

**"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED**

**CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2005**

**Interim Consolidated Financial Statements as at June 30, 2004**

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**The Board of Directors of  
"Bezeq" – The Israel Telecommunication Corp., Limited**

Dear Sirs,

**Re: Review of the Unaudited Condensed Interim Consolidated Financial Statements as  
at June 30, 2005**

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At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunications Corp. Limited (hereinafter "Company") as at June 30, 2005, as well as the condensed interim consolidated statements of operations, the condensed interim statements of changes in shareholders' equity and the condensed interim consolidated statements of cash flows for the three and six-month periods then ended.

Our review was carried out in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel. The procedures included, inter alia, reading the said financial statements, reading the minutes of meetings of the shareholders and of the Board of Directors and its committees, as well as making inquiries of persons responsible for financial and accounting matters.

Reports of other auditors were furnished to us which relate to the review of the condensed interim financial statements of consolidated subsidiaries, whose assets as at June 30, 2005, constitute approximately 37% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 58% of the total revenues included in the condensed interim consolidated statement of operations for the six-month period then ended and approximately 57% of the total revenues included in the condensed interim consolidated statement of operations for the three months then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in which the Company's investments amount to approximately NIS 66 million as at June 30, 2005, and the Company's share in the losses in respect thereof amount to approximately NIS 11 million and approximately NIS 8 million for the six and three-month periods then ended.

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

In the course of our review, including reviewing the reports of other auditors as mentioned above, nothing came to our attention which would indicate the necessity of making material changes to the said interim financial statements in order for them to be in conformity with generally accepted accounting principles and in accordance with the provisions of Section 4 of the Securities Regulations (Periodic and Immediate Reports), 5730-1970.



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We draw attention to the uncertainties relating to the following matters, for which the maximum possible exposure is significant:

1. The continuing opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for early retirement, as described in Note 5.
3. Contingent claims made against the Company and against investee companies, as described in Note 6A.
4. The financial position of a consolidated company including:
  - a. Restrictions imposed by the Ministry of Communications and the Antitrust Commissioner on the Company in connection with additional cash transfers to the consolidated company.
  - b. The resolution of the Company's Board of Directors dated February 17, 2005, pursuant to which the Board stands by its resolution of March 30, 2004 to continue investing in the consolidated company according to the approved work plan, together with other shareholders and financial bodies.

As mentioned in Note 4, the continuation of the operations of the consolidated company is dependent upon the continued receipt of additional loans from shareholders, including loans from the Company and loans from additional lenders in accordance with the consolidated company's work plan.

Somekh Chaikin  
Certified Public Accountants (Isr.)

August 2, 2005

## Condensed Interim Consolidated Balance Sheets as at

### Reported amounts

|  | June 30<br>2005<br>(Unaudited)<br><u>NIS thousands</u> | June 30<br>2004<br>(Unaudited)<br><u>NIS thousands</u> | December 31<br>2004<br>(Audited)<br><u>NIS thousands</u> |
|--|--|--|--|
| <b>Current assets</b>                        |  |  |  |
| Cash and cash equivalents                    | 2,119,303  | 3,199,933  | 1,457,107  |
| Short-term investments                       | 1,504,507  | 1,200,490  | 1,287,809  |
| Trade receivables                            | 2,076,741  | 1,743,501  | 2,115,070  |
| Other receivables and debit balances         | 377,719  | 374,345  | 416,113  |
| Inventory                                    | 285,544  | 143,027  | 314,549  |
|  | <u>6,363,814</u>                                       | <u>6,661,296</u>                                       | <u>5,590,648</u>   |
| <b>Materials and spare parts</b>             | <u>142,092</u>   | <u>150,736</u>   | <u>130,922</u>   |
| <b>Broadcasting rights, net</b>              | <u>159,614</u>   | <u>122,980</u>   | <u>140,496</u>   |
| <b>Investments and long-term receivables</b> |  |  |  |
| Investments, deposits and debit balances     | 924,052  | 738,708  | 872,575  |
| Investments in investee companies            | 65,575   | 60,502   | 70,308   |
|  | <u>989,627</u>   | <u>799,210</u>   | <u>942,883</u>   |
| <b>Fixed assets</b>                          |  |  |  |
| Cost   | 35,030,011   | 31,039,413   | 34,311,281   |
| Less– accumulated depreciation               | 24,695,498   | 21,656,097   | 23,570,947   |
|  | <u>10,334,513</u>                                      | <u>9,383,316</u>                                       | <u>10,740,334</u>  |
| <b>Other assets</b>                          |  |  |  |
| Goodwill                                     | 1,746,099  | 802,746  | 1,792,658  |
| Deferred charges and other assets            | 378,479  | 213,907  | 387,904  |
| Deferred taxes                               | 407,882  | 469,469  | 446,136  |
|  | <u>2,532,460</u>                                       | <u>1,486,122</u>                                       | <u>2,626,698</u>   |
|  | <u><u>20,522,120</u></u>                               | <u><u>18,603,660</u></u>                               | <u><u>20,171,981</u></u>                                 |

|  | June 30<br>2005<br>(Unaudited)<br><u>NIS thousands</u> | June 30<br>2004<br>(Unaudited)<br><u>NIS thousands</u> | December 31<br>2004<br>(Audited)<br><u>NIS thousands</u> |
|--|--|--|--|
| <b>Current liabilities</b>                                 |  |  |  |
| Bank credit  | 89,151   | 1,344,781  | 88,102   |
| Current maturities of:                                     |  |  |  |
| Long-term bank loans                                       | 701,102  | 1,072,694  | 1,304,916  |
| Debentures   | 307,650  | 175,612  | 240,481  |
| Trade payables   | 1,262,678  | 1,362,487  | 1,675,569  |
| Employee severance benefits                                | 625,311  | 658,910  | 592,474  |
| Other current liabilities                                  | 1,391,540  | 1,470,104  | 1,402,140  |
|  | <u>4,377,432</u>                                       | <u>6,084,588</u>                                       | <u>5,303,682</u>   |
| <b>Long-term liabilities</b>                               |  |  |  |
| Long-term loans  | 2,915,511  | 1,177,197  | 2,860,934  |
| Debentures   | 4,756,884  | 3,530,796  | 3,824,539  |
| Employee severance benefits                                | 532,099  | 659,263  | 680,096  |
| Other long-term liabilities                                | 30,417   | 49,200   | 47,375   |
| Loans extended by the minority in a consolidated company:  |  |  |  |
| Loans  | 1,085,140  | 1,048,637  | 1,057,988  |
| Less – minority share in deficit of a consolidated company | <u>(1,085,140)</u>                                     | <u>(1,048,637)</u>                                     | <u>(1,057,988)</u>                                       |
|  | <u>8,234,911</u>                                       | <u>5,416,456</u>                                       | <u>7,412,944</u>   |
| <b>Minority rights</b>                                     | –  | (16,549)   | (10,412)   |
| <b>Contingent liabilities (Note 6)</b>                     |  |  |  |
| <b>Shareholders' equity</b>                                | <u>7,909,777</u>                                       | <u>7,119,165</u>                                       | <u>7,465,767</u>   |
|  | <u>20,522,120</u>                                      | <u>18,603,660</u>                                      | <u>20,171,981</u>  |

\_\_\_\_\_  
Hava Shechter  
(Chairperson of the approval  
meeting)

\_\_\_\_\_  
Amnon Dick  
Chief Executive Officer

\_\_\_\_\_  
Ron Eilon  
Chief Financial Officer

Date of approval of the financial statements: August 2, 2005.

The notes to the financial statements are an integral part thereof.

**Condensed Interim Consolidated Statements of Operations**

**Reported amounts**

|  | For the six-month period<br>ended June 30 |                     | For the three-month period<br>ended June 30 |                     | For the year ended<br>December 31 |
|--|---|---------------------|---|---------------------|-----------------------------------|
|  | 2005<br>(Unaudited)                       | 2004<br>(Unaudited) | 2005<br>(Unaudited)                         | 2004<br>(Unaudited) | 2004<br>(Audited)                 |
|  | NIS thousands                             |                     | NIS thousands                               |                     | NIS thousands                     |
| <b>Revenues (Note 8)</b>   | <b>5,500,498</b>                          | 4,020,781           | <b>2,727,375</b>                            | 2,011,560           | 9,269,804                         |
| <b>Costs and expenses</b>  |   |                     |   |                     |                                   |
| General and operating expenses<br>(Note 9)   | 3,505,652                                 | 2,223,980           | 1,741,801                                   | 1,133,168           | 5,565,090                         |
| Depreciation   | 1,161,317                                 | 938,789             | 583,810                                     | 466,997             | 2,092,475                         |
| Royalties to the Government of Israel  | 130,171                                   | 96,061              | 64,619                                      | 48,689              | 220,691                           |
|  | <b>4,797,140</b>                          | 3,258,830           | <b>2,390,230</b>                            | 1,648,854           | 7,878,256                         |
| Operating income   | <b>703,358</b>                            | 761,951             | <b>337,145</b>                              | 362,706             | 1,391,548                         |
| <b>Financing expenses, net</b>   | <b>(165,079)</b>                          | (68,747)            | <b>(110,203)</b>                            | (37,998)            | (217,529)                         |
| Earnings after financing expenses  | <b>538,279</b>                            | 693,204             | <b>226,942</b>                              | 324,708             | 1,174,019                         |
| <b>Other income (expenses), net<br/>(Note 10)</b>  | <b>152,742</b>                            | (23,001)            | <b>65,128</b>                               | 7,451               | 79,680                            |
| Earnings before income tax   | <b>691,021</b>                            | 670,203             | <b>292,070</b>                              | 332,159             | 1,253,699                         |
| <b>Income tax</b>  | <b>(259,823)</b>                          | (266,778)           | <b>(126,953)</b>                            | (161,464)           | (497,485)                         |
| Earnings after income tax  | <b>431,198</b>                            | 403,425             | <b>165,117</b>                              | 170,695             | 756,214                           |
| <b>Equity in losses of affiliates</b>  | <b>(11,167)</b>                           | (129,330)           | <b>(7,846)</b>                              | (64,446)            | (134,773)                         |
| <b>Minority share in losses (earnings)<br/>of subsidiaries</b>                                     | <b>8,979</b>                              | 128                 | <b>7,032</b>                                | 52                  | (616)                             |
| Earnings before the cumulative effect<br>of a change in accounting method                          | <b>429,010</b>                            | 274,223             | <b>164,303</b>                              | 106,301             | 620,825                           |
| <b>Cumulative effect of a change in<br/>accounting method as at the<br/>beginning of the year*</b> | <b>15,000</b>                             | -                   | -   | -                   | -                                 |
| Net earnings   | <b>444,010</b>                            | 274,223             | <b>164,303</b>                              | 106,301             | 620,825                           |
| <b>Primary and diluted earnings per<br/>NIS 1 par value of common<br/>shares (in NIS):</b>         |   |                     |   |                     |                                   |
| Earnings before the cumulative effect<br>of a change in accounting method                          | <b>0.165</b>                              | 0.105               | <b>0.063</b>                                | 0.041               | 0.238                             |
| Cumulative effect of a change in<br>accounting method  | <b>0.005</b>                              | -                   | -   | -                   | -                                 |
| <b>Net earnings per share</b>  | <b>0.170</b>                              | 0.105               | <b>0.063</b>                                | 0.041               | 0.238                             |

\* See Note 2B.

The notes to the financial statements are an integral part thereof.

**Condensed Interim Statements of Changes in Shareholders' Equity**

**Reported amounts**

|  | Share<br>capital | Capital<br>reserve –<br>share<br>premium | Capital reserve<br>in respect of<br>transactions<br>between the<br>Company and a<br>controlling<br>shareholder | Retained<br>earnings<br>(deficit) | Total            |
|--|------------------|--|--|-----------------------------------|------------------|
|  | NIS thousands    |  |  |                                   |                  |
| <b>Six months ended June 30, 2005</b>                |                  |  |  |                                   |                  |
| Balance as at December 31, 2004<br>(audited)         | 6,309,133        | 1,623,423                                | 37,775   | (504,564)                         | 7,465,767        |
| Net earnings (unaudited)                             | –                | –  | –  | 444,010                           | 444,010          |
| Balance as at June 30, 2005<br>(unaudited)           | <u>6,309,133</u> | <u>1,623,423</u>                         | <u>37,775</u>  | <u>(60,554)</u>                   | <u>7,909,777</u> |
| <b>Six months ended June 30, 2004</b>                |                  |  |  |                                   |                  |
| Balance as at December 31, 2003<br>(audited)         | 6,309,133        | 1,623,423                                | 37,775   | (1,125,389)                       | 6,844,942        |
| Net earnings (unaudited)                             | –                | –  | –  | 274,223                           | 274,223          |
| Balance as at June 30, 2004<br>(unaudited)           | <u>6,309,133</u> | <u>1,623,423</u>                         | <u>37,775</u>  | <u>(851,166)</u>                  | <u>7,119,165</u> |
| <b>Three months ended June 30, 2005</b>              |                  |  |  |                                   |                  |
| Balance as at April 1, 2005<br>(unaudited)           | 6,309,133        | 1,623,423                                | 37,775   | (224,857)                         | 7,745,474        |
| Net earnings (unaudited)                             | –                | –  | –  | 164,303                           | 164,303          |
| Balance as at June 30, 2005<br>(unaudited)           | <u>6,309,133</u> | <u>1,623,423</u>                         | <u>37,775</u>  | <u>(60,554)</u>                   | <u>7,909,777</u> |
| <b>Three months ended June 30, 2004</b>              |                  |  |  |                                   |                  |
| Balance as at April 1, 2004<br>(unaudited)           | 6,309,133        | 1,623,423                                | 37,775   | (957,467)                         | 7,012,864        |
| Net earnings (unaudited)                             | –                | –  | –  | 106,301                           | 106,301          |
| Balance as at June 30, 2004<br>(unaudited)           | <u>6,309,133</u> | <u>1,623,423</u>                         | <u>37,775</u>  | <u>(851,166)</u>                  | <u>7,119,165</u> |
| <b>Year ended December 31, 2004</b>                  |                  |  |  |                                   |                  |
| Balance as at December 31, 2003<br>(audited)         | 6,309,133        | 1,623,423                                | 37,775   | (1,125,389)                       | 6,844,942        |
| Net earnings (audited)                               | –                | –  | –  | 620,825                           | 620,825          |
| <b>Balance as at December 31, 2004<br/>(audited)</b> | <u>6,309,133</u> | <u>1,623,423</u>                         | <u>37,775</u>  | <u>(504,564)</u>                  | <u>7,465,767</u> |

The notes to the financial statements are an integral part thereof.

**Condensed Interim Consolidated Statements of Cash Flows**

**Reported amounts**

|   | For the six-month period<br>ended June 30 |                     | For the three-month period<br>ended June 30 |                     | For the year ended<br>December 31 |
|---|---|---------------------|---|---------------------|-----------------------------------|
|   | 2005<br>(Unaudited)                       | 2004<br>(Unaudited) | 2005<br>(Unaudited)                         | 2004<br>(Unaudited) | 2004<br>(Audited)                 |
|   | NIS thousands                             |                     | NIS thousands                               |                     | NIS thousands                     |
| <b>Cash flows from operating activities</b>   |   |                     |   |                     |                                   |
| Net earnings  | 444,010                                   | 274,223             | 164,303                                     | 106,301             | 620,825                           |
| Adjustments to reconcile net earnings to<br>net cash flows from operating activities<br>(see A below) | 859,607                                   | 1,194,203           | 511,615                                     | 604,235             | 2,229,157                         |
| Net cash generated by operating<br>activities   | 1,303,617                                 | 1,468,426           | 675,918                                     | 710,536             | 2,849,982                         |
| <b>Cash flows from investing activities</b>   |   |                     |   |                     |                                   |
| Investment in fixed assets  | (983,580)                                 | (677,703)           | (508,072)                                   | (280,460)           | (1,650,557)                       |
| Proceeds from disposal of fixed assets<br>and sale of operations                                      | 125,540                                   | 42,663              | 112,972                                     | 19,957              | 131,576                           |
| Investment in long-term deposits and<br>investments   | (6,982)                                   | (28,090)            | (6,982)                                     | (11,917)            | (42,064)                          |
| Realization of long-term deposits and<br>investments  | 8,609                                     | 35,922              | 2,291                                       | 20,478              | 18,094                            |
| Decrease (increase) in short-term<br>investments, net   | (190,036)                                 | 182,192             | 85,053                                      | (77,975)            | 135,602                           |
| Decrease (increase) in materials and<br>spare parts   | (33,816)                                  | (46,401)            | 2,119                                       | 2,881               | 625                               |
| Acquisition of companies consolidated<br>for the first time (see C below)                             | –   | –                   | –   | –                   | (246,935)                         |
| Investment in investee companies  | (5,746)                                   | (108,129)           | (3,118)                                     | (61,221)            | (142,753)                         |
| Investment in other assets  | (39,442)                                  | (70,424)            | (15,682)                                    | (24,762)            | (130,700)                         |
| Net cash used in investing activities   | (1,125,453)                               | (669,970)           | (331,419)                                   | (413,019)           | (1,927,112)                       |
| <b>Cash flows from financing activities</b>   |   |                     |   |                     |                                   |
| Issue of debentures (after deduction of<br>issue expenses)  | 1,238,236                                 | 1,320,294           | 425,941                                     | 1,005,294           | 1,528,092                         |
| Repayment of other debentures   | (120,307)                                 | (544,281)           | (28,704)                                    | (28,246)            | (601,481)                         |
| Receipt of long-term loans  | 417,500                                   | 139,500             | 303,000                                     | 67,474              | 314,900                           |
| Repayment of long-term loans  | (1,052,446)                               | (371,226)           | (460,896)                                   | (238,264)           | (2,605,012)                       |
| Receipt (repayment) of short-term bank<br>credit, net   | 1,049                                     | (97,160)            | (14,410)                                    | (22,085)            | (56,612)                          |
| Net cash generated by (used in)<br>financing activities   | 484,032                                   | 447,127             | 224,931                                     | 784,173             | (1,420,113)                       |
| <b>Increase (decrease) in cash and cash<br/>equivalents</b>   | 662,196                                   | 1,245,583           | 569,430                                     | 1,081,690           | (497,243)                         |
| <b>Balance of cash and cash equivalents<br/>at the beginning of the period</b>                        | 1,457,107                                 | 1,954,350           | 1,549,873                                   | 2,118,243           | 1,954,350                         |
| <b>Balance of cash and cash equivalents<br/>at the end of the period</b>                              | 2,119,303                                 | 3,199,933           | 2,119,303                                   | 3,199,933           | 1,457,107                         |

The notes to the financial statements are integral part thereof.

**Condensed Interim Consolidated Statements of Cash Flows (Contd.)**

**Reported amounts**

|  | For the six-month period<br>ended June 30 |                  | For the three-month period<br>ended June 30 |                | For the year ended<br>December 31 |
|--|---|------------------|---|----------------|-----------------------------------|
|  | 2005                                      | 2004             | 2005  | 2004           | 2004                              |
|  | (Unaudited)                               | (Unaudited)      | (Unaudited)                                 | (Unaudited)    | (Audited)                         |
|  | NIS thousands                             |                  | NIS thousands                               |                | NIS thousands                     |
| <b>A – Adjustments to reconcile net earnings to net cash flows from operating activities</b> |   |                  |   |                |                                   |
| Revenue and expenses not involving cash flows:   |   |                  |   |                |                                   |
| Depreciation   | 1,161,317                                 | 938,789          | 583,810                                     | 466,997        | 2,092,475                         |
| Deferred taxes   | 73,750                                    | 1,804            | 32,891                                      | 64,818         | 219,975                           |
| Company's equity in losses of affiliated companies   | 11,167                                    | 129,330          | 7,846                                       | 64,446         | 134,773                           |
| Minority share in earnings (losses) of a subsidiary  | (8,979)                                   | (128)            | (7,032)                                     | (52)           | 616                               |
| Decrease in employee severance benefits, net   | (115,160)                                 | (59,784)         | (89,874)                                    | (9,067)        | (110,334)                         |
| Loss (gain) on disposal of fixed assets  | (2,749)                                   | 396              | (1,019)                                     | 316            | (7,338)                           |
| Provision for decrease in value of investments   | 4,700                                     | –                | 4,700                                       | –              | 26,000                            |
| Gain from sale of operations   | (103,869)                                 | –                | (2,009)                                     | –              | (35,033)                          |
| Erosion (appreciation) and interest on long-term deposits and investments                    | 13,146                                    | (19,658)         | (8,693)                                     | (12,399)       | 31,199                            |
| Erosion (appreciation) of short-term investments, net  | (26,662)                                  | 10,145           | (12,286)                                    | (6,540)        | (10,584)                          |
| Appreciation (erosion) of long-term liabilities:   |   |                  |   |                |                                   |
| Debentures   | (118,415)                                 | 1,739            | (34,024)                                    | 2,241          | 115,674                           |
| Long-term loans and other liabilities  | 76,058                                    | 44,925           | 50,569                                      | 3,546          | (17,104)                          |
| Amortization of other assets and deferred expenses   | 95,724                                    | 43,918           | 47,788                                      | 20,468         | 110,083                           |
| Changes in asset and liability items:  |   |                  |   |                |                                   |
| Increase in broadcasting rights  | (19,118)                                  | –                | (8,997)                                     | –              | (17,516)                          |
| Decrease (increase) in trade receivables   | (14,518)                                  | 2,600            | (6,248)                                     | 101,905        | 52,827                            |
| Decrease (increase) in other receivables and debit balances                                  | (23,953)                                  | 82,129           | 5,291                                       | (1,336)        | (8,223)                           |
| Decrease (increase) in inventory   | 19,103                                    | (62,752)         | 13,363                                      | (48,457)       | (122,824)                         |
| Decrease in trade payables   | (169,270)                                 | (115,863)        | (26,498)                                    | (168,985)      | (102,466)                         |
| Increase (decrease) in other current liabilities   | 24,318                                    | 211,697          | (38,317)                                    | 129,346        | (126,652)                         |
| Increase (decrease) in deferred revenues   | (16,983)                                  | (15,084)         | 354   | (3,012)        | 3,609                             |
|  | <b>859,607</b>                            | <b>1,194,203</b> | <b>511,615</b>                              | <b>604,235</b> | <b>2,229,157</b>                  |

The notes to the financial statements are an integral part thereof.

**Condensed Interim Consolidated Statements of Cash Flows (Contd.)**

**Reported amounts**

|  | For the six-month period<br>ended June 30 |             | For the three-month period<br>ended June 30 |             | For the year ended<br>December 31 |
|--|---|-------------|---|-------------|-----------------------------------|
|  | 2005                                      | 2004        | 2005  | 2004        | 2004                              |
|  | (Unaudited)                               | (Unaudited) | (Unaudited)                                 | (Unaudited) | (Audited)                         |
|  | NIS thousands                             |             | NIS thousands                               |             | NIS thousands                     |
| <b>B– Non-cash transactions</b>  |   |             |   |             |                                   |
| Acquisition of fixed assets, other assets,<br>materials and spare parts on credit  | <b>72,981</b>                             | 58,299      | <b>72,981</b>                               | 58,299      | 102,687                           |
| Sale of fixed assets on credit   |   | –           |   | –           | 1,196                             |
| <b>C – Company consolidated for the first<br/>time and assumption of full control<br/>of a proportionally consolidated<br/>company</b> |   |             |   |             |                                   |
| Working capital (excluding cash and cash<br>equivalents)   | –   | 1,795,696   | –   | 1,795,696   | 2,057,632                         |
| Fixed assets   | –   | (1,204,051) | –   | (1,204,051) | (2,967,819)                       |
| Long-term liabilities  | –   | 20,862      | –   | 20,862      | 2,322,740                         |
| Minority loans to a subsidiary   | –   | 1,048,637   | –   | 1,048,637   | 1,048,637                         |
| Less minority share in the deficit   | –   | (1,048,637) | –   | (1,048,637) | (1,048,637)                       |
| Minority rights  | –   | (16,549)    | –   | (16,549)    | (16,549)                          |
| Investment in an affiliate   | –   | 180,553     | –   | 180,553     | 178,339                           |
| Goodwill   | –   | (776,511)   | –   | (776,511)   | (1,821,278)                       |
|  | –   | –           | –   | –           | (246,935)                         |

The notes to the financial statements are an integral part thereof.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 1 – GENERAL**

- A. These interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim periods pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB) and according to the provisions of Chapter 4 of the Securities Regulations (Periodic and Immediate Reports) 5730-1970.
- B. These statements should be read in conjunction with the annual financial statements of the Company and its subsidiaries as at December 31, 2004, and for the year then ended, and the accompanying notes thereto (hereinafter – the Annual Reports).
- C. The Company presents in the notes to the interim financial statements only those significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of cellular telephone services, international communication services, domestic communication services, multi-channel television services, the opening of these markets to competition, and decisions of the Ministerial Committee on Privatization relating to the sale of the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2004. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:
- (1) On April 10, 2005, a copy of a letter of the Director General of the Ministry of Communications dated April 6, 2005, was forwarded to the Company. The letter is addressed to the Director of the Government Companies Authority and contains clarifications for the participants in the privatization process of the Company. According to the letter, the clarifications therein are in response to the principal issues raised by the participants in the privatization process, based on the present policy of the Ministry for the promotion of competition in the communications sector and on the provisions of the law and the existing licenses, and they should not be seen as grounds for any expectation or reliance thereon, on the part of the participants. The clarifications relate, *inter alia*, to the following issues: the policy for licensing the provision of telephony services by means of broadband access (VOB) (Voice Over Broadband); the Company's tariffs and volume discounts; baskets of services; interconnect payments; royalties; structural separation; universal service; the Communications Order; the use of ADSL by the subsidiary DBS for providing its services; minimum payment for making a cellular call; fixed-mobile convergence, and number portability. In the opinion of the Company, the clarifications contained in the Director General's letter do not significantly reduce the regulatory uncertainty in which the Group and the Company operate. Furthermore, the letter also refers in a general way to future actions which the Company is unable to assess, at this stage, whether and when they will occur, and is also, therefore, unable to assess their effect on the activities of the Company and the subsidiaries in the Group and on their financial results.
  - (2) Further to Note 1E(1)e. to the financial statements as at December 31, 2004, concerning a policy paper for "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator", on April 20, 2005, the Ministry of Communications informed, *inter alia*, the Company and its subsidiaries that in completing preparation of the policy and after examining the remarks submitted in response to their request, it was considering amending the policy paper so as to allow the Company or one of its subsidiaries to provide VOB services once the Company's market share in fixed-line domestic telephony falls in certain customer segments below 85%. In addition, the Ministry intends to set two review dates, in November 2006 and November 2007, to examine the possibility of permitting the Company or one of its subsidiaries to provide VOB services even if the Company has not lost 15% of its market share, noting the developments in competition in telephony. The Company sees the aforementioned amendment as a possible deterioration of opportunities for itself and for its subsidiaries and informed the Ministry of Communications of its opposition to the policy paper. The Company clarified, *inter alia*, that Bezeq should not be denied the ability to provide VOB services, in that such denial would run counter to the license and the law, would be unprecedented anywhere in the world and would be seriously harmful to the Company and its customers.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 1 – GENERAL (CONTD.)**

**C. (2) (contd.)**

In addition, amendment of that policy would prevent Bezeq International (as a subsidiary of the Company) from providing VOB services and could force Bezeq International out of this developing market, thereby granting its competitors a clear competitive advantage in internet access services and international communication (most of which have received a marketing trial license from the Ministry of Communications for the provision of these telephony services and one of which has also applied for a special general license for providing broadband telephony services), in that they will offer their customers a total communications solution that combines Internet access, international telephony and fixed-line domestic services. In the opinion of Bezeq International, its inability to offer a similar total solution is liable to cause its existing customers to leave in favor of the services of its competitors and to make it difficult to recruit new customers. Bezeq International is unable to estimate, at this stage, the effects of the above, if any, on the results of its operations and its financial position.

- (3) Regarding marketing trial licenses for payment for fixed-line services over the Internet (VOIP), after joint discussion at the Ministry of Communications with the Company and operators who wish to offer this service, the Ministry of Communications issued an administrative directive for the operation of dialing directions and number ranges allocated for the use of the marketing trial licensees on the Company's network. In an additional letter of the Ministry of Communications it was clarified that the Company will not bear "expenses in kind" of the trial, and that to the extent that additional payment is determined as part of VOB policy, that payment will apply retroactively also for the trial period. As at the date of publication of these financial statements, dialing directions have been opened for one licensee, and the Company is in contact with other holders of the trial licenses for their connection to its network. In response to notification that a marketing trial license for VOIP services had been granted to a competing cellular company, the Company requested that the Ministry of Communications delay the license, as far as is possible, at least until the end of the hearing proceedings and the determination of the policy.
- (4) Further to Note 1E(1)f. to the financial statements as at December 31, 2004, concerning the arrangement whereby interconnect fees will not be paid for terminating a call between the networks of the Company and a domestic operator ("HOT"), on April 14, 2005, the Company withdrew its appeal to the Supreme Court.
- (5) Further to Note 1E(1)g. to the financial statements as at December 31, 2004, concerning number portability, on March 29, 2005 the Economic Policy for Fiscal 2005 Law (Legislative Amendments), 5765-2004 was passed by the Knesset. The law includes, among other things, an amendment of the Communications Law (Telecommunications and Broadcasting), 5742-1982, whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006. (If the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone, by an order and with the approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months.)

On April 20, 2005, the Ministry of Communications sent to the licensees a draft numbering plan which it is considering implementing and operating, for their remarks by May 18, 2005. The draft sets out milestones by which the licensee must have installed and operated all the means required for the application of number portability in its systems no later than January 31, 2006, will commence interconnect tests no later than February 1, 2006 and complete them no later than June 1, 2006, and will provide number portability to whoever requests it no later than August 1, 2006.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 1 – GENERAL (CONTD.)**

**C. (5) (contd.)**

On July 31, 2005, the Company submitted its position to the Ministry of Communications, according to which the timetables set for the implementation of the number portability plan, as outlined by the Ministry, are impossible to meet, and requested the establishment of a committee to re-examine the timetables and the options for implementation of the number portability plan and to submit a recommended program, including for changing the law.

The implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. Substantial investment will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. In addition, operation of number portability involves costs relating to joint recording and management with the relevant operators, the full extent of which cannot yet be assessed. Even though the date for the implementation of number portability has been extended beyond the date originally proposed in the Bill (which was February 2006), and with which the Company commented that it believes it will be unable to comply, it will nevertheless be difficult for the Company to ready itself for number portability even by the date approved by the Committee (even if extended to the end of 2006). In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the ability of the Company and of the other companies in the Group to compete.

- (6) On July 14, 2005, the general license of the Company and the licenses of other operators were amended. The amendment to the Company's license states that it will operate in accordance with the Israeli standard which deals with reliability of charging and proper disclosure in telephone bills. According to the amendment, the provisions of the standard concerning proper disclosure in telephone bills will come into force by October 14, 2005, while the provisions relating to reliability of charging will come into force by January 14, 2006.

The Company's license was amended as aforesaid even though the Company submitted its position to the Ministry that there was no justification for the standard in the proposed format and certainly not for turning it, by adoption into the license, into a binding standard. The Company also stated that application of the standard involves considerable investment of resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be effected simultaneously with the implementation of the number portability plan, and that it will need more time for application of the standard.

The Company is prepared to apply the standard in accordance with the amendment to its license, but applied concurrently to the Ministry of Communications and notified that it will not be able to comply with the dates set for application of the standard in accordance with the amendment to its license, and requested that it present the matter before the Ministry so that the Ministry could re-examine the Company's request to allow it a longer period for preparation.

- (7) Further to Note 1B to the financial statements as at December 31, 2004, in the matter of payment of royalties to the Government of Israel, on May 2, 2005, the Company received a copy of a letter dated April 20, 2005, sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 1 – GENERAL (CONTD.)**

**C. (7) (contd.)**

According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the process of sale of the State's holdings in the Company and as part of the preparations for the implementation of number portability service throughout the telecommunications sector, the Telecommunications Regulations (Royalties) will be amended by the Ministries and brought for the approval of the Minister of Communications, the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until a rate of 1% is reached in 2010.

(8) Further to Note 1E(1)(a) to the financial statements as at December 31, 2004, concerning updates of the Company's tariffs:

a. On May 5, 2005, the Company received a letter from the Director General of the Ministry of Communications dated May 4, 2005, which was sent to the Government Companies Authority, the subject of which was amendment of the Communications Regulations (Calculation and linkage of payments for telecommunications services), 5763-2003 ("the Regulations"), which set out the mechanism for annual updating applicable to the controlled tariffs of the Company. In the course of dealing with the annual update of the Company's tariffs, professional persons at the Ministry of Communications became aware that a certain minor modification was required in the method of calculation described in the Regulations, so as to enable more precise measurement of the data used in calculating the annual efficiency factor.

The immediate effect of the adjustment will reduce the revenues of the Company by approximately NIS 30 million per year in each of the years of the arrangement (through the end of 2007). Beyond that, the effects of the adjustment applicable from the June 2006 update could mean even lower revenues than aforesaid, to the extent that the change in the calculation formula also results in a higher efficiency factor in the subsequent updates, which apply from June 2006 to the end of the arrangement period,.

b. On June 1, 2005, the controlled tariffs of the Company were reduced by an average of about 2.2%. The reduction is based on a change of approximately 1.2% in the Consumer Price Index and an average efficiency factor of approximately 3.4%. It should be noted that the update includes, *inter alia*, a reduction of approximately 3.2% in call tariffs and an increase of approximately 1.2% in fixed fees. The reduction also includes the adjusted method of calculation.

D. On May 3, 2005, a collective agreement was signed, whereby the Company will pay its employees, subject to and after completion of transfer of the State's holdings to the Buyer as set out in the sale procedure, a one-time bonus in the amount of half of the wage cut pursuant to the Economic Plan Law and a Collective agreement for encouraging economic growth, in respect of the period from August 28, 2004 through the date of transfer of the State's holdings (since application of that law and the collective agreement regarding the wage cut expired on June 30, 2005, the period will be from August 28, 2004 to June 30, 2005). The value of the bonus for the period to June 30, 2005 is NIS 13 million. No provision in respect of such a bonus has been recorded in the financial statements as the conditions for its grant have not yet been fulfilled.

E. (1) During the period of report, Bezeq Zahav Holdings Ltd. (hereinafter – Bezeq Zahav) a wholly-owned subsidiary of the Company, sold NIS 400 million par value of debentures (Series 4), which it had purchased from the Company. The proceeds in respect of the sale, in the amount of NIS 428,910 thousand, was transferred to the Company by Bezeq Zahav as repayment of a loan which the Company extended to Bezeq Zahav for purchase of those debentures (Series 4). Subsequent to the sale of the debentures, Bezeq Zahav no longer holds any debentures (Series 4) of the Company, and all the debentures from this series, a total of NIS 1,200,000,000 par value, are held by the public.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 1 – GENERAL (CONTD.)**

**E. (contd.)**

- (2) On April 4, 2005, the Company completed a private issuance to institutional investors, of 286,967,000 debentures (Series 5) of NIS 1 par value each. The debentures are registered by name, are repayable in six equal annual amounts in each of the years 2011 to 2016, bear interest of 5.3% and are not secured by any lien. The proceeds from the issuance, which amounted to NIS 315,663,700, were received on April 4, 2005. The purchase price of NIS 1 par value debentures (Series 5) was 110 points, which reflects an annual yield to maturity of 4.46%.
- (3) On February 27, 2005, Pelephone issued NIS 500 million debentures, bearing 4.4% interest, to institutional investors by way of a private placement. The debentures are repayable in twenty half-yearly payments of the principal and interest. On June 29, 2005, Pelephone issued NIS 333 million debentures in a private placement to institutional investors, in consideration of their face value. The proceeds of the issuance were received on July 3, 2005. The debentures are linked to the Index, bear annual interest of 4.55%, and will be repaid in twenty half-yearly payments of the principal and interest commencing January 2006. The purpose of raising this debt is to diversify Pelephone's sources of credit, repayment of loans and extension of the period of the debt.

- F.** On May 10, 2005, the Company received notice from the Director General of the Government Companies Authority dated May 9, 2005, pursuant to Section 37 of the Securities Law, 5728-1968, that representatives of the State had decided to select Ap.Sav.Ar Holdings Ltd. ("the Preferred Bidder") as the Preferred Bidder in the off-exchange process for the sale of 781,513,683 shares of the Company held by the State (which account for approximately 30% of the Company's shares), as well as an option to purchase 277,697,862 Company shares held by the State (which account for approximately 10.66% of the Company's shares), in accordance with the terms of the Sale Agreement ("the State's Holdings").

According to the notice of the Director General of the Government Companies Authority, the Preferred Bidder offered NIS 4,237,000,000 for the State's Holdings ("the Offered Price") in its final offer.

Transfer of the State's Holdings to the Preferred Bidder requires approvals according to any law, including the approval of the Prime Minister and the Minister of Communications pursuant to the Communications Law (Telecommunications and Broadcasting), 5724-1982 ("the Communications Law") and the Telecommunications Order (Determination of an essential service provided by Bezeq, The Israel Telecommunication Corp. Ltd.), 5757-1997 ("the Telecommunications Order"), and the consent of the Antitrust Commissioner pursuant to the Restraint of Trade Law, 5758-1998. After receipt of the requisite approvals, the State transferred the State's Holdings to the Preferred Bidder against payment of the Offered Price plus Accountant General's interest from the date of submission of the bids to the date of transfer of the State's Holdings to the Preferred Bidder.

It should be noted that the consent of the Antitrust Commissioner for the transaction was given on May 17, 2005.

Following the "industrial espionage" affair (see also Note 6A(19) below) and disputes that arose between the State and the Preferred Bidder concerning the effects of the affair on the Bezeq Group, on July 7, 2005, the parties reached agreement regarding various demands made by the Preferred Bidder as a condition for closing the transaction. According to a notice of the Government Companies Authority, the agreement will affect the exercise price of the options which the Preferred Bidder received, insofar as there is a connection, and as a result of the above affair and the accrual of interest on the price of the transaction until its closing.

With the closing of the transaction and grant of control of the Company to the Preferred Bidder in accordance with the Communications Law and the Telecommunications Order, the Company will be released from certain restrictions imposed upon it as a company controlled by the State of Israel, including cancellation and/or modification of some of the provisions of its Articles of Association, which are similar to certain provisions in the Government Companies Law, 5735-1975.

## Notes to the Financial Statements as at June 30, 2005

### NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

#### A. GENERAL

The significant accounting principles applied in these financial statements are consistent with those applied in the preparation of the annual financial statements, except as stated in this Note.

#### B. INITIAL APPLICATION OF ACCOUNTING STANDARDS

Accounting Standard No. 19 – Taxes on Income.

In July 2004 the IASB published Accounting Standard No. 19 – Taxes on Income (hereinafter – "the Standard"). The Standard determines that deferred tax liabilities in respect of all taxable temporary differences are to be recognized, except for a small number of exceptions. In addition, a deferred tax asset in respect of all deductible temporary differences, tax losses and unutilized tax benefits are to be recognized if taxable income is expected against which they can be utilized, except for a small number of exceptions. The new Standard applies to financial statements for periods commencing January 1, 2005. Adoption of the Standard was by way of the cumulative effect of a change in accounting method. The implications of the adoption of Accounting Standard No. 19 was a one-time effect on earnings of NIS 15 million, which derived mainly from an increase in deferred tax assets in respect of buildings and land.

#### C. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

In August 2005 the IASB published Accounting Standard No. 22 – Financial Instruments: Disclosure and Presentation. The standard sets out the rules for the presentation of financial instruments in financial statements, and details the proper disclosure in respect thereof. In addition, the standard determines the method of classification of financial instruments as liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which assets and liabilities should be set off. The new standard will apply to the financial statements for the periods commencing January 1, 2006 or thereafter. The standard determines that it should be adopted "from now on". The comparative amounts stated in the financial statements for periods commencing on the date of application of the standard will not be restated. In the opinion of Company Management, the application of this standard is not expected to have a material effect on the results of operations and the financial position of the Company.

### NOTE 3 – RATES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES

The changes that occurred in the consumer price index and in the exchange rates of the US dollar and the euro in the period of account are as follows:

|                                      | <u>Consumer price<br/>index</u> | <u>Exchange rate of<br/>the US dollar</u> | <u>Exchange rate of<br/>the euro</u> |
|--------------------------------------|---------------------------------|---|--------------------------------------|
|                                      | %                               | %   | %                                    |
| For the six-month period ended:      |                                 |   |                                      |
| June 30, 2005                        | <b>0.497</b>                    | <b>6.175</b>                              | <b>(5.955)</b>                       |
| June 30, 2004                        | 1.511                           | (0.685)                                   | (1.257)                              |
| For the three-month period ended:    |                                 |   |                                      |
| June 30, 2005                        | <b>1.100</b>                    | <b>4.884</b>                              | <b>(2.159)</b>                       |
| June 30, 2004                        | 1.408                           | 2.695                                     | (1.218)                              |
| For the year ended December 31, 2004 | 1.207                           | (1.621)                                   | 6.212                                |

## Notes to the Financial Statements as at June 30, 2005

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### NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

#### A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS")

In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. DBS has accumulated considerable losses and negative cash flows. The loss for the year 2004 amounted to approximately NIS 366 million and the loss for the six-month period ended June 30, 2005, amount to approximately NIS 144 million. As a result of these losses, the capital deficit and working capital deficit as at June 30, 2005 amount to approximately NIS 3,343 million and NIS 468 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,535 million (nominal). The Company's equity in the accumulated losses of DBS from the date of investment is approximately NIS 1,400 million, of which approximately NIS 130 million was recorded during the period of report. (DBS's losses for the period, net of new loans given by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 62 million.

On January 6, 2005, the Company's Board of Directors resolved that in view of the onerous conditions on which the merger of the Company and DBS was made contingent (increasing the Company's holdings in DBS to more than 50%) by the Antitrust Commissioner ("the Commissioner"), (in which, *inter alia*, the Commissioner restricted the funds that could be injected by the Company into DBS so that for a period of nine months from the date of approval of the merger, they would not exceed the proportional part of the Company in the shares of DBS while the other part would be injected by other shareholders in DBS and by institutional investors), the Company would delay, at this stage, the exercise of the warrants for shares it received from DBS in accordance with agreements signed between shareholders in DBS and DBS, so that its holdings in DBS would remain at approximately 49.8%. The Company and DBS each filed an appeal against the decision of the Commissioner to make the Company's permission to increase its holdings in DBS conditional. Concurrently, the cable companies appealed the decision of the Commissioner as aforementioned, in which they request that the Company not be permitted to increase its holdings in DBS. Applications for dismissal *in limine* of this appeal, which were filed by the Company and DBS, were dismissed on July 25, 2005. The cable companies also filed a request to join the appeals filed by the Company and DBS and their request was denied on July 25, 2005. A hearing of the appeals of the Company and DBS has been scheduled for September 22, 2005. On the matter of the Commissioner's letter dated 25 July, 2005 concerning the loan agreements signed by DBS with three institutional entities, see below.

In a letter dated December 31, 2004, the then Minister of Communications notified the Company that based on the findings of the examination it had carried out and after hearing the arguments of the Company and DBS, he is instructing the Company concerning restriction of the additional injection of NIS 440 million, which the Company had decided to transfer to DBS by the end of 2005 in accordance with the approved business plan ("the Additional Injection") to the following format:

- a. The total amount of the additional injection will be limited to a maximum of NIS 350 million (rather than NIS 440 million).
- b. With regard to the NIS 195 million of the additional funding already transferred by the Company to DBS, the Minister does not intend to take any further action.
- c. The remainder of the amount, a maximum of NIS 155 million, will be transferred in equal portions, once every quarter, during 2005, based on the following principles:
  - (1) The Company's share in the aforementioned amount will not exceed 55% (i.e. a maximum of NIS 82.25 million).
  - (2) The share of the other shareholders in DBS and of the banks or institutional bodies in the transfer of the balance will be not less than 45% (i.e. a minimum of NIS 69.75 million).

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)**

**A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (CONTD.)**

The Minister also stated in his letter that in order to allow time to reach financing agreements based on the principles he has set forth, and as an interim step, the Company may inject funds into DBS, out of its share, without a corresponding transfer from the other shareholders, banks and institutional bodies, provided that the required proportions of such a transfer are fully maintained, no later than by April 30, 2005, and that the Company may not provide a guarantee to the shareholders in DBS, the banks or institutional bodies, or make any other similar commitment, for securing their part in the Additional Injection or in credit provided by them to DBS.

Since a new Minister of Communications was appointed after the above decision, the Company delayed taking legal action and met with the new Minister with the intention of convincing her that the decision from December 31, 2004 is basically flawed.

The new Minister concluded that there was no justification for changing the former Minister's instructions. However, taking into consideration the arguments of the Company and DBS on the need for time to implement the directive, she agreed, in a letter dated February 14, 2005, to allow staggered implementation of the former Minister's decision in the following manner:

- a. The Company will be able to inject up to 75% of the maximum amount (NIS 64 million) by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it had transferred by the date of the letter), provided that by the end of June 2005, the proportions of the transfer decided upon by the former Minister are fully maintained.
- b. The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) during the period from July 1, 2005 to the end of 2005, provided that the proportions of the transfer are maintained as set out in the former Minister's letter.

In the opinion of the DBS and the Company, the instructions in the present Minister's letter are materially harmful to DBS and to the Company as the principal shareholder in DBS.

On February 17, 2005, the Board of Directors of the Company resolved that it affirms its resolution from March 2004 as amended in May 2004, to continue to invest the Additional Injection in DBS according to the approved work plan, together with the other shareholders and financial bodies. This resolution was based, *inter alia*, on an external legal opinion that the Minister of Communications does not have the authority to forbid injections of funds into DBS. On February 23, 2005, the Minister of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications will be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including considering calling in the bank guarantee deposited by the Company as required by its general license. The Company applied to the District Court in Jerusalem for a declaratory order determining that the decisions of the Ministers of Communications, which limited the Company's transfers of funds to DBS, were given *ultra vires* and are therefore void. On March 20, 2005, the District Court ruled that the competent court for a decision on the matter is the High Court of Justice, and accordingly transferred the proceeding to that court. Accordingly, on April 17, 2005, the Company filed both an application for leave to appeal the decision of the District Court and an application to convert the claim in the Supreme Court – if the application for leave to appeal is dismissed – to a petition to the High Court of Justice. The application for leave to appeal the decision of the District Court was dismissed, and on May 10, 2005, the petition was filed in the High Court of Justice. Subsequently, on May 10, 2005, the Company filed a petition in the High Court of Justice on this matter. It should be noted that DBS also filed a similar petition, to which the cable companies were joined as respondents, in the High Court of Justice on the same matter. The petition is scheduled for hearing on October 11, 2005.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)**

**A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (CONTD.)**

The petition raises basic questions which are far from simple, both factually and legally, and the Company, relying on its legal advisers, is unable, at this stage, to estimate the outcome. It should be noted that concurrently with the proceeding, the Ministry of Communications announced its intention to foreclose on the Company's guarantee of NIS 10 million. On July 7, 2005, the Company, as is its right under the general license, filed an appeal against the decision of the Ministry to foreclose the guarantee. See also Note 6A(18).

The terms of the long-term loans which DBS received from certain banking corporations (hereinafter "the Banks"), whose balance as at June 30, 2005, is NIS 1,275 million, impose various restrictions (such as restrictions regarding a lien on or sale of certain assets, a restriction on receipt of credit from other banking institutions without prior approval, a restriction relating to the repayment of shareholders' loans and a demand to comply with financial criteria – hereinafter "the Conditions"). As at June 30, 2005, DBS is in compliance with those Conditions.

In March 2005, DBS signed an agreement with an institutional body whereby that body will extend a loan of NIS 15 million to DBS on three dates. Of the aforementioned amount, DBS has received:

- (1) NIS 7.5 million on the date of signing.
- (2) NIS 3.75 million subsequent to the balance sheet date, in July 2005.
- (3) An additional NIS 3.75 million is due on October 1, 2005.

The institutional body has an option, for a period of 12 months from the date of signing the agreement, to extend an additional loan to DBS in the same amount and on the same terms, provided that the amount of the loan is requested in accordance with DBS's business plan.

The loan is linked to the Index and bears interest at a rate of 11%.

The loan is due for repayment, together with the interest and linkage differences, on December 31, 2013, but may be repaid earlier, subject to repayment of part of the bank loans on the terms set out in this agreement.

In April 2005, DBS signed agreements with two additional institutional bodies for receipt of NIS 20 million and NIS 15 million in loans, in one payment on the same terms (including an option for additional loans in the same amounts). These amounts were transferred to the company in May 2005. Each of the three institutional entities has an option to extend an additional loan in the same amount as its above loan, provided that the amounts of the loans are required according to DBS's business plan. In June 2005, one of the entities exercised the option and transferred an additional NIS 20 million into DBS. It is clarified that the Company's undertaking under the signed loan agreements applies also to this additional amount. This additional loan (as well as the other loans extended to DBS by institutional entities as described above), is not in compliance with the terms and restrictions imposed by the Antitrust Commissioner and the Ministers of Communications as described above, in respect of which the Company and DBS applied to the courts.

As described in Note 6B below, the Company undertook, in connection with the abovementioned three loans, that if by December 31, 2013, the loans are not repaid (in full or in part), or upon the existence of certain other conditions, the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differences) and an amount computed according to a predetermined formula which takes into account the value of DBS at that time.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)**

**A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (CONTD.)**

On July 25, 2005, a letter was sent to the Company from the Antitrust Authority, in which a claim is made against the Company that in connection with the loan agreements which DBS signed with three institutional entities as described above and which were forwarded to the Commissioner for review, at his request, that the Company provided a guarantee for part of the loan amounts and therefore those agreements are not in keeping with the terms of the merger laid down by the Commissioner. The letter also alleges that a further transfer of funds by the Company to DBS might already constitute abuse of its monopoly status. The Company's position is that in view of its decision to delay exercise of its option so that its holdings in DBS will remain at approximately 49.8%, the restrictive conditions imposed by the Commissioner have not come into force and are not binding upon it. In its reply to the above letter from the Antitrust Authority, the Company dismissed the allegations of the Commissioner, and reminded him that it had maintained contact with representatives of the Commissioner so that the loan agreements with the institutional investors would conform to a possible outline indicated by the Commissioner, despite the fact that it has not yet exercised the options which are the subject of the merger application it filed, and therefore, as stated, the restrictive conditions are not binding. The Company also noted in its reply that the matter is pending in an appeal to the Antitrust Tribunal. The Company dismissed the allegations of the Commissioner that the loan agreements contravene the provisions of the Restrictive Trade Practices Law and stated that it sees neither cause nor justification for the Commissioner to exercise his authority in this context.

As at June 30, 2005, the Company had transferred NIS 256 million of the Additional Injection.

At a meeting of the shareholders of DBS on January 16, 2005, the representatives of two other shareholders announced that they intend to recommend to the appropriate bodies of their companies that they participate in further transfers of NIS 20 million and NIS 10 million, respectively, to DBS. These recommendations will be in a situation where DBS will also have funding from the other shareholders (including the Company) for executing its business plan and without it instituting a legal proceeding requesting interim relief that could halt the process. From the date of that decision to the date of approval of these financial statements, the additional shareholders have transferred NIS 17 million to DBS, of which NIS 12 million relate to the aforementioned notice.

The continued operation of DBS is conditional upon continuing receipt of additional loans from the shareholders, including loans from the Company, as well as loans from other lenders in accordance with DBS's work plan.

In the opinion of the Management of DBS and of the Company, there is a good chance that the financial resources that DBS will need in the coming year can be arranged, *inter alia* in view of the resolution of the Board of Directors of the Company, as noted above, in order to continue investment in DBS according to the work plan, together with other shareholders and financial entities.

**B. XPERT INTEGRATED SYSTEMS LTD. ("Xpert")**

On July 11, 2005, the Company sold all its holdings (16.3%) in Xpert. The Company's share of the proceeds from the sale of Xpert amount to approximately \$ 2.8 million, which will be paid in installments, that last of which is due in January 2007. A provision for the impairment in value of the investment in the amount of approximately NIS 6 million has been made in the financial statements, based on the above selling price.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 5 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS**

**EARLY RETIREMENT PLAN**

- a. Further to Note 16D to the 2004 financial statements of the Company concerning the process for selecting an alternative to the Makefet Fund in coordination with the employees' representatives, on April 17, 2005, a special collective agreement was signed between the Company and the employees' representatives and the Histadrut, enabling early retirement of employees through that alternative entity. On June 28, 2005, a contract was completed and signed between the Company and Harel Insurance Co. Ltd. ("Harel"). The commitment regulates pension payments in respect of early retirement, as well as retirement pension payment differentials deriving from legislative amendments to the Israeli Economy Recovery Plan Law (Legislative amendments for attaining budget targets and economic policy for 2003 and 2004 fiscal years), 5763-2003) for employees who retired commencing at the end of 2003 and beginning of 2004, and/or who will retire from the Company in accordance with the special collective agreement for retirement dated September 2000, as amended on March 18, 2004 ("the Retirement Agreement"). Following execution of the agreement with Harel, the special collective agreement between the Company and the employees' representatives and the Histadrut was updated and amended on the same date (June 28, 2005).

It should be noted that all the approvals required for validating the agreement with Harel and the special collective agreement dated April 17, 2005, and its amendment, which was signed between the Company and the employees' representatives and the Histadrut, regulating the early retirement of employees through Harel, as the substitute for the Makefet Fund, have been obtained.

As a result of the agreement described above, subsequent to making adjustments which also derived from an updated estimate of total liabilities for employees' retirement, the Company reduced the provision for early retirement in the financial statements for the period ended June 30, 2005 by approximately NIS 90 million.

- b. Notice of a labor dispute sent by the employees' representatives on April 6, 2005, was canceled on April 13, 2005, after an exchange of letters between the Company, the employees representatives and the Government Companies Authority, the main points of which were:

"(1) It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the employees' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which states that 'Immediately after signing this agreement, the parties will commence intensive negotiations to regulate the retirement of the remaining transferred employees by 2011 on the one hand, and the requirements of the Company's Management for organizational and other changes on the other hand.'

(2) The Government Companies Authority clarified that if after sale of the State's holdings in the Company an agreement as referred to above is made, no additional approvals for extension of the validity of the retirement agreement will be required from the Government Companies Authority and the Supervisor of Wages at the Ministry of Finance. The Government Companies Authority also clarified that to the extent its approval is required for the agreement, the sale of the State's holdings will replace the approval.

(3) The correspondence will be presented to the participants in the proceeding for the sale of the State's holdings in the Company."

In the opinion of the Company, the above will not change the existing agreement. Furthermore, the aforementioned clarifications do not have an effect on the financial statements of the Company. To the best of the Company's knowledge, the exchange of letters was presented to the participants in the proceeding for the sale of the State's holdings in the Company.

## Notes to the Financial Statements as at June 30, 2005

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### NOTE 6 – CONTINGENT LIABILITIES

#### A. CLAIMS AND CONTINGENT LIABILITIES

The Company and the investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 19A to the financial statements of the Company as at December 31, 2004. No material changes in contingent liabilities have occurred up to the date of signing these financial statements, other than the following:

- (1) Further to Note 19A(1) to the financial statements as at December 31, 2004, concerning a petition filed in the High Court of Justice by 128 senior employees who were/are employed under personal employment agreements, to set aside a decision of the National Labor Court which dismissed a claim for a 33% salary increment (corresponding to the salary increment given to members of the Knesset and senior civil servants), on May 2, 2005, the High Court of Justice dismissed the petition.
- (2) Further to Note 19A(2)a. to the financial statements as at December 31, 2004, concerning the investigation of the Antitrust Commissioner into suspected restrictive arrangements relating to the supply of large exchanges (public switching) and following the dismissal of the Company's petition to direct the Antitrust Authority to allow the Company a hearing, to submit classified material and to refrain from issuing a determination according to Section 43 of the Antitrust Law, the Company filed a written argument as part of a hearing in the matter of the Antitrust Authority's intention to issue such a determination. Discussions between the Company and the Antitrust Authority in an attempt to arrive at an agreed Order (which would prevent issue of the determination), have not been successful.
- (3) Further to Note 19A(3) to the financial statements as at December 31, 2004, concerning the claim of a group of employees who were employed as non-permanent employees at the Ministry of Communications. On March 6, 2005, a partial judgment was handed down in which the allegation of the plaintiffs concerning their status as "transferred employees" was dismissed, and the court stated its position that the partial decision should become final. The plaintiffs' lawyer is supposed to give notice of the position of the claimants on the matter.
- (4) Further to Note 19A(5) to the financial statements as at December 31, 2004, concerning a number of claims in the matter of recognition of various salary components as pension components and recognition of various components of the determining salary for computing severance pay – the maximum exposure in respect of these claims could, under certain assumptions, reach approximately NIS 2.6 billion. However, in the light of the two judgments on the matter of the administrative call duty component and the matter of the grossing up of the tax component, as described in the aforementioned note, the Company re-assessed the situation and, relying on its external legal advisers, concluded that the exposure amounting to approximately NIS 2.2 billion (out of the maximum exposure) is remote. Out of the remainder of the exposure, in the amount of approximately NIS 392 million, in respect of claims concerning components, which the Company believes, relying on its external legal advisers, that the risk cannot be assessed or that the Company's chances of success in these claims are good, the Company did not include a provision in the financial statements other than a provision of NIS 50 million in respect of the administrative call duty component (according to a formula determined in the decision on this matter) and in respect of a possible settlement in the claim referred to in Note 19A(5)c. to the 2004 financial statements of the Company.
- (5) Further to Note 19A(9) to the financial statements as at December 31, 2004, concerning dismissal of an application for approval of a claim as a class action against the Company and Pelephone, in which it was alleged that the maximum payment that could be collected from a Company subscriber calling a Pelephone subscriber was lower than the amount actually collected – no appeal was filed against the decision and therefore the proceeding has ended.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 6 – CONTINGENT LIABILITIES (CONTD.)**

**A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)**

- (6) Further to Note 19A(10) to the financial statements as at December 31, 2004, concerning two claims for damages in respect of bodily harm which were filed against the Company in 2003 and 2004 in connection with the operation of the Hillel broadcasting station:
- a. On May 9, 2005, the Company received a claim for damages amounting to NIS 46 million which was filed by 14 plaintiffs who were and/or are residents of the moshavim Porath, Ein Vered, Ein Sarid and of the settlement of Kadima, against the Company, the Broadcasting Authority and the State of Israel. According to the plaintiffs, the negligence and/or omissions of the defendants in operating the Hillel broadcasting station, which is situated near the above locations, and which for many decades has allowed uncontrolled and hazardous exposure to radiation from the Hillel broadcasting stations and from installations connected with it, have caused them (or their heirs) bodily harm and property damage of various kinds. It is noted, as described in the above Note, that the opinions of experts in occupational medicine and in non-ionizing radiation safety, filed by the Company as part of its defense in the two claims, state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the cancer allegedly suffered by the plaintiffs in the claims. In relation to these claims, the Company, relying on its external legal advisers (whose opinion relied on the aforementioned expert opinions), believes that the chances of the claims being dismissed are greater than the chances of their being allowed. Accordingly, no provision has been made in the financial statements in respect of this claim.
  - b. On May 23, 2005, the Company received a claim for damages in respect of property damage and financial loss amounting to approximately NIS 141 million, which were allegedly sustained by 53 plaintiffs who were and/or are residents of Moshav Porath. The claim was filed against the Company, the Broadcasting Authority and the State of Israel in the Tel Aviv District Court. According to the plaintiffs, the negligence and/or omissions of the defendants in operating the Hillel broadcasting station, which is situated near the moshav, were the direct cause of irreversible damage to agricultural fields owned by moshav residents, harm to the livelihood of the moshav and enormous financial losses, due, *inter alia*, to the effects of operation of the Hillel broadcasting station and the electromagnetic fields radiating from it towards the agricultural land of the plaintiffs, which the plaintiffs allege damaged their crops and prevented them from making proper use of their agricultural land. In addition, an application was filed to split the reliefs so as to enable future claims for damages. The statement of defense on behalf of the Company and the other defendants has not yet been filed. At this early stage, the Company, based on the opinion of its legal advisers, is unable to estimate the chances of the outcome of the claims against it, and accordingly, no provision has been made in its financial statements in respect of this claim.

As in the first two claims, in this claim the Company has arguments of defense against the other defendants – the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the Company operated the station for and on behalf of the other defendants, in accordance with the operational directives and requirements of the other defendants or either of them, and that the Company acted in accordance with those various directives and requirements, including those which were responsible for the operating activities that were carried out from the Hillel broadcasting station. In addition, also regarding the above claims, the Company has arguments against the relevant insurers, where clarification with the insurance companies of the matter of the insurance cover for the events which are the subject of the claims, have not yet been completed.

It is noted that on December 31, 2003, the Company ceased all broadcasts from the station, as required by the State and the Broadcasting Authority, and since then the site has ceased to function as a broadcasting site.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 6 – CONTINGENT LIABILITIES (CONTD.)**

**A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)**

- (7) Further to Note 19A(14) to the financial statements as at December 31, 2004, concerning a claim together with an application for recognition as a class action, alleging unlawful collection of interest on arrears in respect of a debt which the Company collects for other communications providers, on June 6, 2005, a decision was given by the Tel Aviv District Court, dismissing the plaintiffs' claim and their application for approval as a class action, and ordering them to pay costs.
- (8) Further to Note 19A(19) to the financial statements as at December 31, 2004, concerning a claim filed against the Company and against Makefet Fund by 264 retirees of the Company, for enforcement of the agreement from April 2001, whereby the employees are to be allowed to switch the track of their choice from B to A, on June 6, 2005, the court decided not to dismiss the claim in limine and not to strike the retirees' organization as a plaintiff, but it instructed that the items in the claim relating to demands for payment be struck from the claim (provided a fee has not been quantified and paid in respect of them), so that in practical terms, the claim remained declaratory only. The case is scheduled for hearing on December 15, 2005.
- (9) Further to Note 19A(21) to the financial statements as at December 31, 2004, concerning various claims of six employees who retired on disability pensions due to their medical condition and against a background of the pension reform, the employees were summoned for a repeat medical examination and initially they were offered a 50% reduction in their pension. The employees filed an appeal against Makefet and/or the Company in a claim for payment of a full disability pension. On June 20, 2005, the Supervision of Insurance Business Law was amended so that a retiree whose disability was determined before October 2003 and who accumulated at least five years of disability, or who reached retirement age before the decision to reduce his disability percentage, would not have his pension reduced.

Following this amendment, there were claims of four retirees who meet these criteria. The proceeding in two of the claims to which the amendment to the law does not apply, will continue.

- (10) Further to Note 19A(22) to the financial statements as at December 31, 2004, concerning a claim and application for recognition as a class action, in which it is alleged that the Company adds Value Added Tax to the interest on arrears that it collects in respect of late payment, thereby over-collecting in contravention of the law, since the VAT component is embodied in the Accountant General's arrearage interest that the Company is entitled to charge. On May 3, 2005, a decision was given whereby the Attorney General is required to provide his position on the question of whether he intends to intervene in the proceedings relating to the claim and to clarify his position on whether arrearage interest of the Accountant General includes the VAT component or not.
- (11) Further to Note 19A(23) to the financial statements as at December 31, 2004, concerning a class action in which it is alleged that the Company's charges and calculations for Internet access in the "WOW Extra" and "WOW Summer 2004" campaigns constituted deception, fraud, unjust enrichment and overcharging, the Company's investigation revealed that the plaintiff was not overcharged and for official-technical reasons the charge was split into a charge and a credit. Following the Company's response, the plaintiff requested that his claim be struck from the record, and subsequently, on June 8, 2005, with the consent of the parties, the Haifa District Court decided to strike the claim.
- (12) In the matter of the dispute between the Company and the Ministry of Communications regarding payment of royalties in respect of interconnect revenues from cellular subscribers and Company subscribers in the period between April 1999 and the end of 2000, on July 25, 2005, the Company received a letter from the Director General of the Ministry of Communications demanding that the Company pay the above disputed royalties debt, which amounts to approximately NIS 17 million.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 6 – CONTINGENT LIABILITIES (CONTD.)**

**A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)**

(12) (contd.)

The Company replied to the Ministry of Communications that it is adhering to its legal position, namely, that in respect of the relevant period the Company was not required to pay royalties to the State for interconnection of calls from cellular subscribers to Company subscribers, and that the Ministry gave no reasons for its decision and did not relate to the contentions and data presented recently by the Company to professional personnel at the Ministry. The Company also requested an urgent meeting to discuss the matter with the Director General of the Ministry of Communications, and to postpone the demand for payment until after the aforementioned discussion. The legal advisers of the Company are unable, at this stage, to estimate the outcome of the dispute. However, in the opinion of the Company, that outcome is not expected to have a material impact on the results of the Company's operations or on its financial position.

(13) Further to Note 19A(26) to the financial statements as at December 31, 2004, concerning a claim filed against Bezeq International by a systems vendor, a preliminary hearing was held on March 15, 2005, in which a proposal was made to transfer the case to an arbitration proceeding. The case was scheduled for memorandum, which was postponed in view of the ongoing contacts between the parties. The legal advisers of Bezeq International are unable to estimate the chances of the outcome of the claim at this stage, and accordingly, Bezeq International decided not to include a provision in its interim financial statements in respect of the claim.

(14) Further to Note 19A(28) to the financial statements as at December 31, 2004, concerning allegations of the plaintiffs that Pelephone's pre-paid service constitutes infringement of a patent of the suing company, a decision was recently given by the Registrar of Patents on the matter of revocation of the patent, stating that the patent is unworthy of registration. The date for filing an appeal against the decision of the Registrar of Patents has elapsed.

(15) On July 26, 2005, a petition was filed in the High Court of Justice against the Government of Israel, Pelephone and others, protesting the Government decision on July 24, 2005 to appoint an interministry committee of directors general to examine the subject of cellular antennae in Israel and to submit recommendations to the Government on the matter within one month. The petition is for grant of an order against the Government of Israel to give the reasons why the aforementioned decision should not be cancelled and why an immediate meeting should not be held, without delay, to discuss the proposal of the National Council for Planning and Construction for Amendment No. 1 to Urban Outline Plan 36A. On July 26, 2005, the court forwarded the petition for the response of the respondents within 15 days. The responses have not yet been filed and the hearing of the petition has not yet been scheduled.

(16) Further to Note 19A(36) to the financial statements as at December 31, 2004, concerning a claim filed in the Tel Aviv District Court against DBS, in the matter of payments to cover the electricity consumption of installations for reception of the broadcasts of DBS in condominiums, and the application for approval as a class action, on April 28, 2005, the parties filed an agreed application to strike the action and the application for approval as a class action without an order to pay costs. On May 1, 2005, the claim and the application for approval were struck from the record without an order to pay costs.

(17) On June 30, 2005, the Cable and Satellite Broadcasting Council ("the Council") published its decision concerning an "Invitation to present position papers in the matter of the rules of ownership of the channels produced in Israel", in which the Council invites the public to present its positions on the matter, including the question of whether limitations should be imposed on DBS for the production of channels, as are imposed today only on the cable companies, and if so, what changes and modifications should be made in the rules compared with those applied today to the cable companies. In July 2005 DBS submitted its position to the Council, including its opinion that there is no justification for imposing limitations beyond those currently laid down in the law.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 6 – CONTINGENT LIABILITIES (CONTD.)**

**A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)**

- (18) Further to Note 19C(2) to the financial statements as at December 31, 2004, concerning a bank guarantee of \$10 million in accordance with the Company's general license, on June 22, 2005, the Company received a letter from the Director General of the Ministry of Communications, giving notice of the decision of the Ministry to foreclose on NIS 10 million out of the \$10 million dollar bank guarantee provided by the Company in accordance with its general license. According to the Director General's notice, the decision to foreclose was made in light of the fact that the Company made a commitment to the institutional investors who extended loans to DBS, in which the Company holds approximately 49.8% of the shares, in contravention of the directives of the Minister of Communications.

It should be noted that since the decision of the Minister of Communications to impose limitations and conditions on the Company's transfer of funds to DBS, both DBS and the Company have acted, irrespective of their legal position concerning the lack of authority of the Minister of Communications to intervene on the matter of the transfers of shareholders and other financing entities to DBS, in order to comply with the terms and limitations imposed both by the Minister of Communications and by the Antitrust Commissioner, concurrently with the legal proceedings they instituted in the High Court of Justice and in the Antitrust Tribunal.

The position of the Company is that there is no legal or other basis for the foreclosure of part of the guarantee of which the CEO of the Ministry of Communications notified the Company, and therefore no provision has been made in the financial statements. An appeal against the decision has been delivered to the Minister of Communications and as a result thereof, implementation of the decision has meantime been frozen. An appeal has been filed with the Minister of Communications against the decision and as a result, the foreclosure is suspended for now. It is noted that the hearing of the petitions of the Company and DBS in the High Court of Justice against the Minister of Communications, is scheduled for October 11, 2005.

**(19) The "industrial espionage" affair**

On May 29, 2005, the media published a news item stating that the Government of Israel is conducting an investigation into "industrial espionage" by computerized means (a "Trojan horse" program), in which it was stated that the Company's subsidiaries Pelephone, Bezeq International and DBS, were involved:

- (a) On May 31, 2005, the cable companies ("HOT") filed an *ex parte* application ("the First Application") in the Tel Aviv District Court, in which the court was requested to grant, *inter alia*, an order for the appointment of a receiver, who would be authorized to search and seize commercial secrets of HOT at all the sites operated by DBS and other information of HOT which is confidential or lawfully concealed, as well as other temporary reliefs, mainly to forbid DBS from making use of the commercial secrets of HOT.

The background to the application filed by HOT was newspaper articles about the "industrial espionage" affair conducted by means of Trojan horse software, where according to HOT, DBS appears to have acted illegally, through the Modi'in Ezrachi private investigations firm with which it had signed an agreement, so as to enable it to obtain confidential information of HOT while perpetrating the tort of commercial robbery. As part of the affair, the CFO of DBS, Mr. Katriel Moriah, was detained (and later released).

After dismissal of its application, HOT filed a "revised" *ex parte* application ("the Second Application"), in which it repeated its request, this time stating that its allegations are not based solely on reports in the media as it alleged in the First Application, but also on information conveyed to it by police investigators. At the same time HOT also filed a statement of claim against DBS, which does not include an application for any financial relief and in which the court is requested to grant various declaratory reliefs and mandamuses and injunctions to prohibit DBS from making use of HOT's commercial secrets.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 6 – CONTINGENT LIABILITIES (CONTD.)**

**A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)**

**(19) The "industrial espionage" affair (contd.)**

In its response to the application, DBS rejected the allegations of HOT and stated that without waiving any of its allegations, it is willing to undertake to refrain from making any use of documents relating to the business of HOT which it received from Modi'in Ezrachi, and that if any such document or information is found, that document will be signed, as is, and placed in an envelope and stored in the safe in the office of DBS's legal representative without any use being made of it. In a hearing held on July 7, 2005, and with the consent of the parties, the court made a decision to validate DBS's notice not to make any use of documents and information conveyed to DBS by Modi'in Ezrachi an order. In this way, the court in fact dismissed the applications of HOT for the appointment of a receiver and a temporary injunction of broader scope that the undertaking made by DBS.

On June 30, 2005 DBS, filed a statement of defense in the court, in which it denies the allegations made by HOT in the statement of claim. A date for the hearing the claim has not yet been scheduled. DBS believes, based on its legal advisers, that at this stage the chances of the outcome of the claim cannot be estimated.

- (b) On May 31, 2005, three employees of Bezeq International were called in for questioning as part of the police investigation of the industrial espionage by computer (a Trojan horse program). After being questioned, the employees were released under restriction. Up to the date of publication of the interim financial statements, no action has been taken against Bezeq International and/or its employees which relates to the aforementioned investigation.
- (c) In its response to the news, Pelephone stated that its employees have no connection with obtaining information by unlawful means, that it and its employees were surprised by the news and they had cooperated with the police in clarifying the facts of the affair.

It should be noted that a number of senior employees of the Company were summonsed to the police to make statements regarding confidential documents which were found on the premises of competing entities and to assess the extent of probable damage to the Company as a result. The Company is studying the matter, as well as action regarding Company confidential material found on the premises of its competitors. With regard to the effects of this affair on the privatization of the Company, see Note 1F above.

**B. SECURITIES, LIENS AND GUARANTEES**

In connection with three loan agreements signed between DBS and institutional bodies in March-April 2005, for a total amount of NIS 50 million, with an option to extend additional loans of up to an additional NIS 50 million as described in Note 4 above, the Company undertook that if the loans are not promptly repaid (in full or in part), or if certain other conditions exist (if a final decision is given by the court or a valid decision is made to liquidate DBS, if a receiver is appointed for DBS and/or for all or a material part of its assets, in any case where the guarantee provided to the banks is foreclosed or realized, if the Company sells all its holdings in DBS and in respect of a loan to one institutional body also in a case of transfer of control of the Company from the State to another, and provided six months have not elapsed from the date of actual transfer of the control to the giving of the lender's notice, the lenders will be able to demand repayment of the lower of the amount of the loan balance (principal, interest and linkage differentials) and the amount calculated according to a predetermined formula which takes into account the value of DBS to its shareholders at that time.

**Notes to the Financial Statements as at June 30, 2005**

**NOTE 6 – CONTINGENT LIABILITIES (CONTD.)**

**C. COMMITMENTS**

Further to Note 19B(7) to the financial statements as at December 31, 2004, concerning Pelephone winning a tender issued by the Accountant General at the Ministry of Finance (hereinafter – the AG) for the provision of cellular services to the various government ministries for a period of three years commencing April 2005. The tender includes an option for the AG to extend the agreement for an additional three years. Under the agreement, Pelephone will supply user equipment and cellular services for approximately 25,000 subscribers. The cost of purchasing the subscribers in the AG transaction, in the amount of NIS 30 million for supplying subscriber equipment, was charged to the statement of operations in the previous quarter and in this quarter most of the handsets were supplied to the AG.

**D. FUTURES TRANSACTIONS**

**Forward Currency Transactions – Hedging Transactions**

**Consolidated**

|  | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Amounts receivable</u> | <u>Amounts payable</u> |
|--|---------------------------|-------------------------|-----------------------------|---------------------------|------------------------|
|  | <u>NIS millions</u>       |                         |                             |                           |                        |
| <b>Currency exchange contracts at predetermined interest rates</b>                   | Euro                      | Index                   | October 2005                | 29                        | 28                     |
| <b>Forward contracts at predetermined exchange rate (excluding premium/discount)</b> | Dollars                   | Shekel                  | September 2006              | 643                       | 637                    |
|  | Euro                      | Shekel                  | May 2006                    | 1,608                     | 1,686                  |
|  | CPI-linked NIS            | Shekel                  | January 2006                | 515                       | 519                    |

**NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES**

**A.** Further to Note 27 to the financial statements as at December 31, 2004, concerning advanced negotiations with the Ministry of Defense in the matter of a new agreement for the provision of communication services – a new commercial agreement was signed on May 8, 2005, between the Company and the Ministry of Defense in the name of the State of Israel, for the provision of communication services by the Company. The agreement was approved in advance by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and was subject to approval of the general meeting of the shareholders of the Company (by a special majority), as stipulated in the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. On June 2, 2005, the general meeting of the Company resolved to remove the subject from its agenda at the request of the Company, in view of the approach made by the Ministry of Communications and the request of the State following the request to postpone the discussion. The request of the Ministry of Communications stated, *inter alia*, that under the agreement, discounts would be given which appear to be in contravention of the provisions of the law and the Company's license. The Ministry requested the response of the Company in order to clarify the matter. The Company submitted its remarks to the Ministry, stating that in its opinion, it was a new framework agreement replacing the previous one, in which the Company also gave discounts of various percentages to the IDF. The Company pointed out that its license allows it to enter into a special agreement with the Ministry of Defense for the provision of telecommunications services to the IDF which includes any term agreed upon by the parties, including discounts, as was provided for in the previous framework agreement. The Ministry of Communications has not yet completed its examination of the matter.

In addition, the Company also received a letter from the Antitrust Commissioner stating that the agreement appears to contravene the provisions of the Antitrust Law. The Company is drafting its response to the Commissioner. As at the date of approval of the financial statements, the parties are acting in accordance with the previous framework agreement.

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)**

- B.** Further to Note 27B to the financial statements as at December 31, 2004, concerning a claim filed by the Company against the Ministry of Defense for payment of amounts in connection with a dispute on the matter of an 18% discount which the Ministry of Defense deducted from payments collected by the Company for other communications providers, in April 2005 a settlement agreement was signed after approval by the Audit Committee of the Board of Directors and by the Board of Directors. The general meeting of the shareholders of the Company approved the arrangement on June 2, 2005, in accordance with the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. In June 2005 the settlement agreement was approved by the court which validated it as a court judgment.

The main points of the settlement agreement are as follows:

- (1) To settle a financial claim for approximately NIS 37.4 million (principal) plus interest in an amount estimated at approximately NIS 20 million, which was filed by the Company against the State in the matter of the deduction of discounts of 18% on various charges included under the "Miscellaneous" section in the telephone bills of the IDF, the Ministry of Defense will pay a total of NIS 28.5 million (including VAT if applicable), in three equal installments of NIS 9.5 million each, which will be paid by the following dates: June 30, 2005, January 31, 2006 and June 30, 2006.
- (2) Arrears in any of the payments will incur payment of Accountant General's interest on arrears.
- (3) Subject to the aforesaid, neither party shall have any allegation and/or demand and/or claim against the other on this matter.

Following the settlement agreement, the Company canceled a provision of approximately NIS 15 million.

**C. BENEFITS FOR COMPANY OFFICERS**

- (1) On April 6, 2005, the general meeting of the shareholders approved the Company entering into a commitment for indemnification in respect of a financial liability imposed upon officers in the Company and in respect of reasonable litigation expenses which they incur; in all matters connected, directly or indirectly, with the process of the sale of the State's holdings in the Company by way of a private placement of 30% of the share capital of the Company and options to purchase an additional 10.66% of the share capital of the Company.

The undertaking to indemnify will be granted to officers who served ad/or were appointed and/or will be appointed in the Company starting from the commencement of the Company's preparation for the sale process and until the date of closing the sale process.

The overall scope of the indemnity will not exceed 25% of the shareholders' equity of the Company (according to its 2004 financial statements, linked to the Consumer Price Index of November 2004), including in respect of undertakings to indemnify which were made in advance up to the date of issue of the indemnity note together with the advance undertaking to indemnify in accordance with the letter of the Minister of Finance dated April 21, 2004, which will be given, if given, prior to transfer of the controlling interest in the Company by the State.

- (2) On April 20, 2005, the Audit Committee and the Board of Directors of the Company resolved to insure and indemnify the officers of the Company as follows:
  - a. Approval for exercise of an option to purchase a run-off policy for the liability of the Company's officers, on the terms of the present policy, in accordance with the following changes:

**Notes to the Financial Statements as at June 30, 2005**

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**NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)**

**C. BENEFITS FOR COMPANY OFFICERS (CONTD.)**

- (1) For a period of seven years from the date of the closing of the transfer of the State's shares in the Company which are being sold in accordance with the decision of the Ministerial Committee on Privatization from July 19, 2004 ("the Closing Date of the Sale").
- (2) The total amount of the insurance cover will not exceed \$150 million plus \$30 million in respect of legal expenses in Israel only.
- (3) Limits of liability:
  - a. for the first three years, cover has a limited liability of \$150 million plus \$30 million in respect of legal expenses in Israel only;
  - b. for another three years cover has a limited liability of \$75 million plus \$15 million in respect of legal expenses in Israel only;
  - c. for the seventh year, cover has a limited liability of \$25 million plus \$5 million in respect of legal expenses in Israel only.

It is clarified that there is one limit of liability for the entire run-off period.

- (4) The amount of the premium for the entire period of insurance is \$3 million (in a one-time advance payment).
- b. The approval for making a commitment in advance to indemnify the officers of the Company who were serving in the Company at the time of making the commitment to indemnify, which will apply on the date of closing the sale, or who served during the seven years prior to that date, is in respect of a financial liability imposed upon them in each of the events listed in the indemnity document and on the terms set out therein, in which the officer acted in good faith and had reasonable grounds for assuming that the action is in the best interests of the Company. The undertaking to indemnify will not apply regarding an event for which an insurer acknowledges liability under an insurance policy, but if the officer was ordered, in respect of an event which could be indemnified, to pay an amount exceeding the amount he was paid by the insurer, the Company will indemnify him with the difference, subject to the amount of the indemnity for all the officers in the Company not exceeding \$150 million plus \$30 million in respect of legal expenses in Israel only, per claim, and in total for each year of insurance during the period of insurance.

The above resolutions were approved by the general meeting of the shareholders on May 16, 2005, and will be implemented on the date of closing the sale.

It should be noted that in May 2005, a shareholder in the Company (who holds approximately 0.12% of the Company's shares) filed a claim against the Company, the State of Israel, shareholders in the Company and officers who are entitled to insurance and indemnity as aforesaid, for grant of declaratory relief in that the aforementioned resolutions of the general meeting are void, since they were adopted unlawfully, and since the State has a personal interest in the resolution, and since grant of the indemnification is most exceptional and the insurance involves high costs. The Company filed its response to the claim, rejecting the allegations of the plaintiff.

- (3) On July 11, 2005, it was resolved to call a Special General Meeting of the shareholders of the Company on August 3, 2005, the agenda for which will be extension of the officers' insurance policy, including a run-off option for a period of up to 4 months, at a cost of \$112,500 per month.

Notes to the Financial Statements as at June 30, 2005

**NOTE 8 – REVENUES FROM COMMUNICATION SERVICES**

|  | For the six-month period<br>ended June 30 |                  | For the three-month<br>period ended June 30 |                  | For the year ended<br>December 31 |
|--|---|------------------|---|------------------|-----------------------------------|
|  | 2005                                      | 2004             | 2005  | 2004             | 2004                              |
|  | (Unaudited)                               | (Unaudited)      | (Unaudited)                                 | (Unaudited)      | (Audited)                         |
|  | NIS thousands                             |                  | NIS thousands                               |                  | NIS thousands                     |
| <b>Revenues from communication services –</b>      |   |                  |   |                  |                                   |
| Fixed-line communications - traffic                | 716,460                                   | 833,328          | 348,223                                     | 410,865          | 1,567,631                         |
| Fixed fees   | 1,267,564                                 | 1,230,016        | 643,194                                     | 616,883          | 2,501,250                         |
| Cellular telephone                                 | 1,823,987                                 | 1,050,893        | 896,623                                     | 533,541          | 2,699,876                         |
| International communications and internet services | 380,755                                   | 379,052          | 192,189                                     | 188,710          | 771,290                           |
| Multi-channel television                           | 576,136                                   | –                | 292,002                                     | –                | 529,838                           |
| Installation and sale of equipment to subscribers  | 557,740                                   | 326,479          | 275,705                                     | 159,373          | 825,390                           |
| Miscellaneous                                      | 70,314                                    | 37,547           | 19,244                                      | 21,026           | 89,448                            |
|  | <b>5,374,058</b>                          | <b>3,857,315</b> | <b>2,667,180</b>                            | <b>1,930,398</b> | <b>8,984,723</b>                  |
| Other revenues                                     | 126,440                                   | 163,466          | 60,195                                      | 81,162           | 285,081                           |
|  | <b>5,500,498</b>                          | <b>4,020,781</b> | <b>2,727,375</b>                            | <b>2,011,560</b> | <b>9,269,804</b>                  |

**NOTE 9 – OPERATING AND GENERAL EXPENSES**

|   | For the six-month period<br>ended June 30 |                  | For the three-month<br>period ended June 30 |                  | For the year ended<br>December 31 |
|---|---|------------------|---|------------------|-----------------------------------|
|   | 2005                                      | 2004             | 2005  | 2004             | 2004                              |
|   | (Unaudited)                               | (Unaudited)      | (Unaudited)                                 | (Unaudited)      | (Audited)                         |
|   | NIS thousands                             |                  | NIS thousands                               |                  | NIS thousands                     |
| <b>Salaries and incidental expenses –</b>             |   |                  |   |                  |                                   |
| Operations  | 875,475                                   | 717,481          | 437,879                                     | 351,410*         | 1,578,426                         |
| General and administrative                            | 326,697                                   | 244,314          | 164,254                                     | 129,462*         | 549,869                           |
| Total salaries and related expenses                   | 1,202,172                                 | 961,795          | 602,133                                     | 480,872          | 2,128,295                         |
| General expenses                                      | 613,743                                   | 368,960          | 314,229                                     | 190,825          | 996,323                           |
| Materials and spare parts                             | 499,155                                   | 271,444          | 242,609                                     | 132,877          | 643,013                           |
| Consumption of content from satellite services        | 202,251                                   | –                | 102,053                                     | –                | 200,469                           |
| Cellular telephone expenses                           | 477,642                                   | 251,425          | 223,121                                     | 124,530          | 700,890                           |
| Building maintenance                                  | 169,805                                   | 153,176          | 82,998                                      | 84,399           | 352,430                           |
| Services and maintenance by sub-contractors           | 210,637                                   | 136,275          | 104,876                                     | 66,740           | 341,999                           |
| International communications expenses                 | 130,121                                   | 103,491          | 66,094                                      | 57,721           | 228,936                           |
| Vehicle maintenance expenses                          | 81,164                                    | 60,748           | 41,078                                      | 31,023           | 144,630                           |
| Collection fees                                       | 24,755                                    | 18,911           | 12,682                                      | 10,153           | 39,357                            |
|   | <b>3,611,445</b>                          | <b>2,326,225</b> | <b>1,791,873</b>                            | <b>1,179,140</b> | <b>5,776,342</b>                  |
| Less – salaries charged to investment in fixed assets | 105,793                                   | 102,245          | 50,072                                      | 45,972           | 211,252                           |
|   | <b>3,505,652</b>                          | <b>2,223,980</b> | <b>1,741,801</b>                            | <b>1,133,168</b> | <b>5,565,090</b>                  |

\* Restated.

**Notes to the Financial Statements as at June 30, 2005**

**NOTE 10 – OTHER INCOME (EXPENSES), NET**

|  | For the six-month period<br>ended June 30 |             | For the three-month<br>period ended June 30 |             | For the year ended<br>December 31 |
|--|---|-------------|---|-------------|-----------------------------------|
|  | 2005                                      | 2004        | 2005  | 2004        | 2004                              |
|  | (Unaudited)                               | (Unaudited) | (Unaudited)                                 | (Unaudited) | (Audited)                         |
|  | NIS thousands                             |             | NIS thousands                               |             | NIS thousands                     |
| Provision for claims for salary and pension components   | -   | (30,000)    | -   | -           | 207,000                           |
| Provision for employee severance benefits upon early retirement  | <b>83,000</b>                             | -           | <b>90,000</b>                               | -           | (105,000)                         |
| Provision for impairment and other liabilities in respect of the value of investments in other companies | <b>(4,700)</b>                            | -           | <b>(4,700)</b>                              | -           | (26,000)                          |
| Compensation in respect of a settlement agreement  | <b>14,483</b>                             | -           | -   | -           | -                                 |
| Amortization of goodwill   | <b>(46,559)</b>                           | (364)       | <b>(23,729)</b>                             | (364)       | (35,135)                          |
| Capital gain from sale of operation (1)  | <b>103,869</b>                            | -           | <b>2,009</b>                                | -           | 35,033                            |
| Capital gains, net   | <b>2,749</b>                              | (396)       | <b>1,019</b>                                | (316)       | 7,338                             |
| Others   | <b>(100)</b>                              | 7,759       | <b>79</b>                                   | 8,131       | (3,556)                           |
|  | <b>152,742</b>                            | (23,001)    | <b>65,128</b>                               | 7,451       | 79,680                            |

- (1) Further to Note 9C to the 2004 financial statements concerning the sale of the Company's holdings in the satellite corporation Intelsat, the sale transaction was closed on January 28, 2005, at its original price. The capital gain in the full amount of the consideration was charged to the Statement of Operations in the first quarter of the year.

**NOTE 11 – INCOME TAX**

On July 25, 2005 the Knesset passed the Income Tax Ordinance Amendment Law (No. 147 Temporary Order), 5765-2005 ("the Amendment"), which prescribes a gradual reduction of the corporate tax rate from 34% to 25% in the following manner:

In the 2006 tax year the tax rate will be 31%, in 2007 it will be 29%, in 2008 it will be 27%, in 2009 it will be 26% and from 2010 onwards the tax rate will be 25%.

The current taxes and deferred tax balances as at June 30, 2005 are computed according to the old tax rates in effect prior to the above Amendment. The effect of the change on the consolidated financial statements is expected to be an increase of approximately NIS 45 million in the Company tax expenses on revenues in the statement of operations and a corresponding decrease in the deferred taxes included in the Company balance sheets and a corresponding effect of approximately NIS 40 million in the consolidated statements of operations and balance sheets.

Notes to the Financial Statements as at June 30, 2005

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. STATEMENTS OF OPERATIONS

|  | For the six-month period<br>ended June 30 |                     | For the three-month<br>period ended June 30 |                     | For the year ended<br>December 31 |
|--|---|---------------------|---|---------------------|-----------------------------------|
|  | 2005<br>(Unaudited)                       | 2004<br>(Unaudited) | 2005<br>(Unaudited)                         | 2004<br>(Unaudited) | 2004<br>(Audited)                 |
|  | NIS thousands                             |                     | NIS thousands                               |                     | NIS thousands                     |
| <b>Revenues (Note 12B)</b>   | <b>2,355,190</b>                          | 2,522,148           | <b>1,159,472</b>                            | 1,245,170           | 4,959,691                         |
| <b>Costs and expenses</b>  |   |                     |   |                     |                                   |
| Operating and general expenses<br>(Note 12C)   | <b>1,129,235</b>                          | 1,139,849           | <b>567,231</b>                              | 585,646             | 2,347,448                         |
| Depreciation   | <b>700,478</b>                            | 756,346             | <b>351,083</b>                              | 375,651             | 1,495,909                         |
| Royalties to the Government of<br>Israel   | <b>70,106</b>                             | 74,573              | <b>34,720</b>                               | 37,802              | 145,318                           |
|  | <b>1,899,819</b>                          | 1,970,768           | <b>953,034</b>                              | 999,099             | 3,988,675                         |
| Operating income   | <b>455,371</b>                            | 551,380             | <b>206,438</b>                              | 255,071             | 971,016                           |
| <b>Financing expenses, net</b>   | <b>(31,023)</b>                           | (31,234)            | <b>(25,096)</b>                             | (17,368)            | (93,216)                          |
| Earnings after financing expenses  | <b>424,348</b>                            | 520,146             | <b>181,342</b>                              | 237,703             | 877,800                           |
| <b>Other revenues (expenses), net</b>  | <b>199,400</b>                            | 28,357              | <b>88,629</b>                               | 1,575               | 109,904                           |
| Earnings before income tax   | <b>623,748</b>                            | 491,789             | <b>269,971</b>                              | 239,278             | 987,704                           |
| <b>Income tax</b>  | <b>(198,688)</b>                          | (228,871)           | <b>(95,642)</b>                             | (142,780)           | (387,079)                         |
| Earnings after income tax  | <b>425,060</b>                            | 262,918             | <b>174,329</b>                              | 96,498              | 600,625                           |
| <b>Company's equity in earnings<br/>(losses) of investee companies</b>                           | <b>3,950</b>                              | 11,305              | <b>(10,026)</b>                             | 9,803               | 20,200                            |
| Earnings before the cumulative effect<br>of change in accounting method                          | <b>429,010</b>                            | 274,223             | <b>164,303</b>                              | 106,301             | 620,825                           |
| <b>Cumulative effect of change in<br/>accounting method as at the<br/>beginning of the year*</b> | <b>15,000</b>                             | –                   | –   | –                   | –                                 |
| Net earnings   | <b>444,010</b>                            | 274,223             | <b>164,303</b>                              | 106,301             | 620,825                           |

\* See Note 2B

Notes to the Financial Statements as at June 30, 2005

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. REVENUES FROM COMMUNICATION SERVICES

|   | For the six-month period ended June 30 |             | For the three-month period ended June 30 |             | For the year ended December 31 |
|---|--|-------------|--|-------------|--------------------------------|
|   | 2005                                   | 2004        | 2005                                     | 2004        | 2004                           |
|   | (Unaudited)                            | (Unaudited) | (Unaudited)                              | (Unaudited) | (Audited)                      |
|   | NIS thousands                          |             | NIS thousands                            |             | NIS thousands                  |
| Fixed-line domestic communications -                                |  |             |  |             |                                |
| Traffic   | 744,070                                | 839,487     | 363,610                                  | 413,510     | 1,590,671                      |
| Fixed fees  | 1,190,425                              | 1,169,069   | 604,531                                  | 583,715     | 2,354,700                      |
| Total revenues from fixed-line communications                       | 1,934,495                              | 2,008,556   | 968,141                                  | 997,225     | 3,945,371                      |
| Cellular telephone  | 185,466                                | 219,268     | 92,806                                   | 112,201     | 414,740                        |
| International communications  | 53,978                                 | 66,015      | 25,459                                   | 31,131      | 126,856                        |
| Installation and sale of equipment to subscribers and miscellaneous | 74,274                                 | 127,665     | 20,099                                   | 63,353      | 266,980                        |
|   | 2,248,213                              | 2,421,504   | 1,106,505                                | 1,203,910   | 4,753,947                      |
| Other revenues  | 106,977                                | 100,644     | 52,967                                   | 50,260      | 205,744                        |
|   | 2,355,190                              | 2,522,148   | 1,159,472                                | 1,254,170   | 4,959,691                      |

C. OPERATING AND GENERAL EXPENSES

|   | For the six-month period ended June 30 |             | For the three-month period ended June 30 |             | For the year ended December 31 |
|---|--|-------------|--|-------------|--------------------------------|
|   | 2005                                   | 2004        | 2005                                     | 2004        | 2004                           |
|   | (Unaudited)                            | (Unaudited) | (Unaudited)                              | (Unaudited) | (Audited)                      |
|   | NIS thousands                          |             | NIS thousands                            |             | NIS thousands                  |
| Salaries and related expenses –                       |  |             |  |             |                                |
| Operations  | 552,371                                | 562,908     | 274,904                                  | 272,185     | 1,122,381                      |
| General and administrative                            | 136,773                                | 135,955     | 68,133                                   | 77,982      | 271,310                        |
| Total salaries and related expenses                   | 689,144                                | 698,863     | 343,037                                  | 350,167     | 1,393,691                      |
| General expenses                                      | 154,034                                | 157,493     | 80,274                                   | 79,176      | 341,977                        |
| Materials and spare parts                             | 38,375                                 | 62,795      | 17,485                                   | 33,067      | 114,443                        |
| Building maintenance                                  | 153,088                                | 140,392     | 74,862                                   | 78,355      | 315,074                        |
| Services and maintenance by sub-contractors           | 102,987                                | 102,791     | 52,846                                   | 49,267      | 205,192                        |
| International communications expenses                 | 9,875                                  | 9,340       | 4,800                                    | 5,030       | 27,105                         |
| Vehicle maintenance expenses                          | 57,407                                 | 51,726      | 28,977                                   | 26,409      | 111,359                        |
| Collection fees                                       | 18,238                                 | 18,694      | 9,441                                    | 10,147      | 36,904                         |
|   | 1,223,148                              | 1,242,094   | 611,722                                  | 631,618     | 2,545,745                      |
| Less– salaries charged to investments in fixed assets | 93,913                                 | 102,245     | 44,491                                   | 45,972      | 198,297                        |
|   | 1,129,235                              | 1,139,849   | 567,231                                  | 585,646     | 2,347,448                      |

**Notes to the Financial Statements as at June 30, 2005**

**NOTE 13 – BUSINESS SEGMENTS**

The Company and the investee companies operate in various segments of the communications sector. Data on activities by segment are stated according to the segments of operation of those companies.

**For the six-month period ended June 30, 2005**

|                                   | <b>Domestic fixed<br/>line<br/>communications</b> | <b>Cellular<br/>telephone</b> | <b>International<br/>communications<br/>and Internet<br/>services</b> | <b>Multi-<br/>channel<br/>television</b> | <b>Others</b>  | <b>Adjustments</b> | <b>Consolidated</b> |
|-----------------------------------|---|-------------------------------|---|--|----------------|--------------------|---------------------|
| <b>Revenues</b>                   |   |                               |   |  |                |                    |                     |
| Revenues from<br>external sources | 2,220,879   | 2,204,227                     | 392,789   | 576,136                                  | 106,467        | –                  | 5,500,498           |
| Inter-segment<br>revenues         | 134,311   | 7,565                         | 9,754   | 8,797                                    | 60,817         | (221,244)          | –                   |
| <b>Total revenues</b>             | <b>2,355,190</b>                                  | <b>2,211,792</b>              | <b>402,543</b>  | <b>584,933</b>                           | <b>167,284</b> | <b>(221,244)</b>   | <b>5,500,498</b>    |
| <b>Segment results*</b>           | <b>455,371</b>                                    | <b>254,320</b>                | <b>42,884</b>   | <b>(49,793)</b>                          | <b>576</b>     | <b>–</b>           | <b>703,358</b>      |

**For the six-month period ended June 30, 2004**

|                                   | <b>Domestic fixed<br/>line<br/>communications</b> | <b>Cellular<br/>telephone</b> | <b>International<br/>communications<br/>and Internet<br/>services</b> | <b>Multi-<br/>channel<br/>television</b> | <b>Others</b>  | <b>Adjustments</b> | <b>Consolidated</b> |
|-----------------------------------|---|-------------------------------|---|--|----------------|--------------------|---------------------|
| <b>Revenues</b>                   |   |                               |   |  |                |                    |                     |
| Revenues from<br>external sources | 2,420,696   | 1,074,786                     | 396,638   | –  | 128,661        | –                  | 4,020,781           |
| Inter-segment<br>revenues         | 101,452   | 3,126                         | 4,405   | –  | 22,623         | (131,606)          | –                   |
| <b>Total revenues</b>             | <b>2,522,148</b>                                  | <b>1,077,912</b>              | <b>401,043</b>  | <b>–</b>                                 | <b>151,284</b> | <b>(131,606)</b>   | <b>4,020,781</b>    |
| <b>Segment results*</b>           | <b>551,380</b>                                    | <b>140,007</b>                | <b>66,559</b>   | <b>–</b>                                 | <b>4,005</b>   | <b>–</b>           | <b>761,951</b>      |

\* Segment results do not include Other income (expenses), net, as stated in Note 10.

Notes to the Financial Statements as at June 30, 2005

NOTE 13 – BUSINESS SEGMENTS (CONTD.)

For the three-month period ended June 30, 2005

|                                   | Domestic fixed<br>line<br>communications | Cellular<br>telephone | International<br>communications<br>and Internet<br>services | Multi-<br>channel<br>television | Others | Adjustments | Consolidated |
|-----------------------------------|--|-----------------------|---|---------------------------------|--------|-------------|--------------|
| <b>Revenues</b>                   |  |                       |   |                                 |        |             |              |
| Revenues from<br>external sources | 1,088,439                                | 1,097,947             | 198,977   | 291,742                         | 50,270 | –           | 2,727,375    |
| Inter-segment<br>revenues         | 71,033                                   | 3,524                 | 4,395   | 4,529                           | 33,571 | (117,052)   | –            |
| Total revenues                    | 1,159,472                                | 1,101,471             | 203,372   | 296,271                         | 83,841 | (117,052)   | 2,727,375    |
| <b>Segment results*</b>           | 206,438                                  | 133,051               | 22,367  | (25,340)                        | 629    | –           | 337,145      |

For the three-month period ended June 30, 2004

|                                   | Domestic fixed<br>line<br>communications | Cellular<br>telephone | International<br>communications<br>and Internet<br>services | Multi-<br>channel<br>television | Others | Adjustments | Consolidated |
|-----------------------------------|--|-----------------------|---|---------------------------------|--------|-------------|--------------|
| <b>Revenues</b>                   |  |                       |   |                                 |        |             |              |
| Revenues from<br>external sources | 1,203,825                                | 541,125               | 203,075   | –                               | 63,535 | –           | 2,011,560    |
| Inter-segment<br>revenues         | 50,345                                   | 1,654                 | 358   | –                               | 13,095 | (65,452)    | –            |
| Total revenues                    | 1,254,170                                | 542,779               | 203,433   | –                               | 76,630 | (65,452)    | 2,011,560    |
| <b>Segment results*</b>           | 255,071                                  | 73,197                | 32,010  | –                               | 2,428  | –           | 362,706      |

For the year ended December 31, 2004

|                                   | Domestic fixed<br>line<br>communications | Cellular<br>telephone | International<br>communications<br>and Internet<br>services | Multi-<br>channel<br>television | Others  | Adjustments | Consolidated |
|-----------------------------------|--|-----------------------|---|---------------------------------|---------|-------------|--------------|
| <b>Revenues</b>                   |  |                       |   |                                 |         |             |              |
| Revenues from<br>external sources | 4,736,756                                | 2,966,486             | 797,735   | 529,838                         | 238,989 | –           | 9,269,804    |
| Inter-segment<br>revenues         | 222,935                                  | 8,493                 | 18,704  | 12,304                          | 80,387  | (342,823)   | –            |
| Total revenues                    | 4,959,691                                | 2,974,979             | 816,439   | 542,142                         | 319,376 | (342,823)   | 9,269,804    |
| <b>Segment results*</b>           | 971,016                                  | 379,328               | 118,223   | (85,381)                        | 8,362   | –           | 1,391,548    |

\* Segment results do not include Other income (expenses), net, as stated in Note 10.

Notes to the Financial Statements as at June 30, 2005

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD.**

**1. PELEPHONE COMMUNICATIONS LTD.**

**A. Balance sheet**

|                                  | <b>June 30<br/>2005</b> | <b>June 30<br/>2004</b> | <b>December 31<br/>2004</b> |
|----------------------------------|-------------------------|-------------------------|-----------------------------|
|                                  | <b>(Unaudited)</b>      | <b>(Unaudited)</b>      | <b>(Audited)</b>            |
|                                  | <b>NIS thousands</b>    | <b>NIS thousands</b>    | <b>NIS thousands</b>        |
| Current assets                   | <b>1,632,512</b>        | 1,325,899               | 1,413,049                   |
| Long-term trade receivables      | <b>321,600</b>          | 232,998                 | 278,778                     |
| Investment in investee companies | <b>4,283</b>            | 4,996                   | 4,084                       |
| Deferred income tax              | <b>51,129</b>           | 158,180                 | 106,503                     |
| Fixed assets, net                | <b>3,061,145</b>        | 2,931,469               | 3,093,675                   |
| Other assets                     | <b>330,053</b>          | 368,394                 | 334,028                     |
|                                  | <b>5,400,722</b>        | 5,021,936               | 5,230,117                   |
| Current liabilities              | <b>1,378,262</b>        | 1,962,997               | 1,794,413                   |
| Long-term liabilities            | <b>1,750,652</b>        | 1,050,458               | 1,305,674                   |
| Shareholders' equity             | <b>2,271,808</b>        | 2,008,481               | 2,130,030                   |
|                                  | <b>5,400,722</b>        | 5,021,936               | 5,230,117                   |

Notes to the Financial Statements as at June 30, 2005

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)**

**1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)**

**B. Statement of Operations**

|  | For the six-month<br>period ended June 30 |             | For the three-month<br>period ended June 30 |             | For the year ended<br>December 31 |
|--|---|-------------|---|-------------|-----------------------------------|
|  | 2005                                      | 2004        | 2005  | 2004        | 2004                              |
|  | (Unaudited)                               | (Unaudited) | (Unaudited)                                 | (Unaudited) | (Audited)                         |
|  | NIS thousands                             |             | NIS thousands                               |             | NIS thousands                     |
| Revenues from Pelephone services, sales and services | 2,211,792                                 | 2,155,823   | 1,101,471                                   | 1,085,559   | 4,412,344                         |
| Cost of Pelephone services, sales and services       | 1,686,130                                 | 1,572,966*  | 826,979                                     | 788,345*    | 3,258,877*                        |
| Gross profit   | 525,662                                   | 582,857     | 274,492                                     | 297,214     | 1,153,467                         |
| Sales and marketing expenses                         | 215,172                                   | 236,853*    | 110,192                                     | 120,612*    | 470,408*                          |
| General and administrative expenses                  | 49,968                                    | 67,389*     | 25,051                                      | 30,905*     | 123,935*                          |
| Operating income                                     | 260,522                                   | 278,615     | 139,249                                     | 145,697     | 559,124                           |
| Financing expenses, net                              | (39,448)                                  | (62,944)    | (29,321)                                    | (39,234)    | (99,597)                          |
| Other income, net                                    | 107                                       | 2,872       | 65  | 5,617       | 3,645                             |
| Earnings before income tax                           | 221,181                                   | 218,543     | 109,993                                     | 112,080     | 463,172                           |
| Income tax   | (72,995)                                  | (73,800)    | (36,393)                                    | (36,000)    | (153,400)                         |
| Earnings after income tax                            | 148,186                                   | 144,743     | 73,600                                      | 76,080      | 309,772                           |
| Company's equity in losses of an affiliate           | (6,408)                                   | (3,282)     | (2,904)                                     | (876)       | (9,080)                           |
| Net earnings   | 141,778                                   | 141,461     | 70,696                                      | 75,204      | 300,692                           |

\* Restated

Notes to the Financial Statements as at June 30, 2005

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)**

**2. DBS SATELLITE SERVICES (1998) LTD.**

**A. Balance sheet**

|                          | <b>June 30<br/>2005<br/>(Unaudited)<br/>NIS thousands</b> | <b>June 30<br/>2004<br/>(Unaudited)<br/>NIS thousands</b> | <b>December 31<br/>2004<br/>(Audited)<br/>NIS thousands</b> |
|--------------------------|---|---|---|
| Current assets           | <b>137,105</b>  | 111,184   | 124,393   |
| Broadcasting rights, net | <b>159,613</b>  | 122,980   | 140,496   |
| Fixed assets, net        | <b>1,078,155</b>  | 1,081,071   | 1,102,066   |
|                          | <b>1,374,873</b>  | 1,315,235   | 1,366,955   |
| Current liabilities      | <b>604,918</b>  | 1,910,456   | 595,229   |
| Long-term liabilities    | <b>1,348,381</b>  | 20,862  | 1,299,138   |
| Loans from shareholders  | <b>2,764,591</b>  | 2,418,194   | 2,661,540   |
| Capital deficit          | <b>(3,343,017)</b>  | (3,034,277)   | (3,188,952)   |
|                          | <b>1,374,873</b>  | 1,315,235   | 1,366,955   |

## Notes to the Financial Statements as at June 30, 2005

## NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

## 2. DBS SATELLITE SERVICES (1998) LTD. (CONTD.)

## B. Statement of Operations

|                                     | For the six-month<br>period ended June 30 |             | For the three-month<br>period ended June 30 |             | For the year ended<br>December 31 |
|-------------------------------------|---|-------------|---|-------------|-----------------------------------|
|                                     | 2005                                      | 2004        | 2005  | 2004        | 2004                              |
|                                     | (Unaudited)                               | (Unaudited) | (Unaudited)                                 | (Unaudited) | (Audited)                         |
|                                     | NIS thousands                             |             | NIS thousands                               |             | NIS thousands                     |
| Revenues                            | <b>584,933</b>                            | 485,870     | <b>296,271</b>                              | 250,082     | 1,027,992                         |
| Operating expenses                  | <b>523,797</b>                            | 498,853     | <b>267,382</b>                              | 236,606     | 1,013,403                         |
| Operating income (loss)             | <b>61,136</b>                             | (12,983)    | <b>28,889</b>                               | 13,476      | 14,589                            |
| Sales and marketing expenses        | <b>66,707</b>                             | 60,773      | <b>33,284</b>                               | 32,884      | 133,511                           |
| General and administrative expenses | <b>37,990</b>                             | 36,058      | <b>17,846</b>                               | 17,266      | 72,240                            |
|                                     | <b>104,697</b>                            | 96,831      | <b>51,130</b>                               | 50,150      | 205,751                           |
| Operating loss                      | <b>(43,561)</b>                           | (109,814)   | <b>(22,241)</b>                             | (36,674)    | (191,162)                         |
| Financing expenses, net             | <b>(100,801)</b>                          | (94,304)    | <b>(61,382)</b>                             | (58,468)    | (171,522)                         |
| Other income (expenses), net        | <b>(88)</b>                               | (1,370)     | <b>(8)</b>                                  | 17          | (3,200)                           |
| Net loss                            | <b>(144,450)</b>                          | (205,488)   | <b>(83,631)</b>                             | (95,125)    | (365,884)                         |

Notes to the Financial Statements as at June 30, 2005

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)**

**3. BEZEQ INTERNATIONAL LTD.**

**A. Balance sheet**

|  | <b>June 30<br/>2005<br/>(Unaudited)<br/>NIS thousands</b> | <b>June 30<br/>2004<br/>(Unaudited)<br/>NIS thousands</b> | <b>December 31<br/>2004<br/>(Audited)<br/>NIS thousands</b> |
|--|---|---|---|
| Current assets                           | <b>285,371</b>  | 168,008*  | 223,302*  |
| Long-term investments and debit balances | <b>28,194</b>   | 27,503*   | 26,684*   |
| Fixed assets                             | <b>326,519</b>  | 373,650   | 355,439   |
| Other assets                             | <b>16,522</b>   | 11,099  | 18,106  |
|  | <b>656,606</b>  | 581,260   | 623,531   |
| Current liabilities                      | <b>220,766</b>  | 249,817   | 239,133   |
| Long-term liabilities                    | <b>183,614</b>  | 183,424   | 181,982   |
| Shareholders' equity                     | <b>252,226</b>  | 148,019   | 202,416   |
|  | <b>656,606</b>  | 581,260   | 623,531   |

\* Restated.

Notes to the Financial Statements as at June 30, 2005

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)**

**3. BEZEQ INTERNATIONAL LTD. (CONTD.)**

**B. Statement of Operations**

|  | For the six-month<br>period ended June 30 |             | For the three-month<br>period ended June 30 |             | For the year ended<br>December 31 |
|--|---|-------------|---|-------------|-----------------------------------|
|  | 2005                                      | 2004        | 2005  | 2004        | 2004                              |
|  | (Unaudited)                               | (Unaudited) | (Unaudited)                                 | (Unaudited) | (Audited)                         |
|  | NIS thousands                             |             | NIS thousands                               |             | NIS thousands                     |
| Revenues from international telecommunication services | 402,543                                   | 401,043     | 203,372                                     | 203,433     | 816,439                           |
| Operating expenses                                     | 266,472                                   | 246,949*    | 133,637                                     | 128,373*    | 506,779*                          |
| Gross profit   | 136,071                                   | 154,094     | 69,735                                      | 75,060      | 309,660                           |
| Marketing, general and administrative expenses         | 93,187                                    | 88,435*     | 47,368                                      | 43,950*     | 191,437*                          |
| Operating income                                       | 42,884                                    | 65,659      | 22,367                                      | 31,110      | 118,223                           |
| Financing expenses, net                                | (3,563)                                   | (3,687)     | (1,974)                                     | (581)       | (4,301)                           |
| Earnings after financing, net                          | 39,321                                    | 61,972      | 20,393                                      | 30,529      | 113,922                           |
| Other revenues (expenses), net                         | 46  | 4,583       | (294)                                       | 3,416       | 4,656                             |
| Earnings before income tax                             | 39,367                                    | 66,555      | 20,099                                      | 33,945      | 118,578                           |
| Tax benefit (Income tax)                               | 9,978                                     | (454)       | 3,200                                       | (131)       | 822                               |
| Earnings after income tax                              | 49,345                                    | 66,101      | 23,299                                      | 33,814      | 119,400                           |
| Company's equity in earnings of an affiliated company  | 1,297                                     | 838         | 1,093                                       | 307         | 1,440                             |
| Net earnings   | 50,642                                    | 66,939      | 24,392                                      | 34,121      | 120,840                           |

\* Restated.

24 July, 2005  
17 Tammuz, 5765

Bezeq, The Israel Telecommunications Corp. Ltd.  
15 Hazvi Street  
Jerusalem

Dear Sir,

Re: Reserve in respect of early retirement  
for the balance sheet as at 30<sup>th</sup> June 2005

**Actuarial Qualifications**

Name: David Engelmayer, Actuary  
Education: Qualified actuary – Fellow of the Society of Actuaries in the USA  
Member of the Academy of Actuaries in the U.S.A.  
Full member of the Association of Actuaries in Israel  
M.Sc. in Applied Mathematics, Columbia University, New York  
Consent: The actuary consents to publication of the reserve for early retirement

**General**

As requested, we have prepared a calculation for the liability of Bezeq with regard to future early retirements. Currently there remain 922 employees in the potential group, of whom 462 are transferred workers and 460 are not transferred workers (compared to 987 potential retirees at the last valuation, of whom 492 were transferred workers and 495 were not transferred workers). As directed by you, we used a table of remaining expected early retirement for 526 employees under the early retirement agreement reached with the Workers Committee. Of these 526 retirees, 109 will be non-transferred workers and 417 will be transferred workers.

This calculation does not relate to other types of retirement, such as retirement due to death or disability. The calculation was prepared on the basis of data supplied to us, relying on the data and principles of the calculation in the aforementioned agreement.

The retirement schedule for the 526 employees is:

| Retirement Year | Retirees   | Retirees (previous valuation) |
|-----------------|------------|-------------------------------|
| 2005            | 112        | 123                           |
| 2006            | 200        | 200                           |
| 2007            | 100        | 100                           |
| 2008            | 114        | 118                           |
| <b>Total</b>    | <b>526</b> | <b>546</b>                    |

The retirement of the transferred workers and non-transferred workers is proportional to the total (i.e. about 80% transferred and 20% not transferred), for each calendar year.

The actuarial obligation was calculated using a statistical model which reflects the average expected early retirement costs in each future year.

### **Effects of the pension reform**

The pension agreement provides two systems for determining pension rights for retirees among the transferred workers:

Track A – which was determined on the basis of the assessment pension rules in the civil service, i.e. the pension will be determined on the basis of the average of the grades in the last three years prior to the retirement and updated according to the rules for civil servants. The pension in this track is linked to the cost-of-living increments and the wage agreements in the economy.

Track B – was determined on the basis of the Makefet bylaws, i.e. it sets the pension according to a relative salary average called the "averages method", taking into account the best 25 years (hereinafter: "**the Averages Method**"). A pension in this track is linked to the CPI on the dates on which a cost-of-living increment was given in the economy.

In June 2003, as part of the reform of the pension funds, the Knesset passed a law that cancels agreements that benefit the workers and the employers. This included cancellation of the calculation formulae that had applied until the date of the reform between Bezeq and the Makefet Fund, which regulate the accounting in respect of a worker taking early retirement.

In the litigation between Bezeq, the Capital Market, Insurance and Savings Division of the Ministry of Finance and the Makefet Pension Fund, the parties reached consensus that for the population that retired up to 01.10.2003 (exclusive) the same cost calculation method would apply as for those who retired prior to 01.06.2003. Makefet, for its part, agreed to recognize the company's retirees after 1.10.2003 as pensioners of the Fund if the company would pay the costs in accordance with circulars 2000/1 and 2004/8 of the Capital Markets Division.

Starting on 1.10.2003, the standard bylaws apply to members of the Makefet Fund, and the Makefet Fund, for its part, may not grant benefits beyond the standard bylaws. This includes the matter of CPI linkage.

Several principal points from the pension fund reform:

- Cancellation of the Bezeq-Makefet agreement (the alpha formulae).

- The retirement age for men and women will rise gradually to 67 and 64 respectively. The pace of the rise is as determined in the memorandum of understandings between the Ministry of Finance and the trade unions from 5.1.2004.
- Contributions will rise gradually, for the worker from 5.5% to 7% and for the employer from 12% to 13.5%.
- The rights of the workers will be calculated by the Averages Method according to the 35 best years only (cancellation of Track A).
- The worker will pay up to 1.75% management fees from any pension, on a graduated scale (this does not affect the cost of early retirement).
- The pension will be inflation adjusted only after a cumulative inflation increase of 4.25% or every two years – whichever is the earlier.

At the beginning of July 2005, an agreement was signed between Bezeq and Harel Insurance Company, whereby Bezeq makes a single payment to Harel at the time of retirement of each employee and Harel takes responsibility for the payment of the old-age and survivors pensions to the early retirees, as detailed below. Bezeq will freeze contributions to the Makefet pension fund in respect of those employees who take early retirement according to this agreement.

- Early retirement pension – from the date of the early retirement of the employee until their reaching the statutory retirement age (as defined in the Retirement Age Law, 5764-2004), Harel will pay the retiree a monthly pension according to the amount defined by Bezeq.
- Old age pension – from the month after reaching statutory retirement age, Harel will pay a monthly pension to the retiree, whose sum is the difference between the pension set according to Bezeq and the pension being received from the Makefet Pension Fund under the standard bylaws governing the old pension funds (as defined by the Ministry of Finance).
- Survivors' pension – following the death of the retiree, Harel will pay a pension equal to 60% of the old-age pension (i.e. the difference between the Bezeq and the Makefet pensions) to the spouse of the retiree. Each orphan under age 21 will receive 20% of the old-age pension, up to a maximum of 100% of the basic old-age pension for the spouse and orphans combined. In the event that the 100% limit will be passed, the orphans' share (40%) will be divided equally according to the number of eligible orphans. When an orphan reaches age 21, the orphans' share is reallocated for orphans of a transferred employee, and is not reallocated for the orphans of a non-transferred employee. In the event there is no spouse, each orphan receives a double-share (viz. 40%), while the 100% limit remains in effect.
- All pensions are linked to the inflation index as defined by the pension fund regulations.

This agreement forms the basis of the future costs for Bezeq of future early retirement.

### **Calculation assumptions**

- The agreement between Bezeq and Harel for early retirements (formulae reflecting the agreement can be found as an appendix to the agreement).
- Retirement age: rising to 64/67 in accordance with the Retirement Age Law 5764 – 2004.
- Discount rate: in order to calculate the costs according to the Bezeq-Harel agreement (which specifies that the interest rate varies in line with the duration of the liabilities for each individual employee) we calculated the duration of each individual's liability using a 4% interest rate. The gross interest rate for discounting was then found by linear interpolation of the net redemption yields of the two government bonds with modified durations closest to that of the liability. (A table of government bonds with modified durations and net redemption yields is attached as Appendix Two.) The gross interest thus found was reduced in line with the spread specified by the agreement to arrive at the net interest rate for discounting. For 2005 retirees only, in the event the calculated liability for an employee was within 3 years of the modified duration of the government bond ("Galil" series) with the highest duration, then this duration was used as the gross interest rate.
- Management fees (from pension payments): 1% in 2005, 1.5% in 2006 and 1.75% from 2007 onwards.
- Service costs: according to agreement with Harel
- Mortality: as per circular 2000/1
- Marriage percentage, age differences, orphans: according to employees' actual data.
- Parents: none.
- Retirement grants according to an agreement between the Workers Committee and Bezeq from 2000.
- Salary increases in Track A at 4% per year up to early retirement. Additionally, in keeping with Bezeq's instructions, we have assumed an immediate one-off 1.9% increase in Track A salaries.<sup>1</sup>
- Salary increases in Track B at 1.5% per year up to early retirement<sup>2</sup>
- A worker may take early retirement only if he has accumulated 20 years seniority and he is more than 50 years old.
- The distribution of transferred / non-transferred workers is 421 transferred employees and 105 non-transferred employees.
- Every year, the retirees retire on 1 July of that year, with the exception of 2005 when the retirements are assumed to occur on 1<sup>st</sup> October, as per Bezeq's instructions.
- Under the standard bylaws, the average wage in the economy does not continue to increase for the purpose of determining the pension of a "frozen" member of the pension fund, but is linked to the inflation index only.
- The "bonus" in accrued pension for Track A is based on full (100%) employment.
- Non-transferred employees' accrued pension percent is calculated, for the purpose of calculating the pension according to Bezeq, using the old tables of the pension fund (Aleph-Tet), according to each individual employee's table, and not using the accrual table of the standard bylaws.
- Pension accrual in Makefet pension fund according to the table in Appendix Bet of the standard bylaws and the standard bylaws.

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<sup>1</sup> Needed for calculating pension according to Bezeq.

<sup>2</sup> Needed for calculating pension according to Bezeq and Makefet.

### **Results of the calculation**

- In the previous quarter the early retirement costs for 546 employees retiring between 2005-2008 according to the division given in the table above, was 833.2 million NIS (676.4 million NIS for pensions, 153.8 million NIS for retirement grants and 3.0 million NIS for standard deviation).
- In the current quarter the early retirement costs, using the same assumptions as the previous quarter, for 526 employees retiring between 2005-2008 according to the division given in the table above, are 797.4 million NIS (646.1 million NIS for pensions, 148.2 million NIS for retirement grants and 3.0 million NIS for standard deviation). The difference derives mainly from the reduction in the number of future retirees.
- In the current quarter the early retirement costs, according to the agreement between Bezeq and Harel, for 526 employees retiring between 2005-2008 according to the division given in the table above, are 691.1 million NIS (540.0 million NIS payment to Harel, 148.1 million NIS for retirement grants and 3.0 million NIS for standard deviation). Detailed results can be found in Appendix One.

We have added one standard deviation to the assessment in respect of uncertainty of who are the workers who will actually retire and when during the year they will retire.<sup>3</sup> In future valuations we expect there to be a further element of variability due to the dependence on market interest rates. In accordance with accounting principles, no extra reserve has been allocated to stabilize the reserves in spite of future interest rate movements.

There is a group of 376 employees who have already retired from Bezeq, for whom no payment has yet been made to Harel under the terms of the Bezeq-Harel agreement. We performed a valuation for these employees, under the same assumptions listed above, with the exception of the retirement date, which was here assumed to be 1<sup>st</sup> July. Under this valuation the expected cost to Bezeq for these retirees is 347.3 million NIS. Detailed results can be found in Appendix Three.

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<sup>3</sup> We note that use of an average as a cost estimate is on the conservative side as the approach of Bezeq is to offer early retirement to the longer-serving employees in the potential population. The cost of early retirement for long-serving employees, despite the higher salary, is lower because the time to official retirement is shorter.

**Miscellaneous – Comparison of quarterly data**

- The salary for Track A rose by an average of 0.6%, which is lower than the model's assumed 4% p.a.
- The salary for Track B rose by an average of 0.8%, which is higher than the model's assumed 1.5% p.a.
- The employees' seniority increased by a quarter of a year for all employees.
- The salary for Histaglut grant fell by 1% on average, whilst for the other grants the salary rose by 0.8% on average, which is lower than the model's assumed 4% p.a.

Yours sincerely,

David Engelmayer, Actuary

**Appendix One: Assessment of balance sheet reserve – according to the Bezeq-Harel agreement**

Potential Pool Of Early Retirees

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**Scheduled Leaves:**

| Retire Year  | Total Leaves | Senior Management |              |              | Transferred Employees |              |              | Non-Transferred Employees |              |              | Total     |              |              |               |
|--------------|--------------|-------------------|--------------|--------------|-----------------------|--------------|--------------|---------------------------|--------------|--------------|-----------|--------------|--------------|---------------|
|              |              | Number            | Reserve      | Ma'anak      | Number                | Reserve      | Ma'anak      | Number                    | Reserve      | Ma'anak      | Number    | Reserve      | Ma'anak      | Total         |
| 2005         | 112          | 0                 | 0.0 M        | 0.0 M        | 4                     | 4.9 M        | 1.3 M        | 2                         | 0.7 M        | 0.3 M        | 6         | 5.6 M        | 1.6 M        | 7.2 M         |
| 2006         | 200          | 0                 | 0.0 M        | 0.0 M        | 2                     | 2.2 M        | 0.6 M        | 2                         | 1.0 M        | 0.4 M        | 4         | 3.2 M        | 1.0 M        | 4.2 M         |
| 2007         | 100          | 0                 | 0.0 M        | 0.0 M        | 0                     | 0.0 M        | 0.0 M        | 0                         | 0.0 M        | 0.0 M        | 0         | 0.0 M        | 0.0 M        | 0.0 M         |
| 2008         | 114          | 0                 | 0.0 M        | 0.0 M        | 0                     | 0.0 M        | 0.0 M        | 0                         | 0.0 M        | 0.0 M        | 0         | 0.0 M        | 0.0 M        | 0.0 M         |
| <b>Total</b> | <b>526</b>   | <b>0</b>          | <b>0.0 M</b> | <b>0.0 M</b> | <b>6</b>              | <b>7.1 M</b> | <b>1.9 M</b> | <b>4</b>                  | <b>1.7 M</b> | <b>0.7 M</b> | <b>10</b> | <b>8.8 M</b> | <b>2.7 M</b> | <b>11.5 M</b> |

**Other Leaves:**

| Retire Year  | Total Leaves | Senior Management |              |              | Transferred Employees |                |                | Non-Transferred Employees |               |               | Total      |                |                |                |
|--------------|--------------|-------------------|--------------|--------------|-----------------------|----------------|----------------|---------------------------|---------------|---------------|------------|----------------|----------------|----------------|
|              |              | Number            | Reserve      | Ma'anak      | Number                | Reserve        | Ma'anak        | Number                    | Reserve       | Ma'anak       | Number     | Reserve        | Ma'anak        | Total          |
| 2005         | 112          | 0                 | 0.0 M        | 0.0 M        | 84                    | 97.9 M         | 26.9 M         | 22                        | 8.8 M         | 4.3 M         | 106        | 106.7 M        | 31.2 M         | 137.9 M        |
| 2006         | 200          | 0                 | 0.0 M        | 0.0 M        | 156                   | 184.5 M        | 47.8 M         | 40                        | 15.7 M        | 7.7 M         | 196        | 200.2 M        | 55.5 M         | 255.7 M        |
| 2007         | 100          | 0                 | 0.0 M        | 0.0 M        | 80                    | 96.6 M         | 23.6 M         | 20                        | 7.9 M         | 3.9 M         | 100        | 104.6 M        | 27.5 M         | 132.0 M        |
| 2008         | 114          | 0                 | 0.0 M        | 0.0 M        | 91                    | 110.9 M        | 26.8 M         | 23                        | 8.8 M         | 4.4 M         | 114        | 119.7 M        | 31.3 M         | 151.0 M        |
| <b>Total</b> | <b>526</b>   | <b>0</b>          | <b>0.0 M</b> | <b>0.0 M</b> | <b>411</b>            | <b>490.0 M</b> | <b>125.1 M</b> | <b>105</b>                | <b>41.2 M</b> | <b>20.4 M</b> | <b>516</b> | <b>531.2 M</b> | <b>145.5 M</b> | <b>676.6 M</b> |

**Total Leaves:**

| Retire Year  | Total Leaves | Senior Management |              |              | Transferred Employees |                |                | Non-Transferred Employees |               |               | Total      |                |                |                |
|--------------|--------------|-------------------|--------------|--------------|-----------------------|----------------|----------------|---------------------------|---------------|---------------|------------|----------------|----------------|----------------|
|              |              | Number            | Reserve      | Ma'anak      | Number                | Reserve        | Ma'anak        | Number                    | Reserve       | Ma'anak       | Number     | Reserve        | Ma'anak        | Total          |
| 2005         | 112          | 0                 | 0.0 M        | 0.0 M        | 88                    | 102.8 M        | 28.2 M         | 24                        | 9.5 M         | 4.6 M         | <b>112</b> | <b>112.3 M</b> | <b>32.8 M</b>  | <b>145.2 M</b> |
| 2006         | 200          | 0                 | 0.0 M        | 0.0 M        | 158                   | 186.7 M        | 48.4 M         | 42                        | 16.7 M        | 8.1 M         | <b>200</b> | <b>203.4 M</b> | <b>56.6 M</b>  | <b>259.9 M</b> |
| 2007         | 100          | 0                 | 0.0 M        | 0.0 M        | 80                    | 96.6 M         | 23.6 M         | 20                        | 7.9 M         | 3.9 M         | <b>100</b> | <b>104.6 M</b> | <b>27.5 M</b>  | <b>132.0 M</b> |
| 2008         | 114          | 0                 | 0.0 M        | 0.0 M        | 91                    | 110.9 M        | 26.8 M         | 23                        | 8.8 M         | 4.4 M         | <b>114</b> | <b>119.7 M</b> | <b>31.3 M</b>  | <b>151.0 M</b> |
| <b>Total</b> | <b>526</b>   | <b>0</b>          | <b>0.0 M</b> | <b>0.0 M</b> | <b>417</b>            | <b>497.1 M</b> | <b>127.0 M</b> | <b>109</b>                | <b>42.9 M</b> | <b>21.1 M</b> | <b>526</b> | <b>540.0 M</b> | <b>148.1 M</b> | <b>688.1 M</b> |

**Appendix Two – Bond Yields**

| <i>Series</i> | <i>Modified Duration</i> | <i>Redemption Yield</i> |
|---------------|--------------------------|-------------------------|
| Galil 5205    | 0.1616                   | 5.931%                  |
| Galil 5451    | 0.3288                   | 1.565%                  |
| Galil 5610    | 0.3288                   | 1.835%                  |
| Galil 5207    | 1.1370                   | 2.071%                  |
| Galil 5208    | 1.3862                   | 2.110%                  |
| Galil 4701    | 1.7998                   | 2.078%                  |
| Galil 5701    | 1.9599                   | 2.270%                  |
| Galil 4702    | 1.9642                   | 2.094%                  |
| Galil 5501    | 2.1086                   | 2.165%                  |
| Galil 4703    | 2.5079                   | 2.115%                  |
| Galil 5416    | 2.6716                   | 2.394%                  |
| Galil 5704    | 2.9086                   | 2.335%                  |
| Galil 5417    | 2.9358                   | 2.507%                  |
| Galil 5418    | 3.1874                   | 2.515%                  |
| Galil 5419    | 3.4363                   | 2.596%                  |
| Galil 5901    | 3.8061                   | 2.761%                  |
| Galil 5420    | 3.8490                   | 2.674%                  |
| Galil 5421    | 4.0084                   | 2.833%                  |
| Galil 5423    | 4.4166                   | 2.799%                  |
| Galil 5425    | 4.7255                   | 2.874%                  |
| Galil 5424    | 4.7551                   | 2.800%                  |
| Galil 5426    | 4.9780                   | 2.963%                  |
| Galil 5480    | 5.5323                   | 3.163%                  |
| Galil 5481    | 6.1830                   | 3.350%                  |
| Galil 5427    | 6.4968                   | 3.350%                  |
| Galil 5470    | 7.3543                   | 3.495%                  |
| Galil 5471x   | 8.1166                   | 3.715%                  |
| Galil 5472    | 8.2777                   | 3.725%                  |
| Galil 5903    | 11.7300                  | 4.049%                  |
| Galil 5904    | 13.2174                  | 4.083%                  |

**Appendix Three – Liability for employees who have already retired**

Potential Pool Of Early Retirees

376

**Scheduled Leaves:**

| Retire Year  | Total Leaves | Senior Management |         |         | Transferred Employees |         |         | Non-Transferred Employees |         |         | Total  |         |         |       |
|--------------|--------------|-------------------|---------|---------|-----------------------|---------|---------|---------------------------|---------|---------|--------|---------|---------|-------|
|              |              | Number            | Reserve | Ma'anak | Number                | Reserve | Ma'anak | Number                    | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005         | 376          | 0                 | 0.0 M   | 0.0 M   | 323                   | 328.8 M | 0.0 M   | 53                        | 18.4 M  | 0.0 M   | 376    | 347.3 M | 0.0 M   | 0.0 M |
| 2006         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2007         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2008         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| <b>Total</b> | 376          | 0                 | 0.0 M   | 0.0 M   | 323                   | 328.8 M | 0.0 M   | 53                        | 18.4 M  | 0.0 M   | 376    | 347.3 M | 0.0 M   | 0.0 M |

**Other Leaves:**

| Retire Year  | Total Leaves | Senior Management |         |         | Transferred Employees |         |         | Non-Transferred Employees |         |         | Total  |         |         |       |
|--------------|--------------|-------------------|---------|---------|-----------------------|---------|---------|---------------------------|---------|---------|--------|---------|---------|-------|
|              |              | Number            | Reserve | Ma'anak | Number                | Reserve | Ma'anak | Number                    | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2006         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2007         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2008         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| <b>Total</b> | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |

**Total Leaves:**

| Retire Year  | Total Leaves | Senior Management |         |         | Transferred Employees |         |         | Non-Transferred Employees |         |         | Total  |         |         |       |
|--------------|--------------|-------------------|---------|---------|-----------------------|---------|---------|---------------------------|---------|---------|--------|---------|---------|-------|
|              |              | Number            | Reserve | Ma'anak | Number                | Reserve | Ma'anak | Number                    | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005         | 376          | 0                 | 0.0 M   | 0.0 M   | 323                   | 328.8 M | 0.0 M   | 53                        | 18.4 M  | 0.0 M   | 376    | 347.3 M | 0.0 M   | 0.0 M |
| 2006         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2007         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| 2008         | 0            | 0                 | 0.0 M   | 0.0 M   | 0                     | 0.0 M   | 0.0 M   | 0                         | 0.0 M   | 0.0 M   | 0      | 0.0 M   | 0.0 M   | 0.0 M |
| <b>Total</b> | 376          | 0                 | 0.0 M   | 0.0 M   | 323                   | 328.8 M | 0.0 M   | 53                        | 18.4 M  | 0.0 M   | 376    | 347.3 M | 0.0 M   | 0.0 M |