	(4,707)	(219)	(219)
	1,104	1,181	-	-
Right of use of International Communication Lines (see Note 2L (2))	117,797	50,598	117,797	50,598
Less: amortization	(8,423)	(1,573)	(8,423)	(1,573)
	109,374	49,025	109,374	49,025
Portal start	868	-	-	-
Less: amortization	-	-	-	-
	868	-	-	-
Deferred charges and other (see Note 2L (3))	3,610	924	2,879	870
	114,956	51,130	112,253	49,895

Note 9 - Short-Term Bank Loans

Short-term loans and credit from banks consist of:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Short-term loans at Prime*	10,817	4,279	7,598	1,754
Current maturities of long-term loans	133	980	70	705
	10,950	5,259	7,668	2,459

* The Prime rate as of December 31, 2004 was 5.2% (December 31, 2003- 6.7%).

See Note 14C with regard to bank guarantees.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 10 - Accounts Payable

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Trade payables - open account	60,736	27,992	58,855	26,358
Trade payables abroad	1,195	758	1,195	758
Checks payable	4,258	2,444	3,201	2,023
Accrued expenses	7,194	*5,397	6,163	*4,776
	73,383	36,591	69,414	33,915

Note 11 - Other Payables

Other payables consist of:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Employees and payroll accruals	7,197	5,465	5,399	4,578
Related parties (see Note 17)	2,211	*4,507	1,399	*2,718
Liability for vacation and recreation pay	1,905	1,707	1,682	1,514
Deferred income	2,205	1,489	107	206
Other	266	869	155	872
	13,784	14,037	8,742	9,888

* Reclassified

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 12 - Long-Term Loans and Other Long-Term obligations

Long-term loans and other long-term obligations under capital and operating leases are as follows:

		Consolidated		Company	
		As at	As at	As at	As at
		December	December	December	December
		31	31	31	31
	Interest rate	2004	2003	2004	2003
Capital lease obligations:					
Vehicles (linked to C.P.I.)	5%-7%	139	1,253	70	782
Less: current maturities		(133)	(980)	(70)	(705)
		6	273	-	77
International Communication Lines (linked to the US\$ exchange rate)	*LIBOR +0.5%	82,040	43,911	82,040	43,911
Less: current maturities (presented as accounts payable)		(40,429)	(16,795)	(40,429)	(16,795)
		41,611	27,116	41,611	27,116
Other long-term loans	PRIME + 0.2%	30,500	-	30,500	-
		72,117	27,389	72,111	27,193

*

The LIBOR rates ranges from 1.10% to 1.12%.

Amortization of assets held under capital leases is included as part of depreciation expenses.

Aggregate maturities are as follows:

	As at December 31 2004
2005	40,562

2006	39,481
2007	16,488
2008	7,176
2009	8,443
2010	529
	72,117

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Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 13 - Liability for Severance Pay, Net**

The Company's liability for termination of employer-employee relations is computed according to Israeli Labor Law on the basis of the latest salary paid to each employee multiplied by the number of years of employment. The liability is partially covered by deposits in executive insurance policies at insurance companies.

The Company's net liabilities disclosed in the balance sheet represents the balance of the liability not funded as above:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Liability for severance pay	12,471	9,876	11,298	8,959
Less: amounts funded	(6,231)	(4,948)	(5,526)	(4,436)
	6,240	4,928	5,772	4,523

The expenses in respect to severance pay for the years ended December 31, 2004, 2003 and 2002 are NIS 1,631 (Company - NIS 1,395) NIS 2,372 (Company - NIS 2,162) and NIS 1,796 (Company - NIS 1,673), respectively.

Note 14 - Guarantees, Commitments and Contingent Liabilities**A. License and regulations**

1. The Company received a license from the Ministry of Communications in Israel (hereinafter "MOC") on June 2, 2004 for a period of 20 years. The license grants the Company the right to provide international telephone services, subject to several conditions mentioned in the license.

Under the Telecommunications Law, the MOC is entitled to amend the conditions of the license based upon various considerations such as government policy and public interest. The MOC is also entitled to cancel the license if the Company fails to comply with the terms of the license.

2. The Company has received a license from the MOC which was renewed on January 24, 2002 for a period of five years. The license grants the Company the right to provide Internet and related services, subject to several conditions mentioned in the license.

Under the Telecommunications Law, the MOC is entitled to amend the conditions of the license based upon various considerations such as government policy and public interest. The MOC is also entitled to cancel the license if the Company fails to comply with the terms of the license.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 14 - Guarantees, Commitments and Contingent Liabilities (cont'd)****A. License and regulations (cont'd)**

3. The Company expects to face competition in the future from companies that provide connections to consumers' homes, such as telecommunications providers, digital broadcast satellite (hereinafter - "DBS") providers and cable television companies as well as wireless communication companies.

During 2003, the significant increase in demand for broadband was coupled with intense competition between all ISPs, which resulted in price reductions by all ISPs. Due to this market environment, the Company adopted a more aggressive marketing policy in order to attract a greater number of broadband customers while continuing to keep tight control over expenses.

The Company expects that the competition in the Internet industry will intensify, which, along with possible regulatory changes, may have an adverse effect on revenues and profitability.

In addition, during 2002, the cable television companies received a license to operate as an ISP.

B Legal claims

1. In July 2003 a lawsuit was filed against the Company by an Israeli company claiming for an alleged breach of agreement. The lawsuit seeks damages of NIS 300. In the Company's management view, after consulting with its legal consultants, the Company's position is fairly well established. A provision of NIS 100 has been recorded.
2. From time to time, claims arising from the normal course of business are brought against the Company. In the opinion of management, based on the advice of legal counsel, the ultimate disposition of these matters will not have a material adverse effect on the financial position, liquidity or results of operations of the Company.

C. Guarantees and assigned notes receivable

	December 31 2004	December 31 2003
Guarantees in favor of:		
Others*	10,892	547
	10,892	547

*The amounts stated above represent the maximum undiscounted exposure to the Company, including a guarantee in the sum of NIS 10,111 in favor of the MOC related to the International telephony services license.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 14 - Guarantees, Commitments and Contingent Liabilities (cont'd)**

D. Subsequent to the balance sheet date, the Company entered a commitment to purchase network equipment amounting to approximately NIS 3,700.

E. Subsequent to the balance sheet date, the Company entered a commitment to purchase network equipment amounting to approximately NIS 3,700.

1. The Company leases office premises of 4,250 sq. m. for periods of up to ten years with a renewal option for an additional ten years. Future annual rental expenses under the agreement are approximately NIS 2,140 linked to the rate of exchange of the U.S. Dollar.

The Company's support department rented from a related party 250 square meters of office space in Ramat Gan, Israel. The facilities are leased from Eurocom Holdings until June 30, 2005 (see Note 17A).

In addition, MSN, the Company's subsidiary, was engaged in agreements for the lease of office premises of 325 sq. m. until December 31, 2003 (the termination of the first option period) for the year ended December 31, 2004 for the lease of 700 sq. m., and since January 1, 2005, for the lease of 800 sq. m. This is a sub-lease from GT, the Company's subsidiary. Future monthly rent for all the facilities leased by MSN is NIS 21 (US\$ 4.9). Since January 1, 2004, MSN uses the premises on a monthly basis without renewing the lease agreement (this action is consistent with GT's lease agreement).

The Company has also entered into lease agreements for several sites at which part of the communications equipment is located.

Rental expenses were NIS 2,670 (Company - NIS 2,310), NIS 2,984 (Company - NIS 2,754) and NIS 2,516 (company - NIS 2,283), for the years ended December 31, 2004, 2003 and 2002, respectively.

2. The Group has entered into motor vehicle operating lease agreements for the lease of 110 motor vehicles (Company - 87 motor vehicles) for a period of three years. The Group deposited NIS 598 (Company - NIS 454) pursuant to the terms of the operating lease agreements.

Future minimum lease payments are as follows (assuming renewal options will not be exercised):

	Consolidated	
	As of December 31, 2004	
	Vehicle leases	Office leases
2005	3,026	2,236
2006	2,565	2,236
2007	1,537	2,236
2008	24	2,236
2009 and thereafter	-	2,236
	7,152	11,180

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 14 - Guarantees, Commitments and Contingent Liabilities (cont'd)****F.****Special agreements**

The Company has signed a long-term agreements with Barak I.T.C. (1995) Ltd. and Bezeq International Ltd., two of Israel's long distance carriers, to purchase Rights Of Use (ROU) for international fiber optic lines until the year 2017, with the option to extend the agreement for an additional five year period.

According to the agreement, the Company is obligated to pay ROU charges for each new leased international line ordered in respect of each circuit in thirty-six (36) monthly installments.

As of the balance sheet date, the Company has operated 10 lines with Barak and an additional 2 lines with Bezeq International.

The Company presents the ROU purchase in its financial statements as a capital lease as part of other assets at the net sum of NIS 109,374.

Future installments -

2005	40,429
2006	32,299
2007	9,312
	82,040

G.

The amount of liabilities which are secured by liens is:

	Consolidated As of December 31 2004	Company As of December 31 2004
Short-term loans (current maturities of long term loans)	133	70
Long-term loans	6	-
	139	70

A lien has been placed on motor vehicles to secure the said liabilities, (see also Note 7).

H. The Board of Directors has adopted a plan for the issuance of 2,000,000 options to purchase the Company's Ordinary Shares (hereinafter - "options") to the Company's directors, officers and employees (hereinafter - "the 1999 Plan"). The exercise price of the options was determined at the issuance of the options (see Note 21A(6)).

The plan expired in August 2004 and no plan has replaced it yet.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 14 - Guarantees, Commitments and Contingent Liabilities (cont'd)**

I. The Board of Directors has resolved to indemnify the directors and officers of the Company in respect of damages that they may incur in connection with the Company being a public company, to the extent that these damages are not covered by the directors' and officers' liability insurance.

J. The Company established with Microsoft an Israeli subsidiary: MSN Israel. The Company holds 50.1% of MSN Israel shares. The Company has an obligation to finance losses of MSN Israel up to US\$ 10 million, therefore, the Company is recording 100% of MSN's losses. The accumulated deficit of MSN Israel as at December 31, 2004 is NIS 31.5 million (US\$ 7.3 million).

K.**Royalties commitment**

The Company is obligated to pay royalties to the MOC in respect of revenues from its international telephone services pursuant to the Bezeq Regulations (Royalties), 2001.

The royalties are primarily calculated at the rate of 3.5%. As at December 31, 2004, the maximum amount of the Company's liability in respect of such royalties is estimated to be NIS 150 (US\$ 35).

L.**Stamp duty**

Stamp duty applies in Israel to various types of documents at various rates, depending primarily on the type of the document and the amount specified, or not, therein. In June 2003, the statute imposing stamp duty was amended.

Following this amendment, the Israeli Tax Authority has increased enforcement of this statute. The amendment to the statute and the enforcement actions taken by the Israeli Tax Authority are in legal dispute before the Israeli Supreme Court, which has not yet ruled on this matter. In addition, under current legislation the stamp duty statute is expected to be gradually abolished until its complete cancellation in 2008. To date, the Company has not received a demand for payment of stamp duty following this amendment. The Company does not believe that any stamp duty that may be imposed on it as a result of this amendment will be material to the Company's financial position or results of operations.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 15 - Additional Statement of Operations Data

A. Revenues

Revenues consist of:

	Year ended December 31 2004	Consolidated Year ended December 31 2003	Year ended December 31 2002	Year ended December 31 2004	Company Year ended December 31 2003	Year ended December 31 2002
Access revenues	156,385	146,906	156,336	153,755	136,523	153,973
International telephone services	9,381	-	-	9,381	-	-
Other revenues	53,811	32,736	27,982	17,207	20,871	15,079
	219,577	179,642	184,318	180,343	157,394	169,052

B. Cost of revenues

Cost of revenues consists of:

	Year ended December 31 2004	Consolidated Year ended December 31 2003	Year ended December 31 2002	Year ended December 31 2004	Company Year ended December 31 2003	Year ended December 31 2002
Communication services	29,985	32,920	41,635	27,950	32,882	41,645
Cost of goods sold	6,744	6,035	5,622	6,744	4,951	5,622
	36,729	38,955	47,257	34,694	37,833	47,267
Salaries and related expenses	32,440	28,358	25,167	27,233	24,292	21,923
Depreciation	10,683	10,421	11,367	8,571	7,941	9,672
Other	16,968	15,137	15,773	10,321	7,942	6,936
	96,820	92,871	99,564	80,819	78,008	85,798

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 15 - Additional Statement of Operations Data (cont'd)

C. Selling and marketing expenses

	Year ended December 31 2004	Consolidated Year ended December 31 2003	Year ended December 31 2002	Year ended December 31 2004	Company Year ended December 31 2003	Year ended December 31 2002
Advertising and marketing expenses	40,751	17,512	13,702	39,844	21,680	16,261
Salaries and related expenses	29,200	21,177	20,777	23,907	18,460	19,355
Depreciation	2,091	2,398	2,365	2,091	2,398	2,365
Other	1,113	306	281	-	-	-
	73,155	41,393	37,125	65,842	42,538	37,981

D. General and administrative expenses

	Year ended December 31 2004	Consolidated Year ended December 31 2003	Year ended December 31 2002	Year ended December 31 2004	Company Year ended December 31 2003	Year ended December 31 2002
			NIS thousands			
Professional fees	3,198	3,750	2,776	2,519	3,249	2,377
Salaries and related expenses	13,086	10,259	7,940	9,818	8,801	7,017
Postal and communication expenses	897	2,188	2,227	918	2,155	2,302
Provision for doubtful debts	828	80	1,942	367	(93)	1,612
Legal reserve, net	(672)	309	(604)	(672)	-	(604)
Depreciation	1,593	1,676	1,622	1,593	1,576	1,539
Office maintenance and rent	3,610	2,599	3,925	3,329	2,312	3,518
Management fee to related party*	-	-	-	904	-	-

Other	1,718	1,047	1,381	1,034	959	951
	24,258	21,908	21,209	19,810	18,959	18,712

* See also Note 17(B)

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Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 15 - Additional Statement of Operations Data (cont'd)****E. Financing (income) expenses, net**

Financing income, net, consists of:

	Consolidated				Company	
	Year ended December 31 2004	Year ended December 31 2003	Year ended December 31 2002	Year ended December 31 2004	Year ended December 31 2003	Year ended December 31 2002
Interest (expenses) income on short-term loans from banks and others	(171)	(187)	(343)	(137)	25	(492)
Exchange rate differentials net of interest on short-term Bank deposits	79	(4,822)	1,852	79	(4,822)	1,913
Exchange rate differentials net of interest on long-term loans	133	537	(376)	200	537	(269)
Other, mainly derived from devaluation of Trade receivables and trade payables	81	1,237	1,018	2,310	4,847	2,549
	122	(3,235)	2,151	2,452	587	3,701

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 16 - Income Taxes****A. Adjustments for inflation**

The Income Tax Law (Inflationary Adjustments) - 1985 (hereinafter - the Law) is effective as from the 1985 tax year. The Law introduced the concept of measurement of results for tax purposes on a real (net of inflation) basis. The various adjustments required by the aforesaid Law are designed to achieve taxation of income on a real basis. However, adjustment of the historical income pursuant to the provisions of the tax laws is not always identical with such adjustment for financial reporting purposes based on opinions published by the Institute of Certified Public Accountants in Israel. As a result, differences arise between the inflation adjusted income appearing in the financial statements and the inflation adjusted income reported for tax purposes.

B. Amendments to the Income Tax Ordinance

On June 29, 2004, the Knesset passed the "Law for the Amendment of the Income Tax Ordinance (Amendment No. 140 and Temporary Order) - 2004" (hereinafter - the Amendment). The Amendment provides for a gradual reduction in the company tax rate from 36% to 30% in the following manner: in 2004 the tax rate will be 35%, in 2005 the tax rate will be 34%, in 2006 the tax rate will be 32% and from 2007 onward the tax rate will be 30%.

The current taxes and the deferred taxes balances as at December 31, 2004 are calculated in accordance with the new tax rates specified in the Amendment. The effect of the change on the consolidated financial statements as at the beginning of 2004 is immaterial.

C. The Company has received final tax assessments up to and including the 1999 tax year.

D. Results of operations of the Company for tax purposes are computed in accordance with the Income Tax Law (Inflationary Adjustments), 1985, in real terms, in order to calculate taxation on inflationary earnings after taking into account the changes in the Index.

Income is taxed at the regular corporate tax rate - 35% for 2004.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 16 - Income Taxes (cont'd)****E. Reconciliation of income tax expense:**

A reconciliation of the theoretical tax expense computed on the pre-tax income at the statutory tax rate and the actual income tax provision is as follows:

	Year ended December 31 2004	Consolidated Year ended December 31 2003	Year ended December 31 2002	Year ended December 31 2004	Company Year ended December 31 2003	Year ended December 31 2002
Income before income tax as per income statements	24,389	17,643	28,568	16,827	18,493	30,152
Primary tax rate	35%	36%	36%	35%	36%	36%
Tax calculated according to primary tax rate	8,536	6,351	10,284	5,889	6,657	10,855
Increase in tax resulting from:						
Non-deductible expenses	1,053	451	587	420	420	530
Change in valuation allowance in respect of deferred taxes	(9,371)	(9,343)	(10,001)	(6,378)	(6,602)	(10,715)
Other difference	(519)	606	(870)	69	(475)	(670)
	(8,837)	(8,286)	(10,284)	(5,889)	(6,657)	(10,855)
	(301)	(1,935)	-	-	-	-

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 16 - Income Taxes (cont'd)****F. Deferred taxes comprise:**

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Tax loss carryforward	39,545	27,330	4,401	10,671
Accrued employee rights	2,495	2,389	2,236	2,173
Allowance for doubtful accounts	2,362	2,381	1,661	1,832
Deferred tax asset	44,402	32,100	8,298	14,676
Valuation allowance	*(41,816)	(30,165)	(8,298)	(14,676)
Net deferred tax asset	2,586	1,935	-	-

* The valuation allowance for December 31, 2004 includes NIS 21,022 regarding carryforward losses of GT that was consolidated as of December 31, 2004.

Deferred tax assets for future benefits are included where their realization is more likely than not.

The Group has an operating loss carryforward for tax purposes, as of December 31, 2004 of approximately NIS 112,985 thousand consolidated - including the reconsolidated subsidiary Gold Trade with NIS 60 million (Company - NIS 11,377 thousand). The operating loss carryforward is linked to the Index and has no expiry date.

The Company's management has assessed its deferred tax asset and the need for a valuation allowance. Such as assessment considers whether it is more likely than not that some portion or all of the deferred tax assets may not be realized. The assessment requires considerable judgment on the part of management, with respect to, amongst others, benefits that could be realized from available tax strategies and future taxable income, as well as other positive and negative factors. The ultimate realization of deferred tax assets is dependent upon the Company's ability to generate the appropriate character of future taxable income sufficient to utilize loss carryforwards or tax credits before their expiration.

In determining the potential requirement to establish a valuation allowance, the Company has evaluated all positive and negative evidence, including the work plans of the Group's management and the analysis of scenarios for achieving the work plans. The underlying assumptions utilized in forecasting its future forecasted taxable income require judgment and may be subject to revision based on future business developments. As a result of this assessment, the Company has recorded a valuation allowance on its deferred tax assets, except for two of its subsidiaries.

Note 17 - Related Parties**A. Related party balances arise from the ordinary course of business and are as follows:**

Related parties are comprised of principal shareholders (10% and over of the Company's share capital) the Company's management, immediate family members of the aforementioned and subsidiary and affiliated companies of the aforementioned.

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Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 17 - Related Parties (cont'd)****A. Related party balances arise from the ordinary course of business and are as follows: (cont'd)**

The Company conducts transactions with related parties as detailed below. Transactions with related parties are mainly as follows:

- (a) Communication services, inter alia via satellite, are conducted through a related party.
- (b) Purchase of office equipment for both self use and promotion and cellular mobile phones from related parties.
- (c) Reimbursement for actual expenses (certain employee compensation expenses, including in respect of the CEO and overhead) to the ultimate parent company.
- (d) Rental of certain office premises from a related party.
- (e) Advertising through a related party radio station.

Related parties' balances are presented as follows:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Debit balance (Note 5)	1,213	2,554	429	560
Credit balance (Note 11)	2,211	4,507	1,399	2,718

B. Related party transactions were reflected in the statements of operations as follows:

	Consolidated		Company	
	As at	As at	As at	As at
	December 31	December 31	December 31	December 31
	2004	2003	2004	2003
Revenues	3,290	1,973	1,870	3,621
Cost of revenues - communications expenses	19	4,873	19	4,873
Participation in compensation and other expenses	110	503	(407)	579
Rental expenses	275	281	275	281
Selling and marketing expenses - advertising expenses	3,365	1,113	4,614	6,245
General and administrative expenses - Participation in compensation and other expenses	972	677	417	520
Interest (income) expense	-	(60)	(2,013)	(2,859)

Note 18 - Financial Instruments

Concentration of credit risk

Financial instruments which potentially subject the Company to significant concentrations of credit risk consist principally of bank deposits deposited in one bank account in the sum of NIS 75,304, trade receivables, other receivables and long-term loans. With respect to trade receivables the Company believes that there is limited credit risk exposure due to the relatively small amount owed to the Company by each customer and the large size of the Company's customer base.

With respect to long-term loans, see Note 14(G).

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Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 19 - Segment Reporting**

The Company has identified five reportable segments in 2004, i.e. the provision of Internet services, International telephony services, website content provision, portal operating and after sale activity, and operates in one geographic area, i.e. Israel.

The Company reported for the first time the International telephony services activity as a reportable segment

	Year ended December 31, 2004							Consolidated
	ISP (1)	Telephony services(2)	Portal(3) operating	Website(4) content	After sale(5) Commerce(6) and others	Adjustment		
External revenues for the segment	156,385	9,381	23,886	12,718	17,207	-	-	219,577
Internal revenues for the segment	-	-	4,924	-	-	-	(4,924)	-
Total revenues for the segment	156,385	9,381	28,810	12,718	17,207	-	(4,924)	219,577
Income (loss) from operations	18,315	(10,471)	4,351	5,973	7,178	-	(2)	25,344
Financial expenses								(5,194)
Financial income								5,316
Other expenses, net								(1,077)
Company's share in net loss of investees								
From continued operations						(396)		(396)
Company's share in loss of a subsidiary from discontinued operations						(4,763)		(4,763)
Tax benefit								301
Net income								19,531
Total assets for the segment	257,767	11,629	14,324	9,344	-	9,620	(2,661)	300,023
Total liabilities for the segment	166,719	2,696	45,817	6,585	-	37,166	(80,853)	178,130
Excess liabilities over assets in	-	-	-	-	-	-	-	-

investee companies for the segment								
Total liabilities	166,719	2,696	45,817	6,585	-	37,166	(80,853)	178,130
Capital expenditure	78,734	11,629	2,316	170	-	-	-	92,849
Depreciation and amortization	18,569	950	2,016	321	-	-	-	21,856

(1) ISP-Internet Service Provider - Offering a wide range of Internet access and Internet services.

(2) International telephony services - Offering a wide range of International telephony services.

(3) Portal MSN Israel - The portal offers an electronic advertising media.

(4) Selling Internet content such as electronic newspaper, radio, anti virus and other related products.

(5) Selling products to the subscribers through a variety of on-line shopping and transactional opportunities.

(6) An e-commerce activity which enables the user to make transactions through the Internet

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 19 - Segment Reporting (cont'd)

	Year ended December 31, 2003						
	ISP	Portal	Web site	After sale	Commerce	Adjustments	Consolidated
	operating		content	and others			
External revenues for the segment	146,007	15,460	5,155	13,020	-	-	179,642
Internal revenues for the segment	899	6,257	82	-	-	(7,238)	-
Total revenues for the segment	146,906	21,717	5,237	13,020	-	(7,238)	179,642
Income from operations	13,363	1,419	3,149	5,534	-	5	23,470
Financial expenses							(10,831)
Financial income							7,596
Other expenses, net							(2,592)
Company's share in net loss of investees					(1,538)		(1,538)
Company's share in loss of a subsidiary from discontinued operations					(3,737)		(3,737)
Tax benefit							1,935
Net income							14,303
Total assets for the segment	197,869	11,960	4,693	-	-	(518)	214,004
Total liabilities for the segment	84,983	45,600	8,131	-	-	(50,487)	88,227
Excess liabilities over assets in investee companies for the segment	-	-	-	-	7,706	-	7,706
Total liabilities	84,983	45,600	8,131	-	7,706	(50,487)	95,933
Capital expenditure	62,020	1,688	68	-	-	-	63,776
Depreciation and amortization	13,705	2,363	158	-	-	(7)	16,219

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 19 - Segment Reporting (cont'd)

	Year ended December 31, 2002						
	ISP	Portal	Web site	After sale	Commerce	Adjustments	Consolidated
		operating	content	and others			
External revenues for the segment	155,403	8,900	4,935	15,080	-	-	184,318
Internal revenues for the segment	933	4,769	40	-	-	(5,742)	-
Total revenues for the segment	156,336	13,669	4,975	15,080	-	(5,742)	184,318
Income (loss) from operations	20,584	(4,396)	2,956	7,174	-	102	26,420
Financial expenses							(13,857)
Financial income							16,008
Other expenses, net							(3)
Company's share in net loss of investees					(1,530)		(1,530)
Company's share in loss of a subsidiary from discontinued operations					(7,080)		(7,080)
Net income							19,958
Total assets for the segment	159,489	9,025	815	-	-	(277)	169,052
Total liabilities for the segment	41,838	41,247	9,338	-	-	(40,296)	52,127
Excess liabilities over assets in investee companies for the segment	-	-	-	-	13,157	-	13,157
Total liabilities	41,838	41,247	9,338	-	-	(40,296)	62,584
Capital expenditure	10,874	2,692	19	-	-	-	13,585
Depreciation and amortization	13,450	1,828	157	-	-	(102)	15,333

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 20 - Discontinued Operation**

In the end of 2004, Gold Trade's board of directors reached the decision to close down all its operations except the e-commerce activity P-1000 site. In addition, Gold Trade reached the decision in June 2002 to close down its operation in the line of business of imported merchandise sold through self produced mail order catalog.

The reclassification of the assets and certain liabilities was implemented based on specific allocations. Other liabilities were attributed according to a ration between the deficit derived from the continuing and discontinuing operations.

The reclassification of revenues and expenses to discontinued operations has been implemented on a specific basis with the exception of the financing expenses which were reclassified according to the ratio of liabilities attributed to discontinued operations.

The assets and liabilities of the discontinued operation are as follows:

	As at December 31 2004 NIS thousands	As at December 31 2003 NIS thousands
Assets attributable to discontinued operations		
Trade receivables, net	4,463	-
Other receivables	168	-
Intangible asset - client list*	-	-
	4,631	-
* The intangible asset - client list was attributed to the ongoing operations.		
Liabilities attributable to discontinued operations		
Short-term bank loans	41	-
Account payable	944	-
Other payables	668	-
	1,653	-

The results of the discontinued operation are as follows:

	Year ended December 31 2004	Year ended December 31 2003	Year ended December 31 2002
Revenues	-	-	-
Cost of revenues	-	-	-
Selling and marketing expenses	-	-	-
General and administrative expenses	-	-	-
	-	-	-
Loss from operations	-	-	-
Financing expenses, net	-	-	-

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Net loss after financing expenses	-	-	-
Minority share in loss of subsidiary from discontinued operations	-	-	-
Net loss from discontinued operation	-	-	-
Company's share in net loss of investees	(4,763)	(3,737)	(7,080)

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)**Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and Their Effect on the Financial Statements**

A. The Company's financial statements are prepared in accordance with generally accepted accounting principles in Israel (Israeli GAAP), which differ in certain respects from generally accepted accounting principles in the United States (U.S. GAAP). Differences which have a significant effect on the net assets, income, shareholders' equity or cash flows of the Company and Consolidated, are set out below.

1. Effect of inflation:

The Company, in accordance with Israeli GAAP, comprehensively includes the effect of price level changes in the accompanying financial statements, as described in Note 2C. According to such Israeli accounting principles, the Company has discontinued the adjustment of the financial statements as of January 1, 2004.

U.S. GAAP does not provide for recognition of the effects of such price level changes. Such effects have not been included in a reconciliation to U.S. GAAP.

2. Liability for severance pay

Under Israeli GAAP, amounts funded by purchase of insurance policies are deducted from the related severance pay liability.

Under U.S. GAAP, the cash surrender value of such insurance policies should be presented in the balance sheet as long-term investments and the full severance pay liability should be presented in the balance sheet as a long-term liability. As at December 31, 2004 and 2003, such funded amounts were NIS 6,231 (Company - NIS 5,526), and NIS 4,948 (Company - NIS 4,436) respectively.

3. Affiliate equity amendment deriving from application of U.S. GAAP as a correction to the financial statements under Israeli GAAP

According to Israeli GAAP as prescribed in Accounting Standard 15, the affiliated company - Gold Trade ("GT") wrote down the customer list to its carrying value using the discounted projected cash flows derived from the activity incorporating the customer list over its useful life term.

In the past, GT termed this asset as goodwill since there was no distinction between the titles. Under U.S. GAAP, GT cannot reclassify intangible assets derived from acquisitions unless it meets certain criteria stipulated in EITF D-100. Since this asset is considered to be goodwill under U.S. GAAP it was fully written off, after applying the impairment test that is prescribed in FAS142. In accordance with the said test that was applied on June 30, 2002 GT identified that the reporting unit to which the goodwill is attributed was impaired. When GT applied the second step of the impairment test GT determined that the implied fair value of the goodwill is zero since GT had to attribute fair value to the customer list that was not previously recorded. This year, in its Israeli GAAP figures, GT continued to amortize this client list (previously titled "goodwill") amounting to NIS 3,980. Under US GAAP this asset was fully written off in 2002. (the Company's share of this amortization is NIS 1,921). The amortization described above is reversed in the reconciliation note.

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their Effect on the Financial Statements (cont'd)****A. (cont'd)****4. Changes in exchange rate**

According to Israeli GAAP, the effects of changes in exchange rates in cash are reflected as cash flows from operating activities in the statement of cash flows.

Under U.S. GAAP, the effect of changes in exchange rates on cash are presented separately in the statement of cash flows (see Note 21B.4).

5. Loans in respect of capital leases

According to Israeli GAAP, receipt of loans in respect of capital leases are reflected in the statement of cash flows as cash flows from financing activities as against investing activities from the acquisition of the fixed assets - financed by the lease.

Under U.S. GAAP, as prescribed by SFAS 95, the above mentioned items are reflected as non-cash financing activities (see Note 21B.3).

6. Employee Stock Option Plan

The Board of Directors has adopted a plan for the issuance of 2,000,000 options to purchase the Company's Ordinary Shares (hereinafter - "options") to the Company's directors, officers and employees (hereinafter - "the 1999 Plan"). The exercise price of the options was determined at the issuance of the options.

During 1999, the Board of Directors approved the grant of 653,793 options to the Company's officers. According to the 1999 Plan, each employee shall receive equal numbers of options from each of the groups detailed below, without consideration, to be held in trust in accordance with the Israeli Income Tax Ordinance - Section 102.

Options (from all groups) which would not be exercised within the period of 63 months following the allotment date will expire. The following table summarizes the terms of the option groups:

<u>Group</u>	<u>Vesting (in months)</u>	<u>Exercise price (in \$)</u>
A	12	10.8
B	24	9.6
C	36	8.4
D	48	7.2
E	60	6

Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their Effect on the Financial Statements (cont'd)****A. (cont'd)****6. Employee Stock Option Plan (cont'd)**

Stock option activity during the period indicated is as follows:

	Number of shares	Weighted average exercise price
	NIS	NIS
Balance at December 31, 2002	195,393	36.8
Granted	-	-
Forfeited	(28,650)	-
Balance at December 31, 2003	166,743	36.8
Granted	-	-
Forfeited*	(166,743)	-
Balance at December 31, 2004	-	-

* As of December 31, 2004, the options expired according to the 1999 Plan provisions.

As applicable according to Israeli GAAP, employee stock compensation expenses are not recorded as long as options are not exercised.

Under U.S. GAAP, in accordance with the Accounting Principles Board (hereinafter - "APB") No. 25, recording of compensation expense is required over the vesting period. Under the provisions of APB-25, based on the initial public offering price of \$12 per share, aggregate compensation expense is approximately NIS 2,666 (expenses of NIS 102 for the year ended December 31, 2004, and income of NIS 109 for the year ended December 31, 2003, and expenses of NIS 530 for the year ended December 2002).

7. Consolidation of Variable Interest Entities

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." This Interpretation addresses the consolidation by business enterprises of variable interest entities when the equity investors do not have the characteristics of a controlling financial interest (as defined in the Interpretation). In December 2003, the FASB issued Interpretation No. 46R, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." The FASB deferred the effective date for implementation of this Interpretation until fiscal years ending after March 15, 2004.

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

**Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their
Effect on the Financial Statements (cont'd)**

A. (cont'd)

7. Consolidation of Variable Interest Entities (cont'd)

The Company, according to Israeli GAAP as prescribed in Opinion No. 57 of the Institute of Certified Public Accountants in Israel, treated the investment in its affiliated company GT, a subsidiary of the Company until December 31, 2001. For the years ended December 31, 2002 through December 31, 2003, the Company accounted for its investment under the equity method. The Company has consolidated GT as of December 31, 2004.

Under the provisions of FIN 46R, the Company is required to consolidate GT for all years presented, due to a number of factors which indicate that the Company is the primary beneficiary of GT.

The Company has applied FIN 46R by retroactively restating previously issued financial statements, and recorded a cumulative effect of accounting change as of January 1, 2002 in the amount of NIS 4,382.

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

**Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their
Effect on the Financial Statements (cont'd)**

B. The effect of the material differences between Israeli GAAP and U.S. GAAP on the financial statements.

The following is summary of the material adjustments to net income and shareholders' equity which would have been required if US GAAP had been applied instead of Israeli GAAP.

1. Consolidated Balance Sheets

	Consolidated December 31, 2004			Consolidated December 31, 2003		
	Israeli GAAP	GAAP reconciliation Reported amounts*	U.S. GAAP	Israeli GAAP	GAAP reconciliation Adjusted amounts**	U.S. GAAP
	NIS thousands					
	Restated***					
Current assets						
Cash and cash equivalents	75,637	-	75,637	81,891	10	81,901
Trade receivables, net	52,682	-	52,682	35,569	2,085	37,654
Other receivables	8,948	-	8,948	12,769	4,331	17,100
Deferred taxes	2,564	-	2,564	1,914	-	1,914
Total current assets	139,831	-	139,831	132,143	6,426	138,569
Investments						
Investments in investee companies	-	-	-	1,550	-	1,550
Deferred taxes	22	-	22	21	-	21
	22	-	22	1,571	-	1,571
Restricted assets for employee termination benefits	-	6,231	6,231	-	5,139	5,139
Property and equipment, net	40,583	-	40,583	29,160	3,133	32,293
Other assets and deferred charges	114,956	-700	114,256	51,130	-	51,130
Assets allocated to discontinued operation	4,631	-	4,631	-	15,980	15,980

Total assets	300,023	5,531	305,554	214,004	30,678	244,682
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* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2C).

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

*** Restated

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their Effect on the Financial Statements (cont'd)

B. The effect of the material differences between Israeli GAAP and U.S. GAAP on the financial statements (cont'd)

1. Consolidated Balance Sheets (cont'd)

	Consolidated December 31, 2004			Consolidated December 31, 2003		
	Israeli GAAP	GAAP reconciliation Reported amounts*	U.S. GAAP	Israeli GAAP	GAAP reconciliation Adjusted amounts**	U.S. GAAP
	NIS thousands					
	Restated***					
Liabilities						
Current liabilities						
Short-term bank loans	10,950	-	10,950	5,259	3,010	8,269
Accounts payable	73,383	-	73,383	36,591	677	37,268
Other payables	13,784	-	13,784	14,037	1,551	15,588
Total current liabilities	98,117	-	98,117	55,887	5,238	61,125
Long-term liabilities						
Excess of liabilities over assets in investees	-	-	-	7,706	(7,706)	-
Long-term loans and other						
long-term obligations	72,117	-	72,117	27,389	-	27,389
Deferred revenues	3	-	3	23	-	23
Liability for severance Pay	6,240	6,231	12,471	4,928	5,177	10,105
Total long-term liabilities	78,360	6,231	84,591	40,046	(2,529)	37,517
Liabilities allocated to discontinued operation	1,653	-	1,653	-	41,610	41,610
Shareholders' equity						
Ordinary shares, NIS 0.01 par value (501,000,000 shares authorized; 18,431,500 shares issued and fully paid						

as at December 31, 2004)	197	-	197	197	-	197
Additional paid in capital	215,040	-	215,040	215,040	-	215,040
Capital reserve from purchase of investee company from a related party	(15,709)	18,379	2,670		6,585	6,585
Capital reserve from employee compensation plan	-	2,666	2,666	-	2,564	2,564
Accumulated deficit	(77,635)	(21,745)	(99,380)	(97,166)	(22,790)	(119,956)
Total shareholders' equity	121,893	(700)	121,193	118,071	(13,641)	104,430
Total liabilities and shareholders' equity	300,023	5,531	305,554	214,004	30,678	244,682

* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2C).

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

*** Restated

Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their Effect on the Financial Statements (cont'd)**B. The effect of the material differences between Israeli GAAP and U.S. GAAP on the financial statements (cont'd)****2. Statement of operations**

	Year ended December 31 2004 Reported amounts*	Year ended December 31 2003 Adjusted amounts** Restated***	Year ended December 31 2002
Net income from continued operations according to Israeli GAAP	24,294	18,040	27,038
Application of FIN 46R (A7)	(308)	(445)	5,673
Amortization of customer list (A3)	3,280	1,170	(5,130)
Application of APB 25 (A6)	(102)	109	(530)
Net income from continued operations according to U.S. GAAP	27,164	18,874	27,051
Loss from discontinued operations according to U.S. GAAP	(6,588)	(6,803)	(21,128)
Cumulative effect of change in accounting principle	-	-	(4,382)
Net income in accordance with U.S. GAAP	20,576	12,071	1,541
Basic and diluted net income from continued operations per share (in NIS) in accordance with U.S. GAAP	1.47	1.02	1.47
Basic and diluted net loss from discontinued operations per share (in NIS) in accordance with U.S. GAAP	(0.36)	(0.37)	(1.15)
Basic and diluted cumulative effect of change in accounting principle per share (in NIS) in accordance with U.S. GAAP	-	-	(0.24)

Basic and diluted net income (loss) per share (in NIS) in accordance with U.S. GAAP

1.11 0.65 0.08

* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2C).

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

*** Restated

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

**Note 21 - Significant Differences Between Israeli GAAP and U.S. GAAP and their
Effect on the Financial Statements (cont'd)**

**B. The effect of the material differences between Israeli GAAP and U.S. GAAP on the financial statements
(cont'd)**

3. Condensed Cash Flows

	Year ended December 31 2004 Reported amounts*	Year ended December 31 2003 Adjusted amounts** Restated***	Year ended December 31 2002
Net cash provided by continuing operating activities	38,185	29,172	41,203
Applying FIN 46R	24,580	55	10,388
Changes in exchange rates	1,270	6,299	(6,394)
Net cash provided by continuing operating activities according to U.S. GAAP	64,035	35,526	45,147
Net cash used in continued investment activities	(117,665)	(70,706)	(12,147)
Capital lease	39,177	42,997	-
Applying FIN 46R	10,627	24,280	(18,693)
Net cash used in continued investment activities according to U.S. GAAP	(67,861)	(3,429)	(30,840)
Net cash provided by (used in) continued financing activities	73,226	38,280	(31,528)
Capital lease	(39,177)	(42,997)	-
Applying FIN 46R	(30,521)	(9,488)	1,398
Net cash provided by continued financing activities according to U.S. GAAP	3,528	(14,205)	(30,130)
Discontinued operations			
Net cash provided by (used in) discontinued operations according to U.S. GAAP	(4,696)	(14,860)	6,978
Changes in exchange rates	(1,270)	(6,299)	6,394
Changes in cash and cash equivalents	(6,254)	(3,254)	(2,472)
Changes in cash and cash equivalents			

according to U.S. GAAP	(6,264)	(3,267)	(2,451)
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* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003 (see Note 2C).

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

*** Restated

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 22 - Condensed Financial Statements of the Company in Nominal NIS (For Tax Purposes)**A. Balance sheets**

	As at December 31 2004	As at December 31 2003
Current assets		
Cash and cash equivalents	75,323	81,660
Trade receivables, net	37,723	26,601
Other receivables	7,408	10,539
Total current assets	120,454	118,800
Investments	8,675	-
Property and equipment, net	35,793	26,277
Other assets and deferred charges	112,559	50,238
Total assets	277,481	195,315
	As at December 31 2004	As at December 31 2003
Liabilities		
Current liabilities		
Short-term bank loans	7,668	2,459
Accounts payable	69,414	*33,915
Other payables	8,742	*9,888
Total current liabilities	85,824	46,262
Long-term liabilities		
Excess of liabilities over assets in subsidiaries	-	2,118
Long-term loans	72,111	27,193
Deferred revenues	3	23
Liability for severance pay, net	5,772	4,523
Total long-term liabilities	77,886	33,857
Shareholders' equity (deficit)		
Ordinary shares	184	184
Additional paid-in capital	200,983	200,983
Accumulated deficit	(87,396)	(85,971)

Total shareholders' equity	113,771	115,196
	277,481	195,315

* Reclassified

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Notes to the Financial Statements**(All amounts in thousands of reported NIS, except where otherwise stated)****Note 22 - Condensed Financial Statements of the Company in Nominal NIS (For Tax Purposes) (cont'd)****B. Statement of operations**

	Year ended December 31 2004	Year ended December 31 2003
Revenues	180,343	159,472
Costs and expenses:		
Cost of revenues	80,762	78,702
Selling and marketing expenses	65,779	42,971
General and administrative expenses	19,765	19,076
Total costs and expenses	166,306	140,749
Income from operations	14,037	18,723
Financing income (expenses), net	2,443	(1,848)
Other expenses, net	549	(9)
Income after taxes on income	17,029	16,866
Company's share in net loss of investee	(2,745)	(4,368)
Net income	14,284	12,498

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Notes to the Financial Statements

(All amounts in thousands of reported NIS, except where otherwise stated)

Note 22 - Condensed Financial Statements of the Company in Nominal NIS (For Tax Purposes) (cont'd)

C. Statement of changes in shareholders equity

	Share capital Number of shares NIS 0.01 par value	Amount	Additional paid-in capital	Accumulated deficit NIS thousands	Total
Balance as of December 31, 2002	18,431,500	184	200,983	(98,469)	102,698
Changes during 2003:					
Net income for the year	-	-	-	12,498	12,498
Balance as of December 31, 2003	18,431,500	184	200,983	(85,971)	115,196
Changes during 2004:					
Capital reserve from purchase of investee company	-	-	-	(15,709)	(15,709)
Net income for the year	-	-	-	14,284	14,284
Balance as of December 31, 2004	18,431,500	184	200,983	(87,396)	113,771

List of principal investees and other companies
Annex A

	Equity As at December 31, 2004	Control
Subsidiaries		
MSN Israel Ltd.	50.1%	50.1%
Internet Gold International Ltd.	100%	100%
Gold Mind Ltd.	100%	100%
Start-Net Ltd.	100%	100%
Gold Trade Ltd.	100%	100%

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OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. Operating Results

The following discussion and analysis is based on and should be read in conjunction with our consolidated financial statements, including the related notes, and the other financial information included in this Report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this Report.

Overview

We are a leading Israeli Internet service provider serving as of December 31, 2004, 339,146 residential subscribers and 3,510 business subscribers. We provide a wide array of Internet services tailored to meet the needs of our subscribers, including Internet access and other value-added services, e-commerce and content services.

We currently provide Internet services through a nationwide network providing dial-up, broadband, web hosting, web security and integration services. We offer a wide range of Internet access packages to meet the needs of our residential and business subscribers. We also offer related value-added Internet services, such as web faxing, virtual magazines, anti-virus, anti-spam and hosting, to attract and retain subscribers, increase usage and create additional revenue streams. By offering high-quality, price-competitive Internet access and related services at a varied range, we seek to develop both our residential and business subscriber base. In addition to providing Internet access and related services, we are a major operator in the portals and advertising market through our subsidiary MSN Israel (a joint venture with Microsoft Corp.) and in the e-commerce market through our e-commerce P1000 site.

From the end of 2000 until the fourth quarter of 2002, we concentrated on a strategy focused on profitability rather than market share. During the fourth quarter of 2002, the significant increase in demand for broadband was coupled with intense competition between all local ISPs, which resulted in reductions of service prices by all Internet service providers, or ISPs. Due to this market environment, we adopted a more aggressive marketing policy in order to attract a greater number of broadband customers while continuing to keep tight control on our expenses. This strategy yielded a 54% increase in the number of broadband customers in 2004 as compared to 2003. We have decided to continue this policy during 2005. Due to the price reductions caused by the aggressive competition in the broadband market and the expenses associated with our marketing efforts to attract customers, our profitability may be negatively impacted in the future.

On June 2, 2004 we received a license to provide international telephony services. We launched these services on August 7, 2004. The first service we offered was direct calls from Israel to the rest of the world (approximately 240 countries). We intend to offer supplemental services in the near future, such as pre-paid services, post-paid services and 1-800 services. We offer our services to residential and business subscribers. As of December 31, 2004 we had approximately 86,300 subscribers for these services.

The international telephony market, as well as the internet market, is a very competitive market. Due to the conditions of the market and the entrance of two new competitors (Netvision Ltd and Xfone), we have adopted an aggressive penetration strategy in order to gain subscribers and market share. At this time we are continuing to keep tight control on our expenses but it could be that this strategy could impact negatively on our profitability.

Critical Accounting Policies

We have identified the policies below as critical to the understanding of our financial statements. The application of these policies requires management to make estimates and assumptions that affect the valuation of assets and expenses during the reporting period. There can be no assurance that actual results will not differ from these estimates.

We prepare our financial statements in accordance with Israeli GAAP. As such, we are required to make certain estimates, judgments, and assumptions that management believes are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. Differences between Israeli GAAP and U.S. GAAP as they relate to our financial statements are described in Note 21 to our financial statements.

In accordance with applicable Israeli accounting principles, we maintain our accounts and present our financial statements in NIS, adjusted for changes in the Israeli consumer price index through December 31, 2003. Consequently, all previously published NIS amounts in our financial statements were adjusted each time we published new financial statements in order to reflect changes in the Israeli consumer price index, and so all information is presented in NIS adjusted to December 2003 and constitute the starting point for our nominal financial reports as of January 1, 2004. See Note 2C to the financial statements. Any additions made during 2004 are included according to their nominal values. This presentation of the comparative figures permits the financial information to be presented in NIS with identical purchasing power. The translation of NIS amounts into dollars has been made solely for the convenience of the reader at the representative rate of exchange (as published by the Bank of Israel) at December 31, 2004 of NIS 4.308 = \$1.00.

The significant accounting policies that we believe are most critical to aid a reader in fully understanding and evaluating our financial condition and results of operation under Israeli generally accepted accounting principles are discussed below.

Revenue recognition. Most of our revenues are derived from Internet access. These revenues are recognized ratably over the period that services are provided. Other revenues include international telephony services, website hosting, electronic commerce and advertising revenues. Revenues from international carrier services are recognized according to minutes of traffic, Website hosting revenues are recognized as the services are performed. Electronic commerce revenues are recognized as the services are performed or when the goods are delivered, as applicable. Advertising revenues are recognized on a straight-line basis over the term of the contract. We consider revenue recognition to be critical since we have many revenue engines which involve subjective estimates by our management.

Revenues from sale agreements which do not include a general right of return and which include a number of elements such as: hardware, software and support agreements are split into separate

accounting units and are recognized separately with respect to each accounting unit. An element constitutes a separate accounting unit if, and only if, it has a separate value to the customer and there is reliable and objective evidence regarding the fair value of all the elements of the agreement/the fair value of undelivered elements. Elements that are not split into an accounting unit due to non-fulfillment of the conditions specified above are grouped together under one accounting unit. Revenues from the various accounting units are recognized when the conditions for recognizing the revenues from the elements included in that same accounting unit according to their type have been fulfilled, and only up to the amount of the consideration that is not contingent upon the completion/execution of the other elements of the contract.

Revenues from the sale of software licenses are recognized when all the following conditions have been met: the software has been delivered to the customer, collection of the payment is probable, the amount of the contract has been or can be determined and there is objective and persuasive evidence of the contract and of our ability to allocate the consideration between the elements of the contract.

We evaluate our revenue recognition policy every quarter with respect to existing and new accounting principles. In addition, every quarter we examine the different parameters that may affect our revenues and their recognition, such as customer credits, accrued revenues and revenues from cooperation with third parties. According to these examinations we decide on the required changes, if any, in our revenue recognition policies. Based on our past experience, our policy was appropriate and did not require complex estimates.

Allowance for doubtful accounts. The allowance for doubtful accounts represents management's estimate of the aged receivable balance considered uncollectible, based on past experience. All accounts aged over 150 days and accounts which have been forwarded to our lawyers are considered as doubtful accounts and are recorded as such. We evaluate our guidelines every quarter and examine the material parameters that might affect the assessment of our doubtful accounts, such as the population tendency to make timely payments, rate of checks returned for insufficient payment and blocked bank accounts. Our policy has been consistent and has proven itself over the years. Therefore, based on our past experience we believe this policy is appropriate.

"Impairment of Assets." In February 2003, the Israel Accounting Standards Board published Accounting Standard No. 15 - "Impairment of Assets." The Standard provides procedures which a company must apply in order to ensure that its assets in the consolidated balance sheet are not presented in an amount which is in excess of their recoverable value, which is the higher of the net selling price or the present value of the estimated future cash flows expected to be derived from use and disposal of the asset. With respect to the implementation of this standard, subjective estimates are involved in the process of decision making. In addition, the Standard provides rules for presentation and disclosure with respect to assets whose value has declined.

The Standard applies to financial statements for periods beginning January 1, 2003. The Standard provides that in most cases the transition will be effected by means of the "from hereon" method. As required under the Standard we evaluate its impact every quarter, review cash flow analysis, the market prices of our assets and other relevant estimates to ensure an adequate implementation of the Standard.

The Effect of New Israeli Accounting Standards in the Pre-Application Period

In July 2004, the Israeli Accounting Standards Board published Accounting Standard No. 19, "Taxes on Income". The Standard provides that a liability for deferred taxes is to be recorded for all temporary differences subject to tax, except for a limited number of exceptions. In addition, a deferred tax asset is to be recorded for all temporary differences that may be deducted, losses for tax purposes and tax benefits not yet utilized, if it is anticipated that there will be taxable income against which they can be offset, except for a limited number of exceptions. The new Standard applies to financial statements for periods beginning on January 1, 2005. The Standard provides that it is to be implemented by means of a cumulative effect of a change in accounting method. In our estimation, the impact of the Standard on our results of operations, financial position and cash flows will not be material.

Business Background

We earn revenues from Internet access services and value-added Internet services, advertising on our portals, e-commerce and international telephony services. To date, we have generated most of our revenues from our Internet access services to residential, SOHO (small office and home office) and business subscribers. Internet access revenues primarily consist of monthly subscription for broadband and dial-up access to the Internet. As a result, our revenues are directly affected by the total number of our paying residential, SOHO and business subscribers and the average price for our Internet access service per subscriber. At December 31, 2004 the number of our residential and SOHO subscribers was 339,146 a 9% growth rate in our residential and SOHO subscribers compared to December 31, 2003. The number of our business subscribers increased by 35% in 2004. The following table includes the number of our residential (including SOHO) and business subscribers in 2003 and 2004 (in thousands):

	2003	2004
Broadband	107	164
Dial-Up	63	31
Occasional	143	144
Total residential subscribers	313	339
Business subscribers	2.6	3.5

Most of our subscribers may cancel their subscriptions at any time. Some of our subscribers, who enter into annual, bi-annual or tri-annual contracts under special packages, are subject to certain penalty payments if they cancel during the contract period, including payments for the free benefits they received as part of the special package. Cash received from subscribers is applied to working capital when received.

We also earn revenues from value-added Internet services, such as global roaming, web hosting, web faxing, virtual magazines, anti-virus, anti-spam and online e-commerce site implementation. We earn revenues for these services based either on our fixed prices for the service or a negotiated fee. In addition, we earn revenues from portal advertising at negotiated fees.

In August 2004 we began to earn revenues from international telephony services. These revenues are generated from payments for the minutes used by subscribers. We offer monthly packages and offer discounts to subscribers. Our customers for these services include monthly subscribers and occasional users.

We bill for Internet access and for the international telephony on a monthly basis, which generally runs from the 20th day of the calendar month to the 19th day of the following calendar month. Revenues for services are accrued until the last day of the reporting period. Revenues for other services are recognized as the services are provided, including virtual magazines, anti-virus and website hosting and as products are delivered, including e-commerce activities. In cases where we assume responsibility for the goods sold in e-commerce transactions, we recognize the gross revenues. In cases where we act as a middleman we recognize the net commission as our revenues.

For both Internet access services and other services, we generally bill our residential subscribers on a monthly basis. Most of our residential subscribers pay us by credit card or a bank debit order. Business customers are billed on a monthly (or quarterly) basis, and we generally receive payment in full within 10 to 70 days of invoice.

Significant Costs and Expenses

Cost of Revenues. Our cost of revenues consists primarily of costs of communication services, salaries and related expenses, facilities costs and depreciation expenses. The communication services costs include costs for providing local telephone lines into our points of presence, the use of third party networks and leased lines to connect each of our points of presence to our regional network operations centers, the connection between our regional network operations centers, points of presence and the Internet backbone. We also include in the cost of revenues telecommunication services expenses related to the international telephony services. Since the launch of the international telephony service in August 2004 we have entered into agreements with several international carriers for the purchase of international long distance voice services to about 240 destinations around the world.

We believe that a high level of subscriber satisfaction with the speed and reliability of our network is not only essential for retaining subscribers, but also essential for attracting new subscribers through personal referrals. Accordingly, we have spent significant sums on trans-Atlantic leased lines, to ensure adequate bandwidth to the United States.

We include salary costs for our technical and technical support staff in our cost of revenues. These employees are directly involved in providing our Internet access service and our international telephony services to our subscribers. Most of our technical staff is full-time salaried employees and most of our technical support staff is part-time salaried employees.

Our cost of revenues also includes the costs of facilities used to provide technical services and depreciation, principally in respect of our network equipment.

Selling and Marketing Expenses. Selling and marketing expenses consist primarily of media advertisement and sales promotion costs as well as salaries, commissions and related costs for our sales representatives, facilities costs related to sales and marketing and credit card commissions. Credit card commissions are merchant fees based on the percentage of our revenue earned through credit cards.

General and Administrative Expenses. General and administrative expenses consist primarily of salary and related costs associated with our executive and administrative functions, lease payments for our administrative facilities and other miscellaneous expenses. As of December 31, 2004, we (excluding our subsidiaries) employed 293 full-time salaried employees and 542 part-time employees who are paid on an hourly basis. Staff costs include direct salary costs and related costs such as severance pay, social security and retirement fund contributions, vacation and recreation pay.

Financing Income (Expenses) Net. Net financing income (expenses) includes financing costs, interest income on our cash reserves and exchange rate differentials in real terms as well as devaluation of monetary assets and monetary liabilities. Beginning January 1, 2004 all of these items are stated in nominal values.

Income tax. We assessed our deferred tax assets and the need for a valuation allowance. Such an assessment considers whether it is more likely than not that some portion or all of the deferred tax assets may not be realized. The assessment requires considerable judgment on the part of management, with respect to, among other things, benefits that could be realized from available tax strategies and future taxable income, as well as other positive and negative factors. The ultimate realization of deferred tax assets is dependent upon our ability to generate the appropriate character of future taxable income sufficient to utilize loss carry forwards before their expiration.

Non-Cash Charges. Under U.S. GAAP, but not under Israeli GAAP, we would recognize for the years ended December 31, 1999 through 2004, non-cash charges aggregating NIS 2.7 million (\$ 0.6 million) according to Accounting Principles Board Opinion No. 25 ("APB 25") on account of our Stock Option plan from 1999 (expenses of NIS 102 thousands for the year ended December 31, 2004, and income of NIS 109 thousands for the year ended December 31, 2003, and expenses of NIS 530 thousands for the year ended December 2002).

If in the future, we issue options under a stock option plan with exercise prices below fair market value at the time of issuance, U.S. GAAP, but not Israeli GAAP, would require us to recognize an additional non-cash charge with respect to such issuance.

Results of Operations

The following discussion of our results of operations for the years ended December 31, 2002, 2003 and 2004, including the percentage from revenues data in the following table, is based upon our consolidated statements of operations contained in our consolidated audited financial statements for those periods, and the related notes, included elsewhere in this Report:

	Year ended December 31,		
	2002	2003	2004
Revenues:			
Access revenues	85%	82%	71%
International telephony services	-	-	4
Other revenues	15	18	25
Total revenues	100	100	100
Cost and expenses:			
Cost of revenues	54	52	44
Selling and marketing expenses	20	23	33
General and administrative expenses	12	12	11
Total cost and expenses	86	87	88
Income from operations	14	13	12
Financing income (expenses), net	1	(2)	-
Other expenses, net	-	(1)	-
Net income after financing expenses	15	10	12
Income tax benefit	-	1	-

	Year ended December 31,		
	2002	2003	2004
Net income after income tax benefit	15	11	12
Company's share in net loss of investees	(1)	(1)	-
Minority interest in loss of a subsidiary	-	-	-
Net income from continued operations	14	10	12
Company's share in loss of investees from discontinued operations	(4)	(2)	(2)
Net income	10	8	10

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

Under Israeli GAAP

Revenues. Revenues increased by 22% from NIS 179.6 million (US\$ 41.7 million) for the year ended December 31, 2003 to NIS 219.6 million (US\$ 51 million) for the year ended December 31, 2004. The increase is primarily due to revenues from the new 015 international telephony services that was launched on August 7, 2004 and due to the substantial growth of our interactive advertising and content-based value added services as well as our intense efforts in after-sale activities. We believe the growth rate of our revenues will improve in 2005, driven primarily by the continued expansion of our telephony and e-Advertising businesses, and due to the full year consolidation of our e-commerce P1000 site's revenues in 2005.

Access Revenues. Revenues from Internet access services provided to residential and business subscribers, which represented 71% of our total revenues for 2004, increased by 6% from NIS 146.9 million (US\$ 34.1 million) for 2003 to NIS 156.4 million (US\$ 36.3 million) for 2004. The increase is primarily due to our major efforts to keep our market share regardless of the sharp competition in the market. We expect that in 2005 our access revenues will remain at the same level, based on our forecasts regarding the development of the access services market in Israel.

International Telephony Services. Since the successful launch of our 015 international telephony service on August 7, 2004 we gained revenues of NIS 9.4 million (US\$ 2.2 million) which represents 4% of our total revenues. We believe the growth rate of our revenues from this activity will improve substantially in 2005, driven primarily by the continued expansion of this activity by entering into supplemental activities in the market such as pre-paid, post-paid, calling card services and other related activities.

Other Revenues. Other revenues, which represented 25% of our total revenues for 2004, increased by 64% from NIS 32.7 million (US\$ 7.6 million) for 2003 to NIS 53.8 million (US\$ 12.5 million) for 2004. The increase is primarily due to the substantial growth of our interactive advertising and content-based value added services as well as our intense efforts in after-sale activities. We expect that our other revenues will increase in 2005, based on our market research findings that the interactive advertising market should increase in Israel in 2005 and due to the full year consolidation of our e-commerce P1000 site's revenues in 2005.

Cost of Revenues. Cost of revenues increased by 4% from NIS 92.9 million (US\$ 21.6 million) for 2003 to NIS 96.8 million (US\$ 22.5 million) for 2004. The increase is primarily due to costs of telecommunication services expenses related to the international telephony services. Since the launch of the international telephony service in August 2004 we entered into agreements with several international carriers all over the world for the purchase of international long distance voice services to about 240 destinations around the world. We anticipate that our cost of revenues will increase in 2005, based on our forecasts and estimates of the growth of all of our major activities and due to the full year consolidation of our e-commerce P1000 site activity in 2005.

Selling and Marketing Expenses. Selling and marketing expenses increased by 77% from NIS 41.4 million (US\$ 9.6 million) for 2003 to NIS 73.2 million (US\$ 17 million) for 2004. The increase is primarily due to the initial intensive marketing campaign and other marketing activities for the launch of the new 015 international telephony service, and due to our market share strategy to extend our share of the broadband market, including our advertising campaigns. We expect that our selling and marketing expenses will increase in 2005 due to our continued implementation of our strategy to increase our market share in all of our activities and their related markets.

General and Administrative Expenses. General and administrative expenses increased by 11% from NIS 21.9 million (US\$ 5.1 million) for 2003 to NIS 24.3 million (US\$ 5.6 million) for 2004. The increase was primarily due to general expenses related to our new international telephony services and as a result of our initial and intensive preparations for this activity. We expect that our general and administrative expenses will increase in 2005, primarily due to expected increase in our revenues.

Financing Income (Expenses), Net. In 2004 we had net financing income of NIS 0.12 million (US\$0.03 million) compared to net financing expenses of NIS 3.2 million (US\$0.8 million) for 2003. Our financing income (expenses) are attributed to the exchange rate differentials on the U.S. dollar cash deposits that remained from our initial public offering. We also have U.S. dollar denominated liabilities (rights of use leasing obligations for our international lines).

Other Expenses, Net. In 2004 we had net other expenses of NIS 1.1 million (US\$ 0.26 million) compared with NIS 2.6 million (US\$ 0.6 million) in 2003. Our other expenses are primarily attributable to Internet Gold International Ltd's recording of an additional impairment charge of NIS 1.6 million (US\$0.4 million) with respect to its investment in Compulink, a Greek ISP, in which it holds a 15.2% interest. With this impairment charge Internet Gold International has written off its entire investment in Compulink and its operations can no longer adversely influence our results.

Income Taxes. As of December 31, 2004, we had a tax loss carry forward on a consolidated basis of approximately NIS 113 million (US\$ 26.2 million) - including our re consolidated subsidiary Gold Trade with a tax loss carry forward of NIS 60 million. We assessed our deferred tax assets and the need for a valuation allowance. Such an assessment considers whether it is more likely than not that some portion or all of the deferred tax assets may not be realized. The assessment requires considerable judgment on the part of management, with respect to, among other things, benefits that could be realized from available tax strategies and future taxable income, as well as other positive and negative factors. We cannot be reasonably assured of our ability to further utilize the tax asset in the foreseeable future, except that we anticipate that we will be able to utilize Start-Net's tax loss carry forward for which we recorded a deferred tax asset of NIS 2.3 million (US\$ 0.5 million). In 2003 we recorded deferred tax assets of Gold Mind's tax loss carry forward of NIS 1.9 million (\$0.4 million). During 2004, we utilized most of Gold Mind's tax loss carry forward.

Company's Share in Net Loss of Investees. In 2004 we recorded NIS 0.4 million (US\$ 0.09 million) as our share in the net loss of investees from continued operations of our investees compared to NIS 1.5 million (US\$ 0.35 million) in 2003. In 2004, we recorded NIS 4.8 million (US\$ 1.1 million) as our share in the net loss of investees from discontinued operations of our investees compared to NIS 3.7 million (US\$ 0.9 million) in 2003. At the end of 2004, Gold Trade's board of directors reached the decision to close down all of its operations except the e-commerce activity P-1000 site.

Net Income. We reported net income of NIS 19.5 million (US\$ 4.5 million), for the year ended December 31, 2004 as compared to a net income of NIS 14.3 million (US\$ 3.3 million) for the year ended December 31, 2003.

Under U.S. GAAP

Unless otherwise explained, there are no significant differences between Israeli GAAP and U.S. GAAP

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." This Interpretation addresses the consolidation by business enterprises of variable interest entities when the equity investors do not have the characteristics of a controlling financial interest (as defined in the Interpretation). In December 2003, the FASB issued Interpretation No. 46R, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." The FASB deferred the effective date for implementation of this Interpretation until fiscal years ending after March 15, 2004.

According to Israeli GAAP as prescribed in Opinion No. 57 of the Institute of Certified Public Accountants in Israel, we treated the investment in our affiliated company Gold Trade, as a subsidiary of our company until December 31, 2001. For the years ended December 31, 2002 and December 31, 2003, we accounted for our investment under the equity method. During December 2004, we acquired all of the shares of Gold Trade from a related party and from others therefore we once again consolidated Gold Trade as a subsidiary as of December 31, 2004.

Under the provisions of FIN 46R, we were required to consolidate Gold Trade which met the definition of a VIE for all years presented, due to a number of factors which indicate that we are the primary beneficiary of Gold Trade.

We applied FIN 46R by retroactively restating previously issued financial statements, and recorded a cumulative effect of accounting change as of January 1, 2002 in the amount of NIS 4.4 million (US\$ 1 million).

Revenues. Revenues increased by 23% from NIS 185.6 million (US\$ 43 million) for the year ended December 31, 2003 to NIS 228.8 million (US\$ 53.1 million) for the year ended December 31, 2004. The increase was primarily due to revenues from our new 015 international telephony service that was launched on August 7, 2004 and due to the substantial growth of our interactive advertising and content-based value added services as well as our intense efforts in after-sale activities.

Other Revenues. Other revenues, which represented 28% of our total revenues for 2004, increased by 63% from NIS 38.7 million (US\$ 8.9 million) for 2003 to NIS 63 million (US\$ 14.6 million) for 2004. The increase was primarily due to the substantial growth of our interactive advertising and content-based value added services as well as intense efforts in after-sale activities.

Cost of Revenues. Cost of revenues increased by 4.5% from NIS 93.9 million (US\$ 21.8 million) for 2003 to NIS 98.1 million (US\$ 22.8 million) for 2004. The increase was primarily due to costs of telecommunication services expenses related to our new international telephony services. Since the launch of our international telephony service in August 2004 we have entered into agreements with several international carriers all over the world for the purchase of international long distance voice services to about 240 destinations around the world. The differences between Israeli GAAP and U.S. GAAP relating to our cost of revenues expenses was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Selling and Marketing Expenses. Selling and marketing expenses increased by 70% from NIS 46.4 million (US\$ 10.8 million) for 2003 to NIS 78.7 million (US\$ 18.3 million) for 2004. The increase was primarily due to the initial intensive marketing campaign and other marketing activities associated with our launch of the new 015 service, and due to the implementation of our market share strategy to extend our share of the broadband market, including the costs of our advertising campaigns. The differences between Israeli GAAP and U.S. GAAP relating to our selling and marketing expenses was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R,

General and Administrative Expenses. General and administrative expenses increased by 12% from NIS 24.3 million (US\$ 5.6 million) for 2003 to NIS 27.3 million (US\$ 6.3 million) for 2004. The differences between Israeli GAAP and U.S. GAAP relating to our general and administrative expenses was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R, the amortization of Gold Trade 's customer list of NIS 3.3 million compared to NIS 1.2 million in 2003 and the recording of compensation expenses under U.S. GAAP with respect to grants under our employee stock option plan as required under APB No. 25 - an expense of NIS 0.1 million in 2004 compared to income of NIS 0.11 million in 2003.

Financing Income (Expenses), Net. In 2004 we had net financing expenses of NIS 0.08 million (US\$0.02 million) compared to NIS 3.6 million (US\$0.84 million) for 2003. Our financing expenses were primarily attributable to the exchange rate differentials on the U.S. dollar cash deposits that remained from our initial public offering. We also have U.S. dollar denominated liabilities (rights of use leasing obligations for our international lines). The differences between Israeli GAAP and U.S. GAAP relating to our financing expenses are due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Net Loss from Discontinued Operations. At the end of 2004, Gold Trade's board of directors reached the decision to close down all its operations except the e-commerce activity P-1000 site. In 2004 we recorded a net loss of NIS 6.6 million (US\$ 1.5 million) net loss from discontinued operations compared to a net loss of NIS 6.8 million (US\$ 1.6 million) in 2003.

Net Income. We reported net income of NIS 20.6 million (US\$ 4.8 million), for the year ended December 31, 2004 as compared to a net income of NIS 12.1 million (US\$ 2.8 million) for the year ended December 31, 2003. The differences between Israeli GAAP and U.S. GAAP relating to our net income are due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Under Israeli GAAP

Revenues. Revenues decreased by 3% from NIS 184.3 million (US\$ 42.8 million) for the year ended December 31, 2002 to NIS 179.6 million (US\$ 41.7 million) for the year ended December 31, 2003. The decrease was primarily due to the sharp competition in the market which resulted in lower access fees.

Access Revenues. Revenues from Internet access services provided to residential and business subscribers, which represented 82% of our total revenues for 2003, decreased by 6% from NIS 156.3 million (US\$ 36.3 million) for 2002 to NIS 146.9 million (US\$ 34.1 million) for 2003. The decrease was primarily due to the sharp competition in the market.

Other Revenues. Other revenues, which represented 18% of our total revenues for 2003, increased by 17% from NIS 28 million (US\$ 6.5 million) for 2002 to NIS 32.7 million (US\$ 7.6 million) for 2003. The increase was primarily due to the substantial growth of our interactive advertising and content-based value added services as well as our intense efforts in after-sale activities.

Cost of Revenues. Cost of revenues decreased by 7% from NIS 99.6 million (US\$ 23.1 million) for 2002 to NIS 92.9 million (US\$ 21.6 million) for 2003. The decrease was primarily due to our efforts in reducing the costs of international lines. Cost of revenues as a percentage of revenues decreased from 54% for 2002 to 52% for 2003.

Selling and Marketing Expenses. Selling and marketing expenses increased by 12% from NIS 37.1 million (US\$ 8.6 million) for 2002 to NIS 41.4 million (US\$ 9.6 million) for 2003. The increase was primarily due to costs incurred in implementing our market share strategy to extend our share of the broadband market, including our advertising campaigns.

General and Administrative Expenses. General and administrative expenses were similar to the expenses in the year 2002, NIS 21.2 million (US\$ 4.9 million) for 2002 to NIS 21.9 million (US\$ 5.1 million) for 2003.

Financing Income (Expenses), Net. In 2003 we had net financing expenses of NIS 3.2 million (US\$ 0.7 million) compared to net financing income of NIS 2.2 million (US\$ 0.5 million) for 2002. Our financing expenses were attributable to the exchange rate differentials on the U.S. dollar cash deposits that remained from our initial public offering.

Other Expenses, Net. Internet Gold International recorded an impairment charge of NIS 2.6 million (US\$ 0.6 million) with respect to its investment in Compulink, a Greek ISP, in which it holds a 15.2% interest.

Income Taxes. As of December 31, 2003, we had a tax loss carry forward on a consolidated basis of approximately NIS 81.3 million (US\$ 18.9 million).

Company's Share in Net Loss of Affiliates. In 2003 we recorded NIS 1.5 million (US\$ 0.3 million) of our share in the net loss of our affiliates from continued operations compared to NIS 1.5 million (US\$ 0.3 million) in 2002. We also recorded NIS 3.7 million (US\$ 0.9 million) of our share in net loss of our affiliates from discontinued operations compared to NIS 7.1 million (US\$ 1.6 million) in 2002.

Net Income. We reported net income from continued operations of NIS 18 million (US\$ 4.2 million), for the year ended December 31, 2003 as compared to a net income from continued operations of NIS 27 million (US\$ 6.3 million) for the year ended December 31, 2002. We reported a net loss from discontinued operations of NIS 3.7 million (US\$ 0.9 million), for the year ended December 31, 2003 as compared to a net loss from discontinued operations of NIS 7.1 million (US\$ 1.6 million) for the year ended December 31, 2002. We also reported net income of NIS 14.3 million (US\$ 3.3 million) for the year ended December 31, 2003 as compared to net income of NIS 20 million (US\$ 4.6 million) for the year ended December 31, 2002.

Under U.S. GAAP

Unless otherwise explained, there are no significant differences between Israeli GAAP and U.S. GAAP

Under the provisions of FIN 46R, we were required to consolidate the financials of Gold Trade which met the definition of a VIE for all years presented, due to a number of factors which indicated that we were the primary beneficiary of Gold Trade.

We applied FIN 46R by retroactively restating previously issued financial statements.

Revenues. Revenues decreased by 5% from NIS 194.6 million (US\$ 45.2 million) for the year ended December 31, 2002 to NIS 185.6 million (US\$ 43.1 million) for the year ended December 31, 2003. The decrease was primarily due to the sharp competition in the market which resulted in lower access fees.

Other Revenues. Other revenues were similar in both years, increasing from NIS 38.3 million (US\$ 8.9 million) for 2002 to NIS 38.7 million (US\$ 8.9 million) for 2003

Cost of Revenues. Cost of revenues decreased by 10% from NIS 103.4 million (US\$ 24 million) for 2002 to NIS 93.9 million (US\$ 21.8 million) for 2003. The decrease was primarily due to our efforts in reducing costs of our international lines. The differences between Israeli GAAP and U.S. GAAP relating to our net income was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Selling and Marketing Expenses. Selling and marketing expenses increased by 4% from NIS 44.8 million (US\$ 10.4 million) for 2002 to NIS 46.4 million (US\$ 10.8 million) for 2003. The increase was primarily due to the costs associated with the implementation of our market share strategy to extend our share of the broadband market, including the costs of our advertising campaigns. The differences between Israeli GAAP and U.S. GAAP relating to our net income was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

General and Administrative Expenses. General and administrative expenses were similar in both years, increasing from NIS 23.8 million (US\$ 5.5 million) in 2002 compared to NIS 24.4 million (US\$ 5.7 million) in 2003. The differences between Israeli GAAP and U.S. GAAP relating to our net income was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Financing Income (Expenses), Net. In 2003 we had net financing expenses of NIS 3.6 million (US\$ 0.8 million) compared to net financing income of NIS 2.1 million (US\$ 0.5 million) for 2002. Our financing expenses were attributable to the exchange rate differentials on the U.S. dollar cash deposits that remained from our initial public offering. The differences between Israeli GAAP and U.S. GAAP relating to our net income were due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Net Loss from Discontinued Operations. We reported a net loss from discontinued operations of NIS 6.8 million (US\$ 1.6 million), for the year ended December 31, 2003 as compared to a net loss from discontinued operations of NIS 21.1 million (US\$ 4.9 million) for the year ended December 31, 2002.

Net Income. We reported net income of NIS 12.1 million (US\$ 2.8 million), for the year ended December 31, 2003 as compared to a net income of NIS 1.5 million (US\$ 0.3 million) for the year ended December 31, 2002 (including a cumulative effect of accounting change as of January 1, 2002 in the amount of NIS 4.4 million (US\$ 1 million)). The differences between Israeli GAAP and U.S. GAAP relating to our net income was due to the consolidation of Gold Trade under U.S. GAAP as required by FIN 46R.

Quarterly Results of Operations

The following table sets forth our results of operations for our last eight quarters. The data has been derived from our quarterly earnings releases for those periods which, in the opinion of our management, have been prepared on substantially the same basis as the audited financial statements included in this report. The data for any quarter is not necessarily indicative of the revenues that may be expected for any future period. The percentage data shows revenues and expenses as a percentage of total revenues.

	Three Months Ended							
	Mar. 31,	Jun. 30,	Sept. 30,	Dec. 31,	Mar. 31,	Jun. 30,	Sept. 30,	Dec. 31,
	2003	2003	2003	2003	2004	2004	2004	2004
	Adjusted amounts**				reported amounts*			
	Unaudited							
Revenues:								
Access revenues	37,180	36,424	36,151	37,151	39,124	40,537	38,571	38,153
International								
telephony services	-	-	-	-	-	-	2,092	7,289
Other revenues	6,725	7,531	8,181	10,299	11,852	12,662	13,629	15,668
Total revenues	43,905	43,955	44,332	47,450	50,976	53,199	54,292	61,110
Cost and expenses:								
Cost of revenues	24,267	23,468	22,797	22,339	22,566	21,625	25,344	27,285
Selling and marketing								
expenses	9,624	9,917	9,843	12,009	14,915	17,370	20,462	20,408
General and								
administrative								
expenses	5,144	5,408	5,478	5,878	5,830	5,481	6,572	6,375
Total costs and								
expenses	39,035	38,793	38,118	40,226	43,311	44,476	52,378	54,068
Operating income	4,870	5,162	6,214	7,224	7,665	8,723	1,914	7,042
Financing income								
(expenses), net	(1,058)	(5,721)	3,695	(151)	460	(549)	342	(131)
Other income								
(expenses),								
net	(4)	(12)	(2,587)	11	(642)	(856)	54	367
Net income (loss)								
after financing								
expenses	3,808	(571)	7,322	7,084	7,483	7,318	2,310	7,278
Income tax (expenses)								
benefit	-	2,465	(354)	(176)	(519)	(782)	(240)	1,842
Net income after								
income tax	3,808	1,894	6,968	6,908	6,964	6,536	2,070	9,120
Company's share in								
net loss of investees	(278)	(459)	(48)	(753)	(398)	(210)	105	107
Net income from								
continued operations	3,530	1,435	6,920	6,155	6,566	6,326	2,175	9,227
Company's share in								
net loss of investees								
from discontinued								
operations	(414)	(1,385)	(878)	(1,060)	(576)	(675)	(695)	(2,817)
Net income	3,116	50	6,042	5,095	5,990	5,651	1,480	6,410

Number of
subscribers (at the
end of the period):

Residential subscribers	307,136	305,314	305,261	312,256	318,889	322,863	324,035	339,146
Business subscribers	1,946	2,128	2,333	2,600	2,879	3,016	3,142	3,510

* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003.

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

	Three Months Ended							
	Mar. 31, 2003	Jun. 30, 2003	Sept. 30, 2003	Dec. 31, 2003	Mar. 31, 2004	Jun. 30, 2004	Sept. 30, 2004	Dec. 31, 2004
	(As percentage of total revenues)							
Revenues:	100%	100%	100%	100%	100%	100%	100%	100%
Access revenues	85	83	82	78	77	76	71	62
International telephony services	-	-	-	-	-	-	4	12
Other revenues	15	17	18	22	23	24	25	26
Total revenues	100	100	100	100	100	100	100	100
Costs and expenses:								
Cost of revenues	55	53	51	47	44	41	47	45
Selling and marketing expenses	22	23	22	25	29	33	38	33
General and administrative expenses	12	12	12	12	11	10	12	10
Total costs and expenses	89	88	85	84	84	84	97	88
Operating income	11	12	15	16	16	16	3	12
Financing income (expenses), net	(2)	(13)	8	-	1	(1)	1	-
Other income (expenses), net	-	-	(6)	-	(1)	(2)	-	1
Net income (loss) after financing expenses	9	(1)	17	16	16	13	4	13
Income tax (expenses) benefit	-	6	(1)	-	(1)	(1)	-	3
Net income after income tax	9	5	16	16	15	12	4	16
Company's share in net loss of investees	(1)	(1)	-	(2)	(1)	-	-	-
Net income from continued operations	8	4	16	14	14	12	4	16
Company's share in net loss of investees from discontinued operations	(1)	(3)	(2)	(2)	(1)	(1)	(1)	(5)
Net income	7	1	14	12	13	11	3	11

Conditions in Israel

We are incorporated under the laws of, and our principal executive offices are located in, the State of Israel. Accordingly, we are directly affected by political, economic and military conditions in Israel.

Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in

intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror has been committed inside Israel and against Israeli targets in the West Bank and Gaza. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

In addition, some of our employees in Israel are subject to being called upon to perform military service in Israel, and their absence may have an adverse effect upon our operations. Generally, unless exempt, male adult citizens and permanent residents of Israel under the age of 45 are obligated to perform up to 36 days of military reserve duty annually and all such residents are subject to being called to active duty at any time under emergency circumstances. While we have operated effectively under these requirements since we began operations, we cannot assess the full impact of these requirements on our workforce or business if conditions should change, and we cannot predict the effect on us of any expansion or reduction of these obligations.

Economic Conditions

In recent years Israel has gone through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2004, affecting all banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers. Following the passage by the Israeli Parliament of laws to implement the economic measures, the Israeli trade unions have threatened further strikes or work-stoppages, and these may have a material adverse effect on the Israeli economy and on us.

Trade Agreements

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from the U.S., Australia, and Canada. These preferences allow Israel to export products covered by such programs either duty-free or at reduced tariffs.

Israel and the European Union Community concluded a Free Trade Agreement in July 1975 which confers certain advantages on Israeli exports to most European countries and obligates Israel to lower its tariffs on imports from these countries over a number of years. In 1985, Israel and the U.S. entered into an agreement to establish a free trade area. The free trade area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, which includes Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinition of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

Impact of Devaluation on the NIS vs. US\$ on Results of Operations, Liabilities and Assets

The dollar cost of our operations in Israel is influenced by the exchange rate of U.S. dollar. Devaluation or an increase in valuation of the NIS against the U.S. dollar might reflect on our results of operations.

The following table presents information about the devaluation of the NIS against the dollar:

Year ended	NIS devaluation
December 31,	rate %
2000	(2.7)
2001	9.3
2002	7.3
2003	(7.6)
2004	(1.6)

A devaluation of the NIS in relation to the dollar has the effect of reducing the dollar amount of any of our expenses or liabilities which are payable in NIS, unless those expenses or payables are linked to the dollar. This devaluation also has the effect of decreasing the dollar value of any asset which consists of NIS or receivables payable in NIS, unless the receivables are linked to the dollar. Conversely, any increase in the value of the NIS in relation to the dollar has the effect of increasing the dollar value of any unlinked NIS assets and the dollar amounts of any unlinked NIS liabilities and expenses. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.

Because exchange rates between the NIS and the dollar fluctuate continuously, with a historically declining trend in the value of the NIS, exchange rate fluctuations, particularly larger periodic devaluations, may have an impact on our profitability and period-to-period comparisons of our results.

As a result of the devaluation of the dollar in 2004, we recorded exchange rate expenses on our U.S. deposits of NIS 1.3 million (US\$ 0.3 million).

We have U.S. dollar denominated liabilities (rights of use leasing obligations for our international lines).

According to a new accounting standard, Accounting Standard No. 12, on "Discontinuance of Adjustment of Financial Statements", commencing January 1, 2004, the adjustment of financial statements were discontinued. Consequently, through December 31, 2003, we prepared adjusted financial statements in accordance with Opinion No. 36 of the Institute of Certified Public Accountants in Israel. The adjusted amounts included in the financial statements as at December 31, 2003, constituted the starting point for the nominal financial report as of January 1, 2004.

Effective Corporate Tax Rate

Israeli companies are generally subject to income tax at the rate of 35% of taxable income. For tax purposes, results of operations are measured in real terms. From 1992 through December 31, 2002 we incurred net operating losses. As of December 31, 2004, we had consolidated net operating loss carry forwards of approximately NIS 113 million (US\$ 26.2 million) - including the reconsolidated subsidiary Gold Trade with NIS 60 million. Under current Israeli tax laws, operating loss carry forwards do not expire, are linked to the Israeli inflation rate and may be offset against future taxable income. Corporate Tax rates are declining gradually - in 2005-34%, 2006-32% and 2007-30%.

B. Liquidity and Capital Resources

Liquidity. We have required substantial capital resources to finance the construction of our network and to fund our operations. Historically we financed the construction of our network and funded our operations principally from cash flow from operations, short-term bank credit, revolving short-term bank loans and the proceeds of the initial public offering of our ordinary shares in August 1999.

Working Capital. Our working capital as of December 31, 2004 was NIS 41.7 million (US\$ 9.7 million) as compared to working capital of NIS 76.3 million (US\$ 17.7 million) as of December 31, 2003. The decrease in our working capital is primarily due to the increase in current maturities of long-term obligations arising from our purchase of rights of use of international lines. This ratio shall further drop as we continue to lease additional lines.

The following table summarizes our cash flows for the indicated years:

	Year Ended December 31,		
	2002 Adjusted amounts**	2003 Adjusted amounts** (In thousand)	2004 reported amounts*
Net Income (loss)	19,958	14,303	19,531
Other adjustments for non-cash items	23,611	22,957	27,006
Net changes in assets and liabilities	(2,366)	(8,088)	(8,352)
Net cash provided by (used in) continued operating activities	41,203	29,172	38,185
Net cash provided by (used in) discontinued operating activities	-	-	-
Net cash provided by (used in) operating activities	41,203	29,172	38,185
Net cash provided by (used in) continued investing activities	(12,147)	(70,706)	(117,665)
Net cash provided by (used in) discontinued investing activities	(1)	-	-
Net cash provided by (used in) investing activities	(12,148)	(70,706)	(117,665)
Net cash provided by (used in) continued financing activities	(31,528)	38,280	73,226
Net cash provided by (used in) discontinued financing activities	-	-	-
Net cash provided by (used in) financing activities	(31,528)	38,280	73,226
Net increase (decrease) in cash and cash equivalents	(2,473)	(3,254)	(6,254)

* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003.

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

Net cash provided by operating activities was NIS 38.2 million (US\$ 8.9 million) in 2004, net cash provided by operating activities was NIS 29.2 million (US\$ 6.8 million) in 2003 and net cash provided by operating activities was NIS 41.2 million (US\$ 9.6 million) in 2002. The increase in the net cash provided by operating activities in 2004 compared to 2003 is due to our continuing efforts to implement our profitability strategy.

Net cash used in investing activities was NIS 117.7 million (US\$ 27.3 million) in 2004 and NIS 70.7 million (US\$ 16.4 million) in 2003. Our investing activities have primarily involved purchases of rights of use for international communication lines presented as capital leases, network components, expansion of our network and computer hardware and software costs. The increase in our investing activities was primarily related to the purchase of seven international communication lines during 2004 in the total amount of NIS 69.2 million (US\$ 16.1 million) which are presented as capital leases, and also due to the purchase of network components, expansion of our network and computer hardware and software costs in connection with our intensive preparations to provide international telephony services. In December 2004 we obtained long term loans of NIS 30.5 million (US\$ 7.1 million) from banks (presented as cash provided by financing activities) and granted a loan in the same amount to Gold Trade to cover its obligations to its banks.

According to Israeli GAAP, receipt of loans in respect of capital leases are reflected in the statements of cash flows as cash flows from financing activities rather than investing activities from the acquisition of assets financed by the lease. Under U.S. GAAP, this should be reflected as a non-cash financing activity.

Net cash provided by financing activities was NIS 73.2 million (US\$ 17 million) in 2004 and NIS 38.3 million (US\$ 8.9 million) in 2003. Our financing activities in 2004 included receipt of long-term loans from banks as mentioned above and long term loans with respect to the purchase of rights of use in international communication lines presented as capital leases.

Financing Arrangements. We have a credit line equal to the deposits that we hold with the First International Bank of Israel Ltd.. As of December 31, 2004, our deposits totaled NIS 75.3 million (US\$ 17.5 million). The credit line is repayable on demand. As of December 31, 2004, NIS 10.8 million (US\$ 2.5 million) was outstanding under the credit line. Long-term obligations to suppliers for the right of use of international lines are linked to the U.S. dollar exchange rate, and our long-term leasing agreements for cars are linked to the consumer price index and bear interest at annual rates ranging from 5% to 7%. As of December 31, 2004, there was NIS 41.6 million (US\$ 9.7 million) outstanding under our long-term leasing arrangements.

The following table summarizes our bank debt as of December 31, 2002, 2003 and 2004:

	2002 Adjusted amounts**	At December 31, 2003 Adjusted amounts** (In thousand)	2004 reported amounts*
Short-term:			
Credit	8,996	4,279	10,817
Current maturities of long-term loans under lease arrangements	1,461	980	133
Total short-term debt	10,457	5,259	10,950
Long-term:			
Long-term loans maturities	1,330	273	30,506
Total long-term debt	1,330	273	30,506
Liabilities attributed to discontinued operations	-	-	1,653
Total debt	11,787	5,532	43,109

* With respect to discontinuance of adjustment to the effect of inflation as from the CPI of December 2003.

** Amounts adjusted to reflect inflation in terms of NIS at December 31, 2003.

Capital Expenditures. In 2004, we invested NIS 23.8 million (US\$ 5.5 million) in fixed assets, which included purchases of network components, expansion of our network and computer hardware and software costs. During 2005, we expect to incur capital expenditures of approximately NIS 13 million (US\$ 3 million) (not including the purchase of rights of use of the international lines), of which US\$ 0.6 million of which is already subject to contractual obligations. We anticipate that these expenditures will be funded from our cash flow from operations and borrowings under credit facilities which we may negotiate. Where feasible, we may also finance certain of these expenditures through capital leases or installment purchases if these financing alternatives are available on terms acceptable to us.

Long Term Loans under Lease Arrangements. Our lease obligations as of December 31, 2004 were NIS 41.6 million (US\$ 9.7 million), compared to NIS 27.4 million (US\$ 6.4 million) for December 31, 2003. Such leasing obligations relate to rights of use of twelve international lines under financial lease arrangements and 24 motor vehicles that are under financial lease arrangements as well.

In December 2004, the monthly costs for the rights of use of international lines amounted to NIS 3 million (US\$ 0.7 million) and the monthly rental costs for such vehicles amounted to NIS 90 thousands (US\$ 20.9 thousands).

Based on our current operating plan, we believe that these sources will be sufficient to fund our operating activities, capital expenditures and other obligations through at least until June 2006. However, if during that period or thereafter we are not successful in generating sufficient cash flows from operations or in raising additional capital, whether debt or equity, when required, in sufficient amounts and on terms acceptable to us, our business, results of operations and financial condition could suffer. In addition, if additional funds are raised through the issuance of equity securities, the percentage ownership of our then-current shareholders would be diluted.

C. Research and Development, Patents and Licenses

We have not sponsored any material research and development activities in the last three fiscal years.

D. Trend Information

Recent Accounting Pronouncements Not Yet Fully Adopted

Israeli GAAP:

Accounting Standard No. 19 on "Taxes on Income"

In July 2004, the Israeli Accounting Standards Board published Accounting Standard No. 19, "Taxes on Income". The Standard provides that a liability for deferred taxes is to be recorded for all temporary differences subject to tax, except for a limited number of exceptions. In addition, a deferred tax asset is to be recorded for all temporary differences that may be deducted, losses for tax purposes and tax benefits not yet utilized, if it is anticipated that there will be taxable income against which they can be offset, except for a limited number of exceptions. The new Standard applies to financial statements for periods beginning on January 1, 2005. The Standard provides that it is to be implemented by means of a cumulative effect of a change in accounting method. In our estimation, the impact of the Standard on its results of operations, financial position and cash flows will not be material.

U.S. GAAP:

FASB Statement No. 123 (Revision 2004), Share-Based Payment

In December 2004, the FASB issued SFAS No. 123 (Revision 2004), "Share-Based Payment", (SFAS 123R) that addresses the accounting for share-based payment transactions in which employee services are received in exchange for either equity instruments of the Company, liabilities that are based on the fair value of the Company's equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123R eliminates the ability to account for share-based compensation transactions using the intrinsic value method as prescribed in APB Opinion No. 25, "Accounting for Stock Issued to Employees." Instead, SFAS 123R requires that such transactions be accounted for using a fair-value-based method and that compensation expense be recognized in the statement of operations rather than disclosing the pro forma impact of the stock based compensation. SFAS 123R provides two alternative adoption methods. The first method is a modified prospective transition method whereby a company would recognize share-based employee costs from the beginning of the fiscal period in which the recognition provisions are first applied as if the fair-value-based accounting method had been used to account for all employee awards granted, modified, or settled after the effective date and to any awards that were not fully vested as of the effective date. Measurement and attribution of compensation cost for awards that are unvested as of the effective date of SFAS 123R would be based on the same estimate of the grant-date fair value and the same attribution method used previously under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The second adoption method is a modified retrospective transition method whereby a company would recognize employee compensation cost for periods presented prior to the adoption of SFAS 123R in accordance with the original provisions of SFAS 123; that is, an entity would recognize employee compensation costs in the amounts reported in the pro forma disclosures provided in accordance with SFAS 123. A company would not be permitted to make any changes to those amounts upon adoption of SFAS 123R unless those changes represent a correction of an error. The provisions of SFAS 123R are effective for periods beginning after June 15, 2005. As of December 31, 2004 we did not have any outstanding options that were granted to employees and have no assumption as to the amount of options that may be granted in the future. Accordingly, there is no expected impact of FAS 123R on our future results of operations.

E. Off-Balance Sheet Arrangements

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

F. Tabular Disclosure of Contractual Obligations

The following table summarizes our minimum contractual obligations and commercial commitments, including obligations of discontinued operations, as of December 31, 2004 and the effect we expect them to have on our liquidity and cash flow in future periods.

Contractual Obligations	Payments due by Period				
	Total	less than 1 year	1-3 Years	3-5 Years	more than 5 years
Long-term debt obligations	-	-	-	-	-
Capital (finance) lease obligations	122,558	43,337	78,936	285	-
Operating lease obligations	18,332	5,262	10,834	2,236	-
Purchase obligations	3,700	3,700	-	-	-
Other long-term liabilities reflected on the company's balance sheet under Israeli GAAP	-	-	-	-	-
Total	144,590	52,300	89,770	2,521	-

Not all items were recorded in our balance sheet at December 31, 2004. See Notes 12 and 14 of our Consolidated Financial Statements found elsewhere in this Report. We believe that we will be able to meet these obligations as they become due.

**CERTIFICATION PURSUANT TO
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002**

I, Eli Holtzman certify that:

1. I have reviewed this filing of the financial statements for the year ended December 31, 2004 on Form 6-K of Internet Gold -Golden Lines Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13(a)-15(e) and 15d-15(e)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated Subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) [Reserved]
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 18, 2005

/s/ Eli Holtzman*

Eli Holtzman

Chief Executive Officer

* The originally executed copy of this Certification will be maintained at the Company's offices and will be made available for inspection upon request.

**CERTIFICATION PURSUANT TO
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002**

I, Doron Turgeman, certify that:

1. I have reviewed this filing of the financial statements for the year ended December 31, 2004 on Form 6-K of Internet Gold - Golden Lines Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13(a)-15(e) and 15d-15(e)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated Subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) [Reserved]
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 18, 2005

Doron Turgeman*

Doron Turgeman
Chief Financial Officer

* The originally executed copy of this Certification will be maintained at the Company's offices and will be made available for inspection upon request.



**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the filing of the financial statements for the year-ended December 31, 2004 of Internet Gold - Golden Lines Ltd. (the "Company") on Form 6-K as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Eli Holtzman, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Eli Holtzman*

Eli Holtzman

Chief Executive Officer

March 18, 2005

* The originally executed copy of this Certification will be maintained at the Company's offices and will be made available for inspection upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the filing of the financial statements for the year-ended December 31, 2004 of Internet Gold - Golden Lines Ltd. (the "Company") on Form 6-K as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Doron Turgeman, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Doron Turgeman*
Doron Turgeman
Chief Financial Officer

March 18, 2005

* The originally executed copy of this Certification will be maintained at the Company's offices and will be made available for inspection upon request.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

INTERNET GOLD-GOLDEN LINES LTD.
(Registrant)

By /s/Eli Holtzman
Eli Holtzman
Chief Executive Officer

Date: March 18, 2005