

OFFERING CIRCULAR



The Israel Telecommunication Corp., Limited
(incorporated with limited liability in Israel)

€750,000,000
Euro Medium Term Note Programme

Under this €750,000,000 Euro Medium Term Note Programme (the "**Programme**"), BEZEQ — The Israel Telecommunication Corp., Limited ("**Bezeq**" or the "**Issuer**") may from time to time issue notes (the "**Notes**") denominated in any currency agreed between the Issuer and the relevant Dealer (as defined below). This Offering Circular supersedes the offering circular dated 19th December, 2002. Any Notes issued under the Programme on or after the date of this Offering Circular are issued subject to the provisions herein. This does not affect any Notes already issued.

The maximum aggregate nominal amount of all Notes from time to time outstanding under the Programme will not exceed €750,000,000 (or its equivalent in other currencies calculated as described herein), subject to increase as described herein.

The Notes may be issued on a continuing basis to one or more of the Dealers specified under "*Summary of the Programme*" and any additional Dealer appointed under the Programme from time to time by the Issuer (each a "**Dealer**" and together the "**Dealers**"), which appointment may be for a specific issue or on an ongoing basis. References in this Offering Circular to the "**relevant Dealer**" shall, in the case of an issue of Notes being (or intended to be) subscribed by more than one Dealer, be to all Dealers agreeing to subscribe for such Notes.

Application has been made to the Luxembourg Stock Exchange for Notes issued under the Programme during the period of 12 months from the date of this Offering Circular to be listed on the Luxembourg Stock Exchange. Notice of the aggregate nominal amount of Notes, interest (if any) payable in respect of Notes, the issue price of Notes and any other terms and conditions not contained herein which are applicable to each Tranche (as defined under "*Terms and Conditions of the Notes*") of Notes will be set out in a pricing supplement (the "**Pricing Supplement**") which, with respect to Notes to be listed on the Luxembourg Stock Exchange will be delivered to the Luxembourg Stock Exchange on or before the date of issue of the Notes of such Tranche.

The Programme provides that Notes may be listed on such other or further stock exchange(s) as may be agreed between the Issuer and the relevant Dealer. The Issuer may also issue unlisted Notes.

The Issuer may agree with any Dealer and Deutsche Trustee Company Limited (formerly called Bankers Trustee Company Limited) (the "**Trustee**") that Notes may be issued in a form not contemplated by the Terms and Conditions of the Notes herein, in which event (in the case of Notes intended to be listed on the Luxembourg Stock Exchange) a supplementary Offering Circular, if appropriate, will be made available which will describe the effect of the agreement reached in relation to such Notes.

Arrangers

Deutsche Bank

Merrill Lynch International

Dealers

ABN AMRO
Deutsche Bank
Morgan Stanley

Citigroup
Merrill Lynch International
UBS Investment Bank

The date of this Offering Circular is 18th December, 2003

The Issuer, having made all reasonable enquiries, confirms that the information contained in or incorporated into this Offering Circular is true and accurate in all material respects and is not misleading, that the opinions and intentions expressed in this Offering Circular are honestly held and that there are no other facts the omission of which would make this Offering Circular or any of such information or the expression of any such opinions or intentions misleading. The Issuer accepts responsibility accordingly.

This Offering Circular is to be read in conjunction with all documents which are deemed to be incorporated herein by reference (see "*Documents Incorporated by Reference*"). This Offering Circular shall be read and construed on the basis that such documents are incorporated and form part of this Offering Circular.

The Issuer is a company incorporated in Israel and its shares are listed on the Tel Aviv Stock Exchange ("**TASE**"). As such, the Issuer is subject to Israeli law and regulations and reporting requirements thereunder.

None of the Dealers or the Trustee has independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by the Dealers or the Trustee as to the accuracy or completeness of the information contained or incorporated in this Offering Circular or any other information provided by the Issuer in connection with the Programme. None of the Dealers or the Trustee accepts any liability in relation to the information contained or incorporated by reference in this Offering Circular or any other information provided by the Issuer in connection with the Programme.

No person is or has been authorised by the Issuer to give any information or to make any representation not contained in or not consistent with this Offering Circular or any other information supplied in connection with the Programme or the Notes and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, the Trustee or any of the Dealers.

Neither this Offering Circular nor any other information supplied in connection with the Programme or any Notes (i) is intended to provide the basis of any credit or other evaluation or (ii) should be considered as a recommendation by the Issuer, the Trustee or any of the Dealers that any recipient of this Offering Circular or any other information supplied in connection with the Programme or any Notes should purchase any Notes. Each investor contemplating purchasing any Notes should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer. Neither this Offering Circular nor any other information supplied in connection with the Programme or the issue of any Notes constitutes an offer or invitation by or on behalf of the Issuer or the Trustee or any of the Dealers to any person to subscribe for or to purchase any Notes.

Neither the delivery of this Offering Circular nor the offering, sale or delivery of any Notes shall in any circumstances imply that the information contained herein concerning the Issuer is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Programme is correct as of any time subsequent to the date indicated in the document containing the same. None of the Dealers or the Trustee expressly undertakes to review the financial condition or affairs of the Issuer during the life of the Programme or to advise any investor in the Notes of any information coming to its attention. Investors should review, *inter alia*, the most recently published documents incorporated by reference into this Offering Circular when deciding whether or not to purchase any Notes.

The Notes have not been and will not be registered under the United States Securities Act of 1933, as amended, (the "**Securities Act**") and are subject to U.S. tax law requirements. Subject to certain exceptions, Notes may not be offered, sold or delivered within the United States or to U.S. persons (see "*Subscription and Sale*").

This Offering Circular does not constitute an offer to sell or the solicitation of an offer to buy any Notes in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Offering Circular and the offer or sale of Notes may be restricted by law in certain jurisdictions. The Issuer, the Trustee and the Dealers do not represent that this Offering Circular may be lawfully distributed, or that any Notes may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer, the Trustee or the Dealers which would permit a public offering of any Notes or distribution of this document in any jurisdiction where action for that purpose is required. Accordingly, no Notes may be offered or sold, directly or indirectly, and neither this Offering Circular nor any advertisement or other

offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Offering Circular or any Notes may come must inform themselves about, and observe, any such restrictions on the distribution of this Offering Circular and the offering and sale of Notes. In particular, there are restrictions on the distribution of this Offering Circular and the offer or sale of Notes in the United States, the United Kingdom, Germany, Israel, Japan and The Netherlands (see "*Subscription and Sale*").

All references in this document to "**U.S. dollars**", "**U.S.\$**" and "**\$**" refer to United States dollars, all references to "**shekels**" and "**NIS**" refer to new Israeli shekels, all references to "**Sterling**" and "**£**" refer to pounds sterling and all references to "**euro**" and "**€**" refer to the currency introduced at the start of the third stage of European economic and monetary union pursuant to the Treaty establishing the European Community, as amended. The exchange rate between the U.S. dollar and the new Israeli shekel on 31st December, 2002 was U.S.\$1=4.737 NIS and on 30th September, 2003 was U.S.\$1=4.443 NIS.

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Table of Contents

| | Page |
|---|------|
| Documents Incorporated by Reference | 2 |
| General Description of the Programme | 3 |
| Summary of the Programme | 4 |
| Form of the Notes | 8 |
| Terms and Conditions of the Notes | 10 |
| Form of Pricing Supplement | 31 |
| Use of Proceeds | 38 |
| Capitalisation | 39 |
| The Issuer | 40 |
| Recent Developments and Outlook | 66 |
| Management | 67 |
| Israeli Taxation | 69 |
| Subscription and Sale | 70 |
| General Information | 73 |
| Audited Annual Financial Statements | 75 |
| Unaudited Interim Consolidated Financial Statements | 77 |

In connection with the distribution of any Tranche of Notes, the Dealer (if any) disclosed as the stabilising manager in the applicable Pricing Supplement may over-allot or effect transactions with a view to supporting the market price of the Notes of the Series (as defined below) of which such Tranche forms part at a level higher than that which might otherwise prevail for a limited period. However there may be no obligation on the stabilising manager or any agent of his to do this. Such stabilising, if commenced, may be discontinued at any time and must be brought to an end after a limited period.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents shall be deemed to be incorporated in, and to form part of, this Offering Circular:

- (a) the most recently published audited consolidated annual financial statements and, if published later, the most recently published unaudited interim consolidated financial statements of the Issuer (see "*General Information*" for a description of the financial statements currently published by the Issuer); and
- (b) all supplements or amendments to this Offering Circular circulated by the Issuer from time to time,

save that any statement contained herein or in a document which is deemed to be incorporated by reference herein shall be deemed to be modified or superseded for the purpose of this Offering Circular to the extent that a statement contained in any such subsequent document which is deemed to be incorporated by reference herein modifies or supersedes such earlier statement (whether expressly, by implication or otherwise).

The Issuer will provide, without charge, to each person to whom a copy of this Offering Circular has been delivered, upon the oral or written request of such person, a copy of any or all of the documents deemed to be incorporated herein by reference unless such documents have been modified or superseded as specified above. Requests for such documents should be directed to the Issuer at its office set out at the end of this Offering Circular. In addition, such documents will be available free of charge from the principal office in Luxembourg of Deutsche Bank Luxembourg S.A. (the "**Luxembourg Listing Agent**") for Notes listed on the Luxembourg Stock Exchange.

The Issuer will, in connection with the listing of the Notes on the Luxembourg Stock Exchange, so long as any Note remains outstanding and listed on such exchange, in the event of any material adverse change in the business, financial condition or otherwise of the Issuer which is not reflected in this Offering Circular, prepare a supplement to this Offering Circular or publish a new Offering Circular for use in connection with any subsequent issue of the Notes to be listed on the Luxembourg Stock Exchange.

If the terms of the Programme are modified or amended in a manner which would make this Offering Circular, as so modified or amended, inaccurate or misleading, a new offering circular will be prepared.

GENERAL DESCRIPTION OF THE PROGRAMME

Under the Programme, the Issuer may from time to time issue Notes denominated in any currency, subject to any applicable legal or regulatory restrictions and in accordance with any applicable laws, guidelines, regulations, restrictions or reporting requirements. A summary of the terms and conditions of the Programme and the Notes appears below. The applicable terms of any Notes will be agreed between the Issuer and the relevant Dealer prior to the issue of the Notes and will be set out in the Terms and Conditions of the Notes endorsed on, attached to, or incorporated by reference into, the Notes, as modified and supplemented by the applicable Pricing Supplement attached to, or endorsed on, such Notes, as more fully described under "*Form of the Notes*".

This Offering Circular and any supplement will only be valid for listing Notes on the Luxembourg Stock Exchange during the period of 12 months from the date of this Offering Circular in an aggregate nominal amount which, when added to the aggregate nominal amount then outstanding of all Notes previously or simultaneously issued under the Programme, does not exceed €750,000,000 or its equivalent in other currencies. For the purpose of calculating the euro equivalent of the aggregate nominal amount of Notes issued under the Programme from time to time:

- (a) the euro equivalent of Notes denominated in another Specified Currency (as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") shall be determined by Deutsche Bank AG London (the "**Agent**", which expression shall include any successor agent) either, at the discretion of the Issuer, as of the date on which agreement is reached for the issue of Notes or on the preceding day on which commercial banks and foreign exchange markets are open for business in London and in Frankfurt am Main, in each case on the basis of the reference rate for the sale of the euro against the purchase of such Specified Currency published by the electronic information provider Reuters on page ECB 37 or such other screen page on that service or by such other information service provider which may be determined as the successor for the purposes of displaying such information or, if no such rate is available, on the basis of the exchange rate quoted by any leading bank selected by the Agent on the relevant day of calculation;
- (b) the euro equivalent of Dual Currency Notes, Index Linked Notes and Partly Paid Notes (each as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") shall be calculated in the manner specified above by reference to the original nominal amount on issue of such Notes (in the case of Partly Paid Notes regardless of the subscription price paid); and
- (c) the euro equivalent of Zero Coupon Notes (as specified in the applicable Pricing Supplement in relation to the relevant Notes, described under "*Form of Pricing Supplement*") and other Notes issued at a discount or a premium shall be calculated in the manner specified above by reference to the net proceeds received by the Issuer for the relevant Tranche.

SUMMARY OF THE PROGRAMME

The following summary does not purport to be complete and is taken from, and is qualified in its entirety by, the remainder of this Offering Circular and, in relation to the terms and conditions of any particular Tranche of Notes, the applicable Pricing Supplement. Words and expressions defined in "Form of the Notes" and "Terms and Conditions of the Notes" shall have the same meanings in this summary.

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| Issuer | BEZEQ — The Israel Telecommunication Corp., Limited |
| Description | Euro Medium Term Note Programme |
| Arrangers | Deutsche Bank AG London Merrill Lynch International |
| Dealers | ABN AMRO Bank N.V. Citigroup Global Markets Limited Deutsche Bank AG London Merrill Lynch International Morgan Stanley & Co. International Limited UBS Limited and any other Dealers appointed in accordance with the Programme Agreement. |
| Certain Restrictions | Each issue of Notes denominated in a currency in respect of which particular laws, guidelines, regulations, restrictions or reporting requirements apply will only be issued in circumstances which comply with such laws, guidelines, regulations, restrictions or reporting requirements from time to time (see " <i>Subscription and Sale</i> ") including the following restrictions applicable at the date of this Offering Circular. |

Notes with a maturity of less than one year

Notes having a maturity of less than one year will, if the proceeds of the issue are accepted in the United Kingdom, constitute deposits for the purposes of the prohibition on accepting deposits contained in section 19 of the Financial Services and Markets Act 2000 (the "**FSMA**") unless they are issued to a limited class of professional investors and have a denomination of at least £100,000 or its equivalent, see "*Subscription and Sale*".

Swiss Francs

Issues of Notes denominated in Swiss francs or carrying a Swiss franc-related element with a maturity of more than one year (other than Notes privately placed with a single investor with no publicity) will be effected in compliance with the relevant regulations of the Swiss National Bank based on article 7 of the Federal Law on Banks and Savings Banks of 8th November, 1934 (as amended) and article 15 of the Federal Law on Stock Exchanges and Securities Trading of 24th March, 1995 in connection with article 2, paragraph 2 of the Ordinance of the Federal Banking Commission on Stock Exchanges and Securities Trading of 2nd December, 1996. Under the said regulations, the relevant Dealer or, in the case of a syndicated issue, the lead manager (the "**Swiss Dealer**"), must be a bank domiciled in Switzerland (which includes branches or subsidiaries of a foreign bank located in Switzerland) or a securities dealer duly licensed by the Swiss Federal Banking Commission pursuant to the Federal Law on Stock Exchanges and Securities Trading of 24th March, 1995. The Swiss Dealer must report certain details

of the relevant transaction to the Swiss National Bank no later than the Issue Date of the relevant Notes.

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|----------------------------|---|
| Trustee | Deutsche Trustee Company Limited (formerly called Bankers Trustee Company Limited) |
| Agent | Deutsche Bank AG London |
| Programme Size | Up to €750,000,000 (or its equivalent in other currencies calculated as described under " <i>General Description of the Programme</i> ") outstanding at any time. The Issuer may increase the amount of the Programme in accordance with the terms of the Programme Agreement. |
| Distribution | Notes may be distributed by way of private or public placement and in each case on a syndicated or non-syndicated basis. |
| Currencies | Euro, sterling, U.S. dollars, yen and, subject to any applicable legal or regulatory restrictions, any other currency agreed between the Issuer and the relevant Dealer. |
| Redenomination | The applicable Pricing Supplement may provide that certain Notes may be redenominated in euro. The provisions relating to any such redenomination will be contained in the applicable Pricing Supplement. |
| Maturities | Such maturities as may be agreed between the Issuer and the relevant Dealer, subject to such minimum or maximum maturities as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the Issuer or the relevant Specified Currency. |
| Issue Price | Notes may be issued on a fully-paid or a partly-paid basis and at an issue price which is at par or at a discount to, or premium over, par. |
| Form of Notes | The Notes will be in bearer form and will, on issue, be represented by either a temporary global Note or a permanent global Note as specified in the applicable Pricing Supplement. Temporary global Notes will be exchangeable either for (i) interests in a permanent global Note or (ii) for definitive Notes as indicated in the applicable Pricing Supplement. Permanent global Notes will be exchangeable for definitive Notes upon either (i) not less than 60 days' written notice from Euroclear and/or CBL (acting on the instructions of any holder of an interest in such permanent global Note) to the Agent as described therein or (ii) only upon the occurrence of an Exchange Event as described under " <i>Form of the Notes</i> ". |
| Fixed Rate Notes | Fixed interest will be payable on such date or dates as may be agreed between the Issuer and the relevant Dealer and on redemption, and will be calculated on the basis of such Day Count Fraction as may be agreed between the Issuer and the relevant Dealer. |
| Floating Rate Notes | Floating Rate Notes will bear interest at a rate determined: <ul style="list-style-type: none">(i) on the basis of a reference rate appearing on the agreed screen page of a commercial quotation service; or(ii) on the same basis as the floating rate under a notional interest rate swap transaction in the relevant Specified Currency governed by an agreement incorporating the 2000 ISDA Definitions as published by the International Swaps and Derivatives Association, Inc., and as amended and updated as at the Issue Date of the first Tranche of the Notes of the relevant Series; or |

(iii) on such other basis as may be agreed between the Issuer and the relevant Dealer,

as indicated in the applicable Pricing Supplement.

The margin (if any) relating to such floating rate will be agreed between the Issuer and the relevant Dealer for each Series of Floating Rate Notes.

Index Linked Notes

Payments of principal in respect of Index Linked Redemption Notes or of interest in respect of Index Linked Interest Notes will be calculated by reference to such index and/or formula or to changes in the prices of securities or commodities or to such other factors as the Issuer and the relevant Dealer may agree.

Other provisions in relation to Floating Rate Notes and Index Linked Interest Notes

Floating Rate Notes and Index Linked Interest Notes may also have a maximum interest rate, a minimum interest rate or both, as indicated in the applicable Pricing Supplement.

Interest on Floating Rate Notes and Index Linked Interest Notes in respect of each Interest Period, as agreed prior to issue by the Issuer and the relevant Dealer, will be payable on such Interest Payment Dates, and will be calculated on the basis of such Day Count Fraction, as may be agreed between the Issuer and the relevant Dealer.

Dual Currency Notes

Payments (whether in respect of principal or interest and whether at maturity or otherwise) in respect of Dual Currency Notes will be made in such currencies, and based on such rates of exchange, as the Issuer and the relevant Dealer may agree, as indicated in the applicable Pricing Supplement.

Zero Coupon Notes

Zero Coupon Notes will be offered and sold at a discount to their nominal amount and will not bear interest.

Redemption

The applicable Pricing Supplement will indicate either that the relevant Notes cannot be redeemed prior to their stated maturity (other than in specified instalments, if applicable, or for taxation reasons or following an Event of Default) or that such Notes will be redeemable at the option of the Issuer and/or the Noteholders upon giving irrevocable notice to the Noteholders or the Issuer, as the case may be, on a date or dates specified prior to such stated maturity and at a price or prices and on such other terms as may be agreed between the Issuer and the relevant Dealer.

The applicable Pricing Supplement may provide that Notes may be redeemable in two or more instalments of such amounts and on such dates as are indicated in the applicable Pricing Supplement.

Notes having a maturity of less than one year may be subject to restrictions on their denomination and distribution, see "*Certain Restrictions — Notes with a maturity of less than one year*" above.

Denomination of Notes

Notes will be issued in such denominations as may be agreed between the Issuer and the relevant Dealer save that the minimum denomination of each Note will be such as may be allowed or required from time to time by the relevant central bank (or equivalent body) or any laws or regulations applicable to the relevant Specified Currency, see "*Certain Restrictions — Notes with a maturity of less than one year*" above.

Taxation

All payments in respect of the Notes will be made without deduction for or on account of withholding taxes imposed by the State of Israel or any political subdivision or any authority

thereof or therein having power to tax, subject as provided in Condition 7. In the event that any such deduction is made, the Issuer will, save in certain limited circumstances provided in Condition 7, be required to pay additional amounts to cover the amounts so deducted.

Negative Pledge

The terms of the Notes will contain a negative pledge provision as further described in Condition 3.

Cross Default

The Notes will have the benefit of a cross default provision as further described in Condition 9.

Status of the Notes

The Notes will constitute direct, unconditional, unsubordinated and, subject to the provisions of Condition 3, unsecured obligations of the Issuer and will rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured and unsubordinated obligations of the Issuer, from time to time outstanding.

Listing

Application has been made to list Notes issued under the Programme on the Luxembourg Stock Exchange. The Notes may also be listed on such other or further stock exchange(s) as may be agreed between the Issuer and the relevant Dealer in relation to each Series.

Unlisted Notes may also be issued.

The applicable Pricing Supplement will state whether or not the relevant Notes are to be listed and, if so, on which stock exchange(s).

Governing Law

The Notes will be governed by, and construed in accordance with, English law.

Selling Restrictions

There are restrictions on the offer, sale and transfer of the Notes in the United States, the United Kingdom, Germany, Israel, Japan and The Netherlands and in any other relevant jurisdiction and other restrictions may be required in connection with the offering and sale of a particular Tranche of Notes (see "*Subscription and Sale*").

United States Selling Restrictions

Regulation S, Category 2. TEFRA C or D, as specified in the applicable Pricing Supplement.

FORM OF THE NOTES

Each Tranche of Notes will be in bearer form and will initially be issued in the form of a temporary global note (a "**Temporary Global Note**") or, if so specified in the applicable Pricing Supplement, a permanent global note (a "**Permanent Global Note**") which, in either case, will be delivered on or prior to the original issue date of the Tranche to a common depositary (the "**Common Depositary**") for Euroclear Bank S.A./N.V. as operator of the Euroclear System ("**Euroclear**") and Clearstream Banking, société anonyme ("**CBL**"). Whilst any Note is represented by a Temporary Global Note, payments of principal, interest (if any) and any other amount payable in respect of the Notes due prior to the Exchange Date (as defined below) will be made against presentation of the Temporary Global Note only to the extent that certification (in a form to be provided) to the effect that the beneficial owners of interests in such Note are not U.S. persons or persons who have purchased for resale to any U.S. person, as required by U.S. Treasury regulations, has been received by Euroclear and/or CBL and Euroclear and/or CBL, as applicable, has given a like certification (based on the certifications it has received) to the Agent.

On and after the date (the "**Exchange Date**") which is 40 days after a Temporary Global Note is issued, interests in such Temporary Global Note will be exchangeable (free of charge) upon a request as described therein either for (i) interests in a Permanent Global Note of the same Series or (ii) for definitive Notes of the same Series with, where applicable, receipts, interest coupons and talons attached (as indicated in the applicable Pricing Supplement and subject, in the case of definitive Notes, to such notice period as is specified in the applicable Pricing Supplement), in each case against certification of beneficial ownership as described above unless such certification has already been given. The holder of a Temporary Global Note will not be entitled to collect any payment of interest, principal or other amount due on or after the Exchange Date unless, upon due certification, exchange of the Temporary Global Note for an interest in a Permanent Global Note or for definitive Notes is improperly withheld or refused.

Payments of principal, interest (if any) or any other amounts on a Permanent Global Note will be made through Euroclear and/or CBL against presentation or surrender (as the case may be) of the Permanent Global Note without any requirement for certification.

The applicable Pricing Supplement will specify that a Permanent Global Note will be exchangeable (free of charge), in whole but not in part, for definitive Notes with, where applicable, receipts, interest coupons and talons attached upon either (i) not less than 60 days' written notice from Euroclear and/or CBL (acting on the instructions of any holder of an interest in such Permanent Global Note) to the Agent as described therein or (ii) only upon the occurrence of an Exchange Event. For these purposes, "**Exchange Event**" means that (i) an Event of Default (as defined in Condition 9) has occurred and is continuing, (ii) the Issuer has been notified that both Euroclear and CBL have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or have announced an intention permanently to cease business or have in fact done so and no successor clearing system satisfactory to the Trustee is available or (iii) the Issuer has or will become subject to adverse tax consequences which would not be suffered were the Notes represented by the Permanent Global Note in definitive form. The Issuer will promptly give notice to Noteholders in accordance with Condition 14 if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or CBL (acting on the instructions of any holder of an interest in such Permanent Global Note) or the Trustee may give notice to the Agent requesting exchange and, in the event of the occurrence of an Exchange Event as described in (iii) above, the Issuer may also give notice to the Agent requesting exchange. Any such exchange shall occur not later than 45 days after the date of receipt of the first relevant notice by the Agent.

The following legend will appear on all Notes which have an original maturity of more than 365 days and on all receipts and interest coupons relating to such Notes:

"ANY UNITED STATES PERSON WHO HOLDS THIS OBLIGATION WILL BE SUBJECT TO LIMITATIONS UNDER THE UNITED STATES INCOME TAX LAWS, INCLUDING THE LIMITATIONS PROVIDED IN SECTIONS 165(j) AND 1287(a) OF THE INTERNAL REVENUE CODE."

The sections referred to provide that United States holders, with certain exceptions, will not be entitled to deduct any loss on Notes, receipts or interest coupons and will not be entitled to

capital gains treatment of any gain on any sale, disposition, redemption or payment of principal in respect of such Notes, receipts or interest coupons.

Notes which are represented by a Global Note will only be transferable in accordance with the rules and procedures for the time being of Euroclear or CBL, as the case may be.

Pursuant to the Agency Agreement (as defined under "*Terms and Conditions of the Notes*"), the Agent shall arrange that, where a further Tranche of Notes is issued which is intended to form a single Series with an existing Tranche of Notes, the Notes of such further Tranche shall be assigned a common code and ISIN which are different from the common code and ISIN assigned to Notes of any other Tranche of the same Series until at least the expiry of the distribution compliance period (as defined in Regulation S under the Securities Act) applicable to the Notes of such Tranche.

Any reference herein to Euroclear and/or CBL shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system approved by the Issuer, the Agent and the Trustee or as otherwise specified in the applicable Pricing Supplement.

TERMS AND CONDITIONS OF THE NOTES

The following are the Terms and Conditions of the Notes which will be incorporated by reference into each Global Note (as defined below) and each definitive Note, in the latter case only if permitted by the relevant stock exchange (if any) and agreed by the Issuer and the relevant Dealer at the time of issue but, if not so permitted and agreed, such definitive Note will have endorsed thereon or attached thereto such Terms and Conditions. The applicable Pricing Supplement in relation to any Tranche of Notes may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of such Notes. The applicable Pricing Supplement (or the relevant provisions thereof) will be endorsed upon, or attached to, each Global Note and definitive Note. Reference should be made to "Form of the Notes" for a description of the content of Pricing Supplements which will specify which of such terms are to apply in relation to the relevant Notes.

This Note is one of a Series (as defined below) of Notes issued by BEZEQ — The Israel Telecommunication Corp., Limited (the "**Issuer**") constituted by a Trust Deed dated 7th August, 2000 (such Trust Deed as further modified and/or supplemented and/or restated from time to time, the "**Trust Deed**") made between the Issuer and Deutsche Trustee Company Limited (formerly called Bankers Trustee Company Limited) (the "**Trustee**") which expression shall include any successor as trustee).

References herein to the "**Notes**" shall be references to the Notes of this Series and shall mean:

- (a) in relation to any Notes represented by a global Note (a "**Global Note**"), units of the lowest Specified Denomination in the Specified Currency;
- (b) any Global Note; and
- (c) any definitive Notes issued in exchange for a Global Note.

The Notes, the Receipts (as defined below) and the Coupons (as defined below) have the benefit of an amended and restated Agency Agreement dated 18th December, 2003, (such Agency Agreement as further amended and/or supplemented and/or restated from time to time, the "**Agency Agreement**") and made between the Issuer, Deutsche Bank AG London as issuing and principal paying agent and agent bank (the "**Agent**", which expression shall include any successor agent), the other paying agents named therein (together with the Agent, unless the context otherwise requires, the "**Paying Agents**", which expression shall include any additional or successor paying agents) and the Trustee.

Interest bearing definitive Notes have interest coupons ("**Coupons**") and, if indicated in the applicable Pricing Supplement, talons for further Coupons ("**Talons**") attached on issue. Any reference herein to Coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons. Definitive Notes repayable in instalments have receipts ("**Receipts**") for the payment of the instalments of principal (other than the final instalment) attached on issue. Global Notes do not have Receipts, Coupons or Talons attached on issue.

The Pricing Supplement for this Note (or the relevant provisions thereof) is attached to or endorsed on this Note and supplements these Terms and Conditions and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with these Terms and Conditions, replace or modify these Terms and Conditions for the purposes of this Note. References to the "**applicable Pricing Supplement**" are to the Pricing Supplement (or the relevant provisions thereof) attached to or endorsed on this Note.

The Trustee acts for the benefit of the holders for the time being of the Notes (the "**Noteholders**" which expression shall, in relation to any Notes represented by a Global Note, be construed as provided below), the holders of the Receipts (the "**Receiptholders**") and the holders of the Coupons (the "**Couponholders**", which expression shall, unless the context otherwise requires, include the holders of the Talons) in accordance with the provisions of the Trust Deed.

As used herein, "**Tranche**" means Notes which are identical in all respects (including as to listing) and "**Series**" means a Tranche of Notes together with any further Tranche or Tranches of Notes which are (i) expressed to be consolidated and form a single series and (ii) identical in all

respects (including as to listing) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices.

Copies of the Trust Deed and the Agency Agreement are available for inspection during normal business hours at the principal office for the time being of the Trustee (being at 18th December, 2003 at Winchester House, 1 Great Winchester Street, London EC2N 2DB) and at the specified office of each of the Paying Agents. Copies of the applicable Pricing Supplement are obtainable during normal business hours at the specified office of each of the Paying Agents save that, if this Note is an unlisted Note of any Series, the applicable Pricing Supplement will only be obtainable by a Noteholder holding one or more unlisted Notes of that Series and such Noteholder must produce evidence satisfactory to the relevant Paying Agent as to its holding of such Notes and identity. The Noteholders, the Receiptholders and the Couponholders are deemed to have notice of, and are entitled to the benefit of, all the provisions of the Trust Deed, the Agency Agreement and the applicable Pricing Supplement which are applicable to them. The statements in these Terms and Conditions include summaries of, and are subject to, the detailed provisions of the Trust Deed.

Words and expressions defined in the Trust Deed and the Agency Agreement or used in the applicable Pricing Supplement shall have the same meanings where used in these Terms and Conditions unless the context otherwise requires or unless otherwise stated and provided that, in the event of inconsistency between the Agency Agreement and the Trust Deed, the Trust Deed will prevail and, in the event of inconsistency between the Agency Agreement or the Trust Deed and the applicable Pricing Supplement, the applicable Pricing Supplement will prevail.

1. Form, Denomination and Title

The Notes are in bearer form and, in the case of definitive Notes, serially numbered, in the Specified Currency and the Specified Denomination(s). Notes of one Specified Denomination may not be exchanged for Notes of another Specified Denomination.

This Note may be a Fixed Rate Note, a Floating Rate Note, a Zero Coupon Note, an Index Linked Interest Note, a Dual Currency Interest Note or a combination of any of the foregoing, depending upon the Interest Basis shown in the applicable Pricing Supplement.

This Note may be an Index Linked Redemption Note, an Instalment Note, a Dual Currency Redemption Note, a Partly Paid Note or a combination of any of the foregoing, depending upon the Redemption/Payment Basis shown in the applicable Pricing Supplement.

Definitive Notes are issued with Coupons attached, unless they are Zero Coupon Notes in which case references to Coupons and Couponholders in these Terms and Conditions are not applicable.

Subject as set out below, title to the Notes, Receipts and Coupons will pass by delivery. The Issuer and the Paying Agents will (except as otherwise required by law) deem and treat the bearer of any Note, Receipt or Coupon as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes but, in the case of any Global Note, without prejudice to the provisions set out in the next succeeding paragraph.

For so long as any of the Notes is represented by a Global Note held on behalf of Euroclear Bank S.A./N.V. as operator of the Euroclear System ("**Euroclear**") and/or Clearstream Banking, société anonyme ("**CBL**"), each person (other than Euroclear or CBL) who is for the time being shown in the records of Euroclear or of CBL as the holder of a particular nominal amount of such Notes (in which regard any certificate or other document issued by Euroclear or CBL as to the nominal amount of such Notes standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer, the Trustee and the Paying Agents as the holder of such nominal amount of such Notes for all purposes other than with respect to the payment of principal or interest on such nominal amount of such Notes, for which purpose the bearer of the relevant Global Note shall be treated by the Issuer, the Trustee and any Paying Agent as the holder of such nominal amount of such Notes in accordance with and subject to the terms of the relevant Global Note and the expressions "**Noteholder**" and "**holder of Notes**" and related expressions shall be construed accordingly. Notes which are represented by a

Global Note will be transferable only in accordance with the rules and procedures for the time being of Euroclear or CBL, as the case may be.

References to Euroclear and/or CBL shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system approved by the Issuer, the Agent and the Trustee or otherwise specified in the applicable Pricing Supplement.

2. Status of the Notes

The Notes and any relative Receipts and Coupons are direct, unconditional, unsubordinated and (subject to the provisions of Condition 3) unsecured obligations of the Issuer and rank *pari passu* among themselves and (save for certain obligations required to be preferred by law) equally with all other unsecured and unsubordinated obligations of the Issuer, from time to time outstanding.

3. Negative Pledge

So long as any of the Notes remains outstanding, the Issuer will not create or have outstanding any mortgage, charge, lien, pledge or other security interest (each a “**Security Interest**”) upon, or with respect to, any of its present or future business, undertaking, assets or revenues (including any uncalled capital) to secure any Relevant Indebtedness (as defined below) or any guarantee or indemnity in respect of any Relevant Indebtedness, unless the Issuer shall, in the case of the creation of a Security Interest, before or at the same time and, in any other case, promptly, take any and all action necessary to ensure that:

- (a) all amounts payable by it under the Notes, the Coupons, the Receipts and the Trust Deed are secured by the Security Interest equally and rateably with the Relevant Indebtedness or guarantee or indemnity to the satisfaction of the Trustee; or
- (b) such other Security Interest or other arrangement (whether or not it includes the giving of a Security Interest) is provided either (A) as the Trustee shall in its absolute discretion deem not materially less beneficial to the interests of the Noteholders or (B) as shall be approved by an Extraordinary Resolution (which is defined in the Trust Deed as a resolution duly passed by a majority of not less than three-fourths of the votes cast thereon) of the Noteholders.

For the purposes of this Condition, “**Relevant Indebtedness**” means any Indebtedness for Borrowed Money described in sub-paragraph (B) of the definition thereof in Condition 9(b) which is for the time being, or is capable of being, quoted, listed or ordinarily dealt in on any stock exchange, over-the-counter or other securities market other than any such Indebtedness for Borrowed Money which is, or is capable of being, quoted, listed or ordinarily dealt in solely on a stock exchange, over-the-counter or other securities market in Israel.

4. Interest

(a) Interest on Fixed Rate Notes

Each Fixed Rate Note bears interest on its outstanding nominal amount (or, if it is a Partly Paid Note, the amount paid up) from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest. Interest will be payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Maturity Date.

Except as provided in the applicable Pricing Supplement, the amount of interest payable on each Interest Payment Date in respect of the Fixed Interest Period ending on (but excluding) such date will amount to the Fixed Interest Amount. Payments of interest on any Interest Payment Date will, if so specified in the applicable Pricing Supplement, amount to the Broken Amount so specified.

As used in these Terms and Conditions, “**Fixed Interest Period**” means the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

If interest is required to be calculated for a period other than a Fixed Interest Period, such interest shall be calculated by applying the Rate of Interest to each Specified Denomination,

multiplying such sum by the applicable Day Count Fraction and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

“Day Count Fraction” means, in respect of the calculation of an amount of interest in accordance with this Condition 4(a):

- (i) if **“Actual/Actual (ISMA)”** is specified in the applicable Pricing Supplement:
 - (A) in the case of Notes where the number of days in the relevant period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (the **“Accrual Period”**) is equal to or shorter than the Determination Period during which the Accrual Period ends, the number of days in such Accrual Period divided by the product of (1) the number of days in such Determination Period and (2) the number of Determination Dates that would occur in one calendar year; or
 - (B) in the case of Notes where the Accrual Period is longer than the Determination Period during which the Accrual Period ends, the sum of:
 - (1) the number of days in such Accrual Period falling in the Determination Period in which the Accrual Period begins divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates (as specified in the applicable Pricing Supplement) that would occur in one calendar year; and
 - (2) the number of days in such Accrual Period falling in the next Determination Period divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and
- (ii) if **“30/360”** is specified in the applicable Pricing Supplement, the number of days in the period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (such number of days being calculated on the basis of a year of 360 days with 12 30-day months) divided by 360.

In these Terms and Conditions:

“Determination Period” means the period from (and including) a Determination Date to but excluding the next Determination Date (including, where either the Interest Commencement Date or the final Interest Payment Date is not a Determination Date, the period commencing on the first Determination Date prior to, and ending on the first Determination Date falling after, such date); and

“sub-unit” means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, one cent.

(b) *Interest on Floating Rate Notes and Index Linked Interest Notes*

(i) *Interest Payment Dates*

Each Floating Rate Note and Index Linked Interest Note bears interest on its outstanding nominal amount (or, if it is a Partly Paid Note, the amount paid up) from (and including) the Interest Commencement Date and such interest will be payable in arrear on either:

- (A) the Specified Interest Payment Date(s) in each year specified in the applicable Pricing Supplement; or
- (B) if no Specified Interest Payment Date(s) is/are specified in the applicable Pricing Supplement, each date (each such date, together with each Specified Interest Payment Date, an **“Interest Payment Date”**) which falls the number of months or other period specified as the Specified Period in the applicable Pricing Supplement.

ment after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Interest Commencement Date.

Such interest will be payable in respect of each Interest Period (which expression shall, in these Terms and Conditions, mean the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date).

If a Business Day Convention is specified in the applicable Pricing Supplement and (x) if there is no numerically corresponding day on the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then, if the Business Day Convention specified is:

- (1) in any case where Specified Periods are specified in accordance with Condition 4(b)(i)(B) above, the Floating Rate Convention, such Interest Payment Date (i) in the case of (x) above, shall be the last day that is a Business Day in the relevant month and the provisions of (B) below shall apply *mutatis mutandis* or (ii) in the case of (y) above, shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event (A) such Interest Payment Date shall be brought forward to the immediately preceding Business Day and (B) each subsequent Interest Payment Date shall be the last Business Day in the month which falls the Specified Period after the preceding applicable Interest Payment Date occurred; or
- (2) the Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day; or
- (3) the Modified Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event such Interest Payment Date shall be brought forward to the immediately preceding Business Day; or
- (4) the Preceding Business Day Convention, such Interest Payment Date shall be brought forward to the immediately preceding Business Day.

In these Terms and Conditions, “**Business Day**” means a day which is both:

- (A) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London and any Additional Business Centre specified in the applicable Pricing Supplement; and
- (B) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than London and any Additional Business Centre and which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney/Melbourne and Auckland/Wellington, respectively) or (2) in relation to any sum payable in euro, a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System (the “**TARGET System**”) is open.

(ii) *Rate of Interest*

The Rate of Interest payable from time to time in respect of Floating Rate Notes and Index Linked Interest Notes will be determined in the manner specified in the applicable Pricing Supplement.

(A) *Screen Rate Determination for Floating Rate Notes*

Where Screen Rate Determination is specified in the applicable Pricing Supplement as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will, subject as provided below, be either:

- (1) the offered quotation; or
- (2) the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards, in the case of the London inter-bank offered rate (“LIBOR”), or to the third decimal place, with 0.0005 being rounded upwards, in the case of the Euro-zone inter-bank offered rate (“EURIBOR”)) of the offered quotations,

(expressed as a percentage rate per annum) for the Reference Rate which appears or appear, as the case may be, on the Relevant Screen Page as at 11.00 a.m. (London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the Interest Determination Date in question plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any), all as determined by the Agent. If five or more of such offered quotations are available on the Relevant Screen Page, the highest (or, if there is more than one such highest quotation, one only of such quotations) and the lowest (or, if there is more than one such lowest quotation, one only of such quotations) shall be disregarded by the Agent for the purpose of determining the arithmetic mean (rounded as provided above) of such offered quotations.

The Agency Agreement contains provisions for determining the Rate of Interest in the event that the Relevant Screen Page is not available or if, in the case of (1) above, no such offered quotation appears or, in the case of (2) above, fewer than three such offered quotations appear, in each case as at the time specified in the preceding paragraph.

If the Reference Rate from time to time in respect of Floating Rate Notes is specified in the applicable Pricing Supplement as being other than LIBOR or EURIBOR, the Rate of Interest in respect of such Notes will be determined as provided in the applicable Pricing Supplement.

(B) *ISDA Determination for Floating Rate Notes*

Where ISDA Determination is specified in the applicable Pricing Supplement as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will be the relevant ISDA Rate plus or minus (as indicated in the applicable Pricing Supplement) the Margin (if any). For the purposes of this sub-paragraph (A), “**ISDA Rate**” for an Interest Period means a rate equal to the Floating Rate that would be determined by the Agent under an interest rate swap transaction if the Agent were acting as Calculation Agent for that swap transaction under the terms of an agreement incorporating the 2000 ISDA Definitions as published by the International Swaps and Derivatives Association, Inc. and as amended and updated as at the Issue Date of the first Tranche of the Notes (the “**ISDA Definitions**”) and under which:

- (1) the Floating Rate Option is as specified in the applicable Pricing Supplement;
- (2) the Designated Maturity is a period specified in the applicable Pricing Supplement; and
- (3) the relevant Reset Date is either (i) if the applicable Floating Rate Option is based on LIBOR or on EURIBOR, the first day of that Interest Period or (ii) in any other case, as specified in the applicable Pricing Supplement.

For the purposes of this sub-paragraph (A), “**Floating Rate**”, “**Calculation Agent**”, “**Floating Rate Option**”, “**Designated Maturity**” and “**Reset Date**” have the meanings given to those terms in the ISDA Definitions.

(iii) *Minimum Rate of Interest and/or Maximum Rate of Interest*

If the applicable Pricing Supplement specifies a Minimum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is less

than such Minimum Rate of Interest, the Rate of Interest for such Interest Period shall be such Minimum Rate of Interest.

If the applicable Pricing Supplement specifies a Maximum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (ii) above is greater than such Maximum Rate of Interest, the Rate of Interest for such Interest Period shall be such Maximum Rate of Interest.

(iv) *Determination of Rate of Interest and calculation of Interest Amounts*

The Agent, in the case of Floating Rate Notes, and the Calculation Agent, in the case of Index Linked Interest Notes, will at or as soon as practicable after each time at which the Rate of Interest is to be determined, determine the Rate of Interest for the relevant Interest Period. In the case of Index Linked Interest Notes, the Calculation Agent will notify the Agent of the Rate of Interest for the relevant Interest Period as soon as practicable after calculating the same.

The Agent will calculate the amount of interest (the **“Interest Amount”**) payable on the Floating Rate Notes or Index Linked Interest Notes in respect of each Specified Denomination for the relevant Interest Period. Each Interest Amount shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction and rounding the resultant figure to the nearest sub-unit of the relevant Specified Currency, half of any such sub-unit being rounded upwards or otherwise in accordance with applicable market convention.

“Day Count Fraction” means, in respect of the calculation of an amount of interest for any Interest Period in accordance with this condition 4(b):

- (A) if **“Actual/365”** or **“Actual/Actual”** is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365 (or, if any portion of that Interest Period falls in a leap year, the sum of (1) the actual number of days in that portion of the Interest Period falling in a leap year divided by 366 and (2) the actual number of days in that portion of the Interest Period falling in a non-leap year divided by 365);
- (B) if **“Actual/365 (Fixed)”** is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365;
- (C) if **“Actual/365 (Sterling)”** is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 365 or, in the case of an Interest Payment Date falling in a leap year, 366;
- (D) if **“Actual/360”** is specified in the applicable Pricing Supplement, the actual number of days in the Interest Period divided by 360;
- (E) if **“30/360”**, **“360/360”** or **“Bond Basis”** is specified in the applicable Pricing Supplement, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months (unless (1) the last day of the Interest Period is the 31st day of a month but the first day of the Interest Period is a day other than the 30th or 31st day of a month, in which case the month that includes that last day shall not be considered to be shortened to a 30-day month, or (2) the last day of the Interest Period is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month)); and
- (F) if **“30E/360”** or **“Eurobond Basis”** is specified in the applicable Pricing Supplement, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months, without regard to the date of the first day or last day of the Interest Period unless, in the case of the final Interest Period, the Maturity Date is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month).

(v) *Notification of Rate of Interest and Interest Amounts*

The Agent will cause the Rate of Interest and each Interest Amount for each Interest Period and the relevant Interest Payment Date to be notified to the Issuer, the Trustee and, not later than the first day of the relevant Interest Period, any stock exchange on which the relevant Floating Rate Notes or Index Linked Interest Notes are for the time being listed and notice thereof to be published in accordance with Condition 14 as soon as possible after their determination but in no event later than the fourth London Business Day thereafter. Each Interest Amount and Interest Payment Date so notified may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without prior notice in the event of an extension or shortening of the Interest Period. Any such amendment will be promptly notified to each stock exchange on which the relevant Floating Rate Notes or Index Linked Interest Notes are for the time being listed and to the Noteholders in accordance with Condition 14. For the purposes of this paragraph, the expression “**London Business Day**” means a day (other than a Saturday or a Sunday) on which banks and foreign exchange markets are open for general business in London.

(vi) *Determination or Calculation by Trustee*

If for any reason at any relevant time the Agent, or as the case may be, the Calculation Agent defaults in its obligation to determine the Rate of Interest or to calculate any Interest Amount in accordance with sub-paragraph (ii)(A) or (B) above or as otherwise specified in the applicable Pricing Supplement, as the case may be, and in each case in accordance with (iv) above, the Trustee shall determine the Rate of Interest at each such rate as, in its absolute discretion (having such regard as it shall think fit to the foregoing provisions of this Condition, but subject always to any minimum or maximum Rate of Interest specified in the applicable Pricing Supplement), it shall deem fair and reasonable in all the circumstances or, as the case may be, the Trustee shall calculate the Interest Amount(s) in such manner as it shall deem fair and reasonable in all the circumstances and each such determination or calculation shall be deemed to have been made by the Agent or the Calculation Agent, as applicable.

(vii) *Certificates to be final*

All certificates, communications, opinions, determinations, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition 4(b), whether by the Agent or, if applicable, the Calculation Agent or the Trustee, shall (in the absence of wilful default, bad faith or manifest error) be binding on the Issuer, the Agent, the Trustee, the Calculation Agent (if applicable), the other Paying Agents and all Noteholders, Receiptholders and Couponholders and (in the absence as aforesaid) no liability to the Issuer, the Noteholders, the Receiptholders or the Couponholders shall attach to the Agent or, if applicable, the Calculation Agent or the Trustee in connection with the exercise or non-exercise by it of its powers, duties and discretions pursuant to such provisions.

(c) *Interest on Dual Currency Interest Notes*

The rate or amount of interest payable in respect of Dual Currency Interest Notes shall be determined in the manner specified in the applicable Pricing Supplement.

(d) *Interest on Partly Paid Notes*

In the case of Partly Paid Notes (other than Partly Paid Notes which are Zero Coupon Notes), interest will accrue as aforesaid on the paid-up nominal amount of such Notes and otherwise as specified in the applicable Pricing Supplement.

(e) *Accrual of interest*

Each Note (or in the case of the redemption of part only of a Note, that part only of such Note) will cease to bear interest (if any) from the date for its redemption unless, upon due

presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue as provided in the Trust Deed.

5. Payments

(a) *Method of payment*

Subject as provided below:

- (i) payments in a Specified Currency other than euro will be made by credit or transfer to an account in the relevant Specified Currency (which, in the case of a payment in Japanese yen to a non-resident of Japan, shall be a non-resident account) maintained by the payee with, or, at the option of the payee, by a cheque in such Specified Currency drawn on, a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney/Melbourne or Auckland/Wellington, respectively); and
- (ii) payments in euro will be made by credit or transfer to a euro account (or any other account to which euro may be credited or transferred) specified by the payee or, at the option of the payee, by a euro cheque.

Payments will be subject in all cases to any fiscal or other laws and regulations applicable thereto in the place of payment, but without prejudice to the provisions of Condition 7.

(b) *Presentation of definitive Notes, Receipts and Coupons*

Payments of principal in respect of definitive Notes will (subject as provided below) be made in the manner provided in paragraph (a) above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of definitive Notes, and payments of interest in respect of definitive Notes will (subject as provided below) be made as aforesaid only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of Coupons, in each case at the specified office of any Paying Agent outside the United States (which expression, as used herein, means the United States of America (including the States and the District of Columbia, its territories, its possessions and other areas subject to its jurisdiction)).

Payments of instalments of principal (if any) in respect of definitive Notes, other than the final instalment, will (subject as provided below) be made in the manner provided in paragraph (a) above against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Receipt in accordance with the preceding paragraph. Payment of the final instalment will be made in the manner provided in paragraph (a) above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Note in accordance with the preceding paragraph. Each Receipt must be presented for payment of the relevant instalment together with the definitive Note to which it appertains. Receipts presented without the definitive Note to which they appertain do not constitute valid obligations of the Issuer. Upon the date on which any definitive Note becomes due and repayable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Fixed Rate Notes in definitive form (other than Dual Currency Notes, Index Linked Notes or Long Maturity Notes (as defined below)) should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the sum due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of 10 years after the Relevant Date (as defined in Condition 7) in respect of such principal (whether or not such Coupon would otherwise have become void under Condition 8) or, if later, five years from the date on which such Coupon would otherwise have become due, but in no event thereafter.

Upon any Fixed Rate Note in definitive form becoming due and repayable prior to its Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

Upon the date on which any Floating Rate Note, Dual Currency Note, Index Linked Note or Long Maturity Note in definitive form becomes due and repayable, all unmatured Coupons and Talons (if any) relating thereto (whether or not attached) shall become void and no payment or, as the case may be, exchange for further Coupons shall be made in respect thereof. A “**Long Maturity Note**” is a Fixed Rate Note (other than a Fixed Rate Note which on issue had a Talon attached) whose nominal amount on issue is less than the aggregate interest payable thereon.

If the due date for redemption of any definitive Note is not an Interest Payment Date, interest (if any) accrued in respect of such Note from (and including) the preceding Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against surrender of the relevant definitive Note.

(c) *Payments in respect of Global Notes*

Payments of principal and interest (if any) in respect of Notes represented by any Global Note will (subject as provided below) be made in the manner specified above in relation to definitive Notes and otherwise in the manner specified in the relevant Global Note against presentation or surrender, as the case may be, of such Global Note at the specified office of any Paying Agent outside the United States. A record of each payment made against presentation or surrender of any Global Note, distinguishing between any payment of principal and any payment of interest, will be made on such Global Note by the Paying Agent to which it is presented and such record shall be *prima facie* evidence that the payment in question has been made.

(d) *General provisions applicable to payments*

The holder of a Global Note shall be the only person entitled to receive payments in respect of Notes represented by such Global Note and the Issuer will be discharged by payment to, or to the order of, the holder of such Global Note in respect of each amount so paid. Each of the persons shown in the records of Euroclear or CBL as the beneficial holder of a particular nominal amount of Notes represented by such Global Note must look solely to Euroclear or CBL, as the case may be, for his share of each payment so made by the Issuer to, or to the order of, the holder of such Global Note.

Notwithstanding the foregoing provisions of this Condition, if any amount of principal and/or interest in respect of Notes is payable in U.S. dollars, such U.S. dollar payments of principal and/or interest in respect of such Notes will be made at the specified office of a Paying Agent in the United States if:

- (i) the Issuer has appointed Paying Agents with specified offices outside the United States with the reasonable expectation that such Paying Agents would be able to make payment in U.S. dollars at such specified offices outside the United States of the full amount of principal and interest on the Notes in the manner provided above when due;
- (ii) payment of the full amount of such principal and interest at all such specified offices outside the United States is illegal or effectively precluded by exchange controls or other similar restrictions on the full payment or receipt of principal and interest in U.S. dollars; and
- (iii) such payment is then permitted under United States law without involving, in the opinion of the Issuer, adverse tax consequences to the Issuer.

(e) *Payment Day*

If the date for payment of any amount in respect of any Note, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment until the next following Payment Day in the relevant place and shall not be entitled to further interest or other

payment in respect of such delay. For these purposes, “**Payment Day**” means any day which (subject to Condition 8) is:

- (i) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in:
 - (A) the relevant place of presentation; and
 - (B) any Additional Financial Centre specified in the applicable Pricing Supplement; and
- (ii) either (1) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than the place of presentation and any Additional Financial Centre and which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney/Melbourne and Auckland/Wellington, respectively) or (2) in relation to any sum payable in euro, a day on which the TARGET System is open.

(f) *Interpretation of principal and interest*

Any reference in these Terms and Conditions to principal in respect of the Notes shall be deemed to include, as applicable:

- (i) any additional amounts which may be payable with respect to principal under Condition 7 or under any undertakings given in addition thereto, or in substitution therefor, pursuant to the Trust Deed;
- (ii) the Final Redemption Amount of the Notes;
- (iii) the Early Redemption Amount of the Notes;
- (iv) the Optional Redemption Amount(s) (if any) of the Notes;
- (v) in relation to Notes redeemable in instalments, the Instalment Amounts;
- (vi) in relation to Zero Coupon Notes, the Amortised Face Amount (as defined in Condition 6(e)); and
- (vii) any premium and any other amounts (other than interest) which may be payable by the Issuer under or in respect of the Notes.

Any reference in these Terms and Conditions to interest in respect of the Notes shall be deemed to include, as applicable, any additional amounts which may be payable with respect to interest under Condition 7 or under any undertakings given in addition thereto, or in substitution therefor, pursuant to the Trust Deed.

6. Redemption and Purchase

(a) *Redemption at maturity*

Unless previously redeemed or purchased and cancelled as specified below, each Note (including each Index Linked Redemption Note and Dual Currency Redemption Note) will be redeemed by the Issuer at its Final Redemption Amount specified in, or determined in the manner specified in, the applicable Pricing Supplement in the relevant Specified Currency on the Maturity Date.

(b) *Redemption for tax reasons*

The Notes may be redeemed at the option of the Issuer in whole, but not in part, at any time (if this Note is neither a Floating Rate Note, an Index Linked Interest Note nor a Dual Interest Currency Note) or on any Interest Payment Date (if this Note is either a Floating Rate Note, an Index Linked Interest Note or a Dual Interest Currency Note), on giving not less than 30 nor more than 60 days’ notice to the Agent and, in accordance with Condition 14, to the Noteholders (which notice shall be irrevocable), if:

- (i) on the occasion of the next payment due under the Notes, the Issuer has or will become obliged to pay additional amounts as provided or referred to in Condition 7 to any greater extent than would have been required under Condition 7 had a payment in respect of the Notes been required to be made on the date on which agreement is reached to issue the first Tranche of Notes, as a result of any change in, or amendment to, the laws or regulations of a Tax Jurisdiction (as defined in Condition 7), or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective on or after the date on which agreement is reached to issue the first Tranche of the Notes; and
- (ii) such obligation cannot be avoided by the Issuer taking reasonable measures available to it,

provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Issuer would be obliged to pay such additional amounts were a payment in respect of the Notes then due.

Prior to the publication of any notice of redemption pursuant to this Condition, the Issuer shall deliver to the Trustee and the Agent a certificate signed by two Directors of the Issuer stating that the Issuer is entitled to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred, and an opinion of independent legal advisers of recognised standing to the effect that the Issuer has or will become obliged to pay such additional amounts as a result of such change or amendment. The Trustee shall be entitled to accept such statement and opinion as sufficient evidence of the conditions precedent set out above, in which case they shall be conclusive and binding on the Noteholders, the Receiptholders and the Couponholders.

Notes redeemed pursuant to this Condition 6(b) will be redeemed at their Early Redemption Amount referred to in paragraph (e) below together (if appropriate) with interest accrued to (but excluding) the date of redemption.

(c) *Redemption at the option of the Issuer (Issuer Call)*

If Issuer Call is specified in the applicable Pricing Supplement, the Issuer may, having given:

- (i) not less than 15 nor more than 30 days' notice to the Noteholders in accordance with Condition 14; and
- (ii) not less than 15 days before the giving of the notice referred to in (i), notice to the Trustee and the Agent;

(which notices shall be irrevocable and shall specify the date fixed for redemption), redeem all or some only of the Notes then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in, or determined in the manner specified in, the applicable Pricing Supplement together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a nominal amount not less than the Minimum Redemption Amount and not more than the Maximum Redemption Amount, in each case as may be specified in the applicable Pricing Supplement. In the case of a partial redemption of Notes, the Notes to be redeemed ("**Redeemed Notes**") will be selected individually by lot, in the case of Redeemed Notes represented by definitive Notes, and in accordance with the rules of Euroclear and/or CBL, in the case of Redeemed Notes represented by a Global Note, not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the "**Selection Date**"). In the case of Redeemed Notes represented by definitive Notes, a list of the serial numbers of such Redeemed Notes will be published in accordance with Condition 14 not less than 15 days prior to the date fixed for redemption. The aggregate nominal amount of Redeemed Notes represented by definitive Notes shall bear the same proportion to the aggregate nominal amount of all Redeemed Notes as the aggregate nominal amount of definitive Notes outstanding bears to the aggregate nominal amount of the Notes outstanding, in each case on the Selection Date, provided that such first mentioned nominal amount shall, if necessary, be rounded downwards to the nearest integral multiple of the Specified Denomination, and the aggregate nominal amount of Redeemed Notes represented by a

Global Note shall be equal to the balance of the Redeemed Notes. No exchange of the relevant Global Note will be permitted during the period from (and including) the Selection Date to (and including) the date fixed for redemption pursuant to this paragraph (c) and notice to that effect shall be given by the Issuer to the Noteholders in accordance with Condition 14 at least five days prior to the Selection Date.

(d) *Redemption at the option of the Noteholders (Investor Put)*

If Investor Put is specified in the applicable Pricing Supplement, upon the holder of any Note giving to the Issuer in accordance with Condition 14 not less than 15 nor more than 30 days' notice the Issuer will, upon the expiry of such notice, redeem, subject to, and in accordance with, the terms specified in the applicable Pricing Supplement, such Note on the Optional Redemption Date and at the Optional Redemption Amount together, if appropriate, with interest accrued to (but excluding) the Optional Redemption Date.

To exercise the right to require redemption of this Note the holder of this Note must deliver, at the specified office of any Paying Agent at any time during normal business hours of such Paying Agent falling within the notice period, a duly completed and signed notice of exercise in the form (for the time being current) obtainable from any specified office of any Paying Agent (a "**Put Notice**") and in which the holder must specify a bank account (or, if payment is required to be made by cheque, an address) to which payment is to be made under this Condition accompanied by, if this Note is in definitive form, this Note or evidence satisfactory to the Paying Agent concerned that this Note will, following delivery of the Put Notice, be held to its order or under its control.

Any Put Notice given by a holder of any Note pursuant to this paragraph shall be irrevocable.

(e) *Early Redemption Amounts*

For the purpose of paragraph (b) above and Condition 9, each Note will be redeemed at its Early Redemption Amount calculated as follows:

- (i) in the case of a Note with a Final Redemption Amount equal to the Issue Price, at the Final Redemption Amount thereof;
- (ii) in the case of a Note (other than a Zero Coupon Note but including an Instalment Note and a Partly Paid Note) with a Final Redemption Amount which is or may be less or greater than the Issue Price or which is payable in a Specified Currency other than that in which the Note is denominated, at the amount specified in, or determined in the manner specified in, the applicable Pricing Supplement or, if no such amount or manner is so specified in the applicable Pricing Supplement, at its nominal amount; or
- (iii) in the case of a Zero Coupon Note, at an amount (the "**Amortised Face Amount**") calculated in accordance with the following formula:

Early Redemption Amount = $RP \times (1 + AY)^y$ where:

"**RP**" means the Reference Price;

"**AY**" means the Accrual Yield (expressed as a decimal); and

"**y**" is a fraction the numerator of which is equal to the number of days (calculated on the basis of a 360-day year consisting of 12 months of 30 days each) from (and including) the Issue Date of the first Tranche of the Notes to (but excluding) the date fixed for redemption or (as the case may be) the date upon which such Note becomes due and repayable and the denominator of which is 360,

or on such other calculation basis as may be specified in the applicable Pricing Supplement.

(f) *Instalments*

Instalment Notes will be redeemed in the Instalment Amounts and on the Instalment Dates. In the case of early redemption, the Early Redemption Amount will be determined pursuant to paragraph (e) above.

(g) *Partly Paid Notes*

Partly Paid Notes will be redeemed, whether at maturity, early redemption or otherwise, in accordance with the provisions of this Condition and the applicable Pricing Supplement.

(h) *Purchases*

The Issuer or any Subsidiary of the Issuer may at any time purchase Notes (provided that, in the case of definitive Notes, all unmatured Receipts, Coupons and Talons appertaining thereto are purchased therewith) at any price in the open market or otherwise. If purchases are made by tender, tenders must be available to all Noteholders alike. Such Notes may be held, reissued, resold or, at the option of the Issuer, surrendered to any Paying Agent for cancellation.

(i) *Cancellation*

All Notes which are redeemed will, subject to paragraph (h) above, forthwith be cancelled (together with all unmatured Receipts, Coupons and Talons attached thereto or surrendered therewith at the time of redemption). All Notes so cancelled and any Notes purchased and cancelled pursuant to paragraph (h) above (together with all unmatured Receipts, Coupons and Talons cancelled therewith) shall be forwarded to the Agent and cannot be reissued or resold.

(j) *Late payment on Zero Coupon Notes*

If the amount payable in respect of any Zero Coupon Note upon redemption of such Zero Coupon Note pursuant to paragraph (a), (b), (c) or (d) above or upon its becoming due and repayable as provided in Condition 9 is improperly withheld or refused, the amount due and repayable in respect of such Zero Coupon Note shall be the amount calculated as provided in paragraph (e)(iii) above as though the references therein to the date fixed for the redemption or the date upon which such Zero Coupon Note becomes due and repayable were replaced by references to the date which is the earlier of:

- (i) the date on which all amounts due in respect of such Zero Coupon Note have been paid; and
- (ii) five days after the date on which the full amount of the moneys payable in respect of such Zero Coupon Note has been received by the Agent or the Trustee and notice to that effect has been given to the Noteholders in accordance with Condition 14.

7. Taxation

All payments of principal and interest in respect of the Notes, Receipts and Coupons by the Issuer will be made without withholding or deduction for or on account of any present or future taxes or duties of whatever nature imposed or levied by or on behalf of any Tax Jurisdiction unless such withholding or deduction is required by law. In such event, the Issuer will pay such additional amounts as shall be necessary in order that the net amounts received by the holders of the Notes, Receipts or Coupons after such withholding or deduction shall equal the respective amounts of principal and interest which would otherwise have been receivable in respect of the Notes, Receipts or Coupons, as the case may be, in the absence of such withholding or deduction; except that no such additional amounts shall be payable with respect to any Note, Receipt or Coupon:

- (a) presented for payment in the State of Israel; or
- (b) presented for payment by or on behalf of a holder who is liable for such taxes or duties in respect of such Note, Receipt or Coupon by reason of his having some

connection with a Tax Jurisdiction other than the mere holding of such Note, Receipt or Coupon; or

- (c) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC or any other Directive implementing the conclusions of the ECOFIN Council meeting of 26th-27th November, 2000 on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (d) presented for payment by or on behalf of a holder who would be able to avoid such withholding or deduction by presenting the relevant Note, Receipt or Coupon to another Paying Agent in a Member State of the European Union; or
- (e) presented for payment more than 30 days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on presenting the same for payment on such thirtieth day assuming that day to have been a Payment Day (as defined in Condition 5(e)).

As used herein:

- (i) **“Tax Jurisdiction”** means the State of Israel or any political subdivision or any authority thereof or therein having power to tax; and
- (ii) the **“Relevant Date”** means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Agent or in accordance with the Trust Deed by the Trustee on or prior to such due date, it means the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Noteholders in accordance with Condition 14.

8. Prescription

The Notes, Receipts and Coupons will become void unless presented for payment within a period of 10 years (in the case of principal) and five years (in the case of interest) after the Relevant Date (as defined in Condition 7) therefor.

There shall not be included in any Coupon sheet issued on exchange of a Talon any Coupon the claim for payment in respect of which would be void pursuant to this Condition or Condition 5(b) or any Talon which would be void pursuant to Condition 5(b).

9. Events of Default

- (a) The Trustee at its discretion may, and if so requested in writing by the holders of at least one-quarter in aggregate nominal amount of the Notes then outstanding or if so directed by an Extraordinary Resolution of the Noteholders shall (subject to being indemnified to its satisfaction), give notice to the Issuer that the Notes are, and they shall accordingly forthwith become, immediately due and repayable at their Early Redemption Amount, together with accrued interest as provided in the Trust Deed, after the occurrence of any of the following events (each an **“Event of Default”**):
 - (i) if default is made in the payment of any principal or interest due in respect of the Notes or any of them and the default continues for a period of seven days in the case of principal and 14 days in the case of interest; or
 - (ii) if the Issuer fails to perform or observe any of its other obligations under these Terms and Conditions or the Trust Deed and (except in any case where the Trustee considers such failure is incapable of remedy when no such continuation or notice as is hereinafter mentioned will be required) the failure continues for the period of 30 days next following the service by the Trustee on the Issuer of notice requiring the same to be remedied; or
 - (iii) if (A) any Indebtedness for Borrowed Money (as defined below) of the Issuer or any of its Principal Subsidiaries (as defined below) becomes, or becomes capable of being declared, due and repayable prematurely by reason of an event of default (however described); or (B) the Issuer or any of its Principal Subsidiaries fails to make any

payment in respect of any Indebtedness for Borrowed Money on the due date for payment thereof as extended by any originally applicable grace period; or (C) any security given by the Issuer or any of its Principal Subsidiaries in relation to any Indebtedness for Borrowed Money becomes enforceable; or (D) default is made by the Issuer or any of its Principal Subsidiaries in making any payment due under any guarantee and/or indemnity given by it in relation to any Indebtedness for Borrowed Money of any other person, PROVIDED that no event of default or prepayment event subsisting on the Issue Date of the first Tranche of the Notes or arising at any time under any Existing Indebtedness as a result of a Change of Control shall constitute an Event of Default under paragraph (iii)(A) and for the purposes of such Existing Indebtedness, paragraph (iii)(C) shall be deemed to be amended by the insertion of the words "and any step has been taken to enforce such security" after the words "becomes enforceable" at the end of such paragraph and PROVIDED FURTHER that no event described in this paragraph (iii) shall constitute an Event of Default unless the Indebtedness for Borrowed Money or other relative liability either alone or when aggregated with other Indebtedness for Borrowed Money and/or other liabilities relative to all (if any) other events which shall have occurred and be continuing shall amount to at least U.S.\$10,000,000 (or its equivalent in any other currency or currencies); or

- (iv) if any order is made by any competent court or resolution passed for the winding up or dissolution of the Issuer or any of its Principal Subsidiaries, save for the purposes of reorganisation on terms previously approved in writing by the Trustee or by an Extraordinary Resolution of the Noteholders; or
- (v) if the Issuer or any of its Principal Subsidiaries ceases or threatens to cease to carry on the whole or substantially the whole of its business, save for the purposes of reorganisation on terms previously approved in writing by the Trustee or by an Extraordinary Resolution of the Noteholders, or the Issuer or any of its Principal Subsidiaries stops or threatens to stop payment of, or is unable to, or admits inability to, pay, its debts (or any class of its debts) as they fall due, or is deemed unable to pay its debts pursuant to or for the purposes of any applicable law, or is adjudicated or found bankrupt or insolvent; or
- (vi) if (A) proceedings are initiated against the Issuer or any of its Principal Subsidiaries under any applicable liquidation, insolvency, composition, reorganisation or other similar laws, or an application is made for the appointment of an administrative or other receiver, manager, administrator or other similar official, or an administrative or other receiver, manager, administrator or other similar official is appointed, in relation to the Issuer or any of its Principal Subsidiaries or, as the case may be, in relation to the whole or a part of the undertaking or assets of any of them, or an encumbrancer takes possession of the whole or a part of the undertaking or assets of any of them, or a distress, execution, attachment, sequestration or other process is levied, enforced upon, sued out or put in force against the whole or a part of the undertaking or assets of any of them and (B) in any case (other than the appointment of an administrator) is not discharged within 60 days; or
- (vii) if the Issuer or any of its Principal Subsidiaries initiates or consents to judicial proceedings relating to itself under any applicable liquidation, insolvency, composition, reorganisation or other similar laws or makes a conveyance or assignment for the benefit of, or enters into any composition or other arrangement with, its creditors generally (or any class of its creditors) or any meeting is convened to consider a proposal for an arrangement or composition with its creditors generally (or any class of its creditors);

provided that, in the case of any Event of Default other than those referred to in paragraphs (i) and, in relation to the Issuer, (iv) above, the Trustee shall have certified in writing to the Issuer that such Event of Default is, in its opinion, materially prejudicial to the interests of the Noteholders.

(b) *Definitions*

For the purposes of this Condition:

- (i) **“Change of Control”** means the State of Israel reducing, announcing an intention to reduce or taking any other step with a view to reducing any of its shareholding from time to time in the Issuer;
- (ii) **“Existing Indebtedness”** means any Indebtedness for Borrowed Money of the Issuer outstanding on 7th August, 2000 and any refinancing of such indebtedness by the lenders or holders thereof on substantially similar terms other than as to maturity, rate of interest or other economic terms;
- (iii) **“Indebtedness for Borrowed Money”** means any present or future indebtedness (whether being principal, premium, interest or other amounts) for or in respect of (A) money borrowed, (B) any notes, bonds, debentures, debenture stock, loan stock or other securities offered, issued or distributed whether by way of public offer, private placement, acquisition consideration or otherwise and whether issued for cash or in whole or in part for a consideration other than cash, or (C) any liability under or in respect of any acceptance or acceptance credit;
- (iv) **“Principal Subsidiary”** at any time shall mean a Subsidiary of the Issuer:
 - (A) whose gross revenues attributable to the Issuer (consolidated in the case of a Subsidiary which itself has Subsidiaries) represent not less than 15 per cent. of the consolidated gross revenues of the Issuer, all as calculated respectively by reference to the then latest audited accounts (consolidated or, as the case may be, unconsolidated) of such Subsidiary and the then latest audited consolidated accounts of the Issuer; or
 - (B) whose total assets (consolidated in the case of a Subsidiary which itself has Subsidiaries) represent not less than 20 per cent. of the consolidated total assets of the Issuer, all as calculated respectively by reference to the then latest audited accounts (consolidated or, as the case may be, unconsolidated) of such Subsidiary and the then latest audited consolidated accounts of the Issuer; or
 - (C) to which is transferred the whole or substantially the whole of the undertaking and assets of a Subsidiary of the Issuer which immediately before the transfer is a Principal Subsidiary,

all as more particularly defined in the Trust Deed.

A report (whether or not addressed to the Trustee) by the Auditors (as defined in the Trust Deed) that in their opinion a Subsidiary of the Issuer is or is not or was or was not at any particular time or throughout any specified period a Principal Subsidiary shall, in the absence of manifest error, be conclusive and binding on all parties; and

“Subsidiary” means a company whose accounts are either fully or proportionately consolidated with the accounts of the Issuer in accordance with generally accepted accounting principles in Israel in effect on 7th August, 2000.

10. Substitution

The Trustee may, without the consent of the Noteholders, Receiptholders or Couponholders, agree with the Issuer to the substitution in place of the Issuer (or of any previous substitute) as the principal debtor under the Notes, the Receipts, the Coupons and the Trust Deed of any wholly-owned Subsidiary of the Issuer, subject to the Notes, the Receipts and the Coupons being unconditionally and irrevocably guaranteed by the Issuer and to the Trustee being satisfied that the interests of the Noteholders will not be materially prejudiced thereby and certain other conditions set out in the Trust Deed being complied with.

In the event of any such substitution pursuant to Condition 10 and the Trust Deed, no later than 14 days after the execution of all relevant documentation and compliance with the requirements of the Trust Deed, the replacement issuer shall give notice thereof to the

Noteholders in accordance with Condition 14 and will prepare a supplement to this Offering Circular or publish a new Offering Circular for use in connection with any subsequent issue of the Notes to be listed on the Luxembourg Stock Exchange.

11. Replacement of Notes, Receipts, Coupons and Talons

Should any Note, Receipt, Coupon or Talon be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Agent upon payment by the claimant of such costs and expenses as may be incurred in connection therewith and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Notes, Receipts, Coupons or Talons must be surrendered before replacements will be issued.

12. Paying Agents

The names of the initial Paying Agents and their initial specified offices are set out below.

The Issuer is entitled, with the prior written approval of the Trustee, to vary or terminate the appointment of any Paying Agent and/or appoint additional or other Paying Agents and/or approve any change in the specified office through which any Paying Agent acts, provided that:

- (a) there will at all times be an Agent and a Paying Agent with its specified office in a country outside the Tax Jurisdiction;
- (b) so long as the Notes are listed on any stock exchange or admitted to listing by any other relevant authority, there will at all times be a Paying Agent with a specified office in such place as may be required by the rules and regulations of the relevant stock exchange or any other relevant authority; and
- (c) if European Council Directive 2003/48/EC or any other Directive implementing the conclusions of the ECOFIN Council meeting of 26th-27th November, 2000 on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to such Directive is brought into force, the Issuer undertakes that it will ensure that it maintains a Paying Agent in a Member State of the European Union that will not be obliged to withhold or deduct tax pursuant to any such Directive or law.

In addition, the Issuer shall forthwith appoint a Paying Agent having a specified office in New York City in the circumstances described in Condition 5(d). Any variation, termination, appointment or change shall only take effect (other than in the case of insolvency, when it shall be of immediate effect) after not less than 30 nor more than 45 days' prior notice thereof shall have been given to the Noteholders in accordance with Condition 14.

In acting under the Agency Agreement, the Paying Agents act solely as agents of the Issuer and, in certain circumstances, of the Trustee and do not assume any obligation to, or relationship of agency or trust with, any Noteholders, Receiptholders or Couponholders. The Agency Agreement contains provisions permitting any entity into which any Paying Agent is merged or converted or with which it is consolidated or to which it transfers all or substantially all of its assets to become the successor paying agent.

13. Exchange of Talons

On and after the Interest Payment Date on which the final Coupon comprised in any Coupon sheet matures, the Talon (if any) forming part of such Coupon sheet may be surrendered at the specified office of the Agent or any other Paying Agent in exchange for a further Coupon sheet including (if such further Coupon sheet does not include Coupons to (and including) the final date for the payment of interest due in respect of the Note to which it appertains) a further Talon, subject to the provisions of Condition 8.

14. Notices

All notices regarding the Notes will be deemed to be validly given if published (i) in a leading English language daily newspaper of general circulation in London, and (ii) if and

for so long as the Notes are listed on the Luxembourg Stock Exchange and the rules of such exchange so require, a daily newspaper of general circulation in Luxembourg. It is expected that such publication will be made in the *Financial Times* in London and the *Luxemburger Wort* in Luxembourg. The Issuer shall also ensure that notices are duly published in a manner which complies with the rules and regulations of any stock exchange or any other relevant authority on which the Notes are for the time being listed or by which they have been admitted to listing. Any such notice will be deemed to have been given on the date of the first publication or, where required to be published in more than one newspaper, on the date of the first publication in all required newspapers.

Until such time as any definitive Notes are issued, there may, so long as any Global Notes representing the Notes are held in their entirety on behalf of Euroclear and/or CBL, be substituted for such publication in such newspaper(s) the delivery of the relevant notice to Euroclear and/or CBL for communication by them to the holders of the Notes and, in addition, for so long as any Notes are listed on a stock exchange or admitted to listing by any other relevant authority and the rules of that stock exchange or other relevant authority so require, such notice will be published in a daily newspaper of general circulation in the place or places required by those rules. Any such notice shall be deemed to have been given to the holders of the Notes on the seventh day after the day on which the said notice was given to Euroclear and/or CBL.

Notices to be given by any Noteholder shall be in writing and given by lodging the same, together (in the case of any Note in definitive form) with the relative Note or Notes, with the Agent. Whilst any of the Notes are represented by a Global Note, such notice may be given by any holder of a Note to the Agent through Euroclear and/or CBL, as the case may be, in such manner as the Agent and Euroclear and/or CBL, as the case may be, may approve for this purpose.

15. Meetings of Noteholders, Modification and Waiver

The Trust Deed contains provisions for convening meetings of the Noteholders to consider any matter affecting their interests, including the sanctioning by Extraordinary Resolution of a modification of any of the provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed. Such a meeting may be convened by the Issuer or Noteholders holding not less than 10 per cent. in nominal amount of the Notes for the time being remaining outstanding. The quorum at any such meeting for passing an Extraordinary Resolution is one or more persons holding or representing not less than 50 per cent. in nominal amount of the Notes for the time being outstanding, or at any adjourned meeting one or more persons being or representing Noteholders whatever the nominal amount of the Notes so held or represented, except that at any meeting the business of which includes the modification of certain provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed (including modifying the date of maturity of the Notes or any date for payment of interest thereon, reducing or cancelling the amount of principal or the rate of interest payable in respect of the Notes or altering the currency of payment of the Notes, the Receipts or the Coupons), the quorum shall be one or more persons holding or representing not less than two-thirds in nominal amount of the Notes for the time being outstanding, or at any adjourned such meeting one or more persons holding or representing not less than one-third in nominal amount of the Notes for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Noteholders shall be binding on all the Noteholders, whether or not they are present at the meeting, and on all Receiptholders and Couponholders.

The Trustee and the Issuer may agree, without the consent of the Noteholders, Receiptholders or Couponholders, to:

- (a) any modification of any of the provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed which, in the opinion of the Trustee, is not materially prejudicial to the interests of the Noteholders; or
- (b) any modification of any of the provisions of these Terms and Conditions, the Notes, the Receipts, the Coupons or the Trust Deed which is of a formal, minor or technical

nature or is made to correct a manifest error or to comply with mandatory provisions of the law.

Any such modification shall be binding on the Noteholders, the Receiptholders and the Couponholders and any such modification shall be notified to the Noteholders in accordance with Condition 14 as soon as practicable thereafter.

The Trust Deed contains provisions for convening a single meeting of the Noteholders and the holders of Notes of other Series in certain circumstances where the Trustee so decides.

16. Further Issues

The Issuer shall be at liberty from time to time without the consent of the Noteholders, the Receiptholders or the Couponholders to create and issue further notes having terms and conditions the same as the Notes or the same in all respects save for the amount and date of the first payment of interest thereon and so that the same shall be consolidated and form a single Series with the outstanding Notes. The Trust Deed contains provisions for convening a single meeting of the Noteholders and the holders of notes of other Series in certain circumstances where the Trustee so decides.

17. Contracts (Rights of Third Parties) Act 1999

No rights are conferred on any person under the Contracts (Rights of Third Parties) Act 1999 to enforce any term of this Note, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

18. Governing Law and Submission to Jurisdiction

(a) Governing law

The Trust Deed, the Agency Agreement, the Notes, the Receipts and the Coupons are governed by, and shall be construed in accordance with, English law.

(b) Submission to jurisdiction

The Issuer has in the Trust Deed agreed, for the exclusive benefit of the Trustee, the Noteholders, the Receiptholders and the Couponholders, that the courts of England are to have jurisdiction to settle any disputes which may arise out of or in connection with the Trust Deed, the Notes, the Receipts and/or the Coupons and that accordingly any suit, action or proceedings (together referred to as "**Proceedings**") arising out of or in connection with the Trust Deed, the Notes, the Receipts and/or the Coupons may be brought in the English courts.

The Issuer has in the Trust Deed irrevocably waived any objection which it may have now or hereafter to the laying of the venue of any such Proceedings in any English court and any claim that any such Proceedings have been brought in an inconvenient forum and has further irrevocably agreed that a judgment in any such Proceedings brought in the English courts shall be conclusive and binding upon it and may be enforced in the courts of any other jurisdiction.

(c) Appointment of Process Agent

The Issuer has in the Trust Deed appointed Law Debenture Corporate Services Limited at its registered office at Fifth Floor, Wood Street, London, EC2V 7EX as its agent for service of process, and undertakes that, in the event of Law Debenture Corporate Services Limited ceasing so to act or ceasing to be registered in England, it will appoint such other person as the Trustee shall approve as its agent for service of process in England in respect of any Proceedings. Nothing herein shall affect the right to serve proceedings in any other manner permitted by law.

(d) Waiver of immunity

To the extent that the Issuer may claim sovereign or other similar immunity from jurisdiction, execution following judgment or settlement, the Issuer has in the Trust Deed irrevoca-

bly and unconditionally waived with respect to the Trust Deed, the Notes, the Receipts and the Coupons any right to claim sovereign or other similar immunity from jurisdiction or execution and any similar defence and has irrevocably and unconditionally consented to the giving of any relief or the issue of any process, including without limitation, the making, enforcement or execution against any property whatsoever (irrespective of its use or intended use) of any order or judgment made or given in connection with any Proceedings. This provision is without prejudice to the rights of the Issuer in respect of any suits, actions or proceedings which do not arise out of or in connection with the Trust Deed, the Notes, the Receipts and the Coupons.

(e) *Limitation on enforcement*

Without derogating from any rights claimed by the Israeli Government with respect to certain properties and notwithstanding the above paragraphs of this Condition 18, none of the Trustee, the Noteholders, the Receiptholders or the Couponholders shall have any right to seek, enforce or execute any order or judgment made or given in connection with any Proceedings, or to take any other action to enforce Proceedings, against two properties which the Issuer occupies under a lease, namely (i) 479,000 square metres near Rishpon on which a broadcasting station is located and operated by the Issuer, and (ii) 1,300,000 square metres at Sakia (close to the Hiria dump) on which a reception station and warehouses of the Issuer are located. Such exclusion regarding these two properties shall not derogate from any of Bezeq's rights, claims or arguments in connection with such properties or its disputes with the Government of Israel.

For limitations on the transfer of certain assets, see "The Issuer — Relationship with Government — Government Control and Privatisation" and "The Issuer — Properties".

FORM OF PRICING SUPPLEMENT

Set out below is the form of Pricing Supplement which will be completed for each Tranche of Notes issued under the Programme.

[Date]

BEZEQ

The Israel Telecommunication Corp., Limited

Issue of [Aggregate Nominal Amount of Tranche] [Title of Notes]

under the €750,000,000
Euro Medium Term Note Programme

This document constitutes the Pricing Supplement relating to the issue of Notes described herein. Terms used herein shall be deemed to be defined as such for the purposes of the Conditions set forth in the Offering Circular dated 18th December, 2003. This Pricing Supplement is supplemental to and must be read in conjunction with such Offering Circular.

[The following alternative language applies if the first tranche of an issue which is being increased was issued under an Offering Circular with an earlier date.]

Terms used herein shall be deemed to be defined as such for the purposes of the Conditions (the “**Conditions**”) set forth in the Offering Circular dated [original date]. This Pricing Supplement contains the final terms of the Notes and must be read in conjunction with the Offering Circular dated [current date], save in respect of the Conditions which are extracted from the Offering Circular dated [original date] and are attached hereto.]

[Include whichever of the following apply or specify as “Not Applicable” (N/A). Note that the numbering should remain as set out below, even if “Not Applicable” is indicated for individual paragraphs or sub-paragraphs. Italics denote directions for completing the Pricing Supplement.]

[If the Notes have a maturity of less than one year from the date of their issue, the minimum denomination may need to be £100,000 or its equivalent in any other currency.]

1. (i) Series Number: []
(ii) Tranche Number: []
(If fungible with an existing Series, details of that Series, including the date on which the Note become fungible)
2. **Specified Currency or Currencies:** []
3. **Aggregate Nominal Amount:**
— Tranche: []
— Series: []
4. (i) Issue Price of Tranche: [] per cent. of the Aggregate Nominal Amount [plus accrued interest from [insert date] (in the case of fungible issues only, if applicable)]
(ii) Net proceeds: [] *(Required only for listed issues)*
5. **Specified Denominations:** []
[]
6. [(i)] Issue Date [and Interest Commencement Date]: []
[(ii)] Interest Commencement Date (if different from the Issue Date): []
7. **Maturity Date:** *[Fixed rate — specify date/
Floating rate — Interest Payment Date falling in or nearest to [specify month]]*

8. **Interest Basis:** [[] per cent. Fixed Rate]
 [[LIBOR/EURIBOR] +/- [] per cent.
 Floating Rate]
 [Zero Coupon]
 [Index Linked Interest]
 [Dual Currency Interest]
 [*specify other*]
 (further particulars specified below)
9. **Redemption/Payment Basis:** [Redemption at par]
 [Index Linked Redemption]
 [Dual Currency Redemption]
 [Partly Paid]
 [Instalment]
 [*specify other*]
10. **Change of Interest Basis or Redemption/
 Payment Basis:** [*Specify details of any provision for
 change of Notes into another Interest
 Basis or Redemption/Payment Basis*]
11. **Put/Call Options:** [Investor Put]
 [Issuer Call]
 [(further particulars specified below)]
12. **Date approval for issuance of Notes
 obtained:** []
13. **Listing:** [Luxembourg/*specify other*/None]
14. **Method of distribution:** [Syndicated/Non-syndicated]
- PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE**
15. **Fixed Rate Note Provisions** [Applicable/Not Applicable]
*(If not applicable, delete the remaining
 sub-paragraphs of this paragraph)*
- (i) **Rate(s) of Interest:** [] per cent. per annum [payable
 [annually/semi-annually/quarterly] in
 arrear]
*(If payable other than annually, consider
 amending Condition 4)*
- (ii) **Interest Payment Date(s):** [[] in each year up to and including
 the Maturity Date]/[*specify other*]
*(NB: This will need to be amended in the
 case of long or short coupons)*
- (iii) **Fixed Interest Amount(s):** [] per [] in nominal amount
- (iv) **Broken Amount(s):** [*Insert particulars of any initial or final
 broken interest amounts which do not
 correspond with the Fixed Interest
 Amount*]
- (v) **Day Count Fraction:** [30/360 or Actual/Actual (ISMA) or *specify
 other*]
- (vi) **Determination Date(s):** [] in each year
 [*Insert regular interest payment dates,
 ignoring issue date or maturity date in
 the case of long or short first or last
 coupon*]
*(NB: This will need to be amended in the
 case of regular interest payment dates
 which are not of equal duration)*
*(NB: Only relevant where Day Count
 Fraction is Actual/Actual (ISMA))*
- (vii) **Other terms relating to the method of
 calculating interest for Fixed Rate
 Notes:** [None/*Give details*]

16. Floating Rate Note Provisions

[Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)

- (i) Specified Period(s)/Specified Interest Payment Dates: []
- (ii) Business Day Convention: [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/[*specify other*]]
- (iii) Additional Business Centre(s): []
- (iv) Manner in which the Rate of Interest and Interest Amount is to be determined: [Screen Rate Determination/ISDA Determination/*specify other*]
- (v) Party responsible for calculating the Rate of Interest and Interest Amount (if not the Agent): []
- (vi) Screen Rate Determination:
- Reference Rate: []
(Either LIBOR, EURIBOR or other, although additional information is required if other — including fallback provisions in the Agency Agreement)
- Interest Determination Date(s): []
(Second London business day prior to the start of each Interest Period if LIBOR (other than Sterling or euro LIBOR), first day of each Interest Period if Sterling LIBOR and the second day on which the TARGET System is operating prior to the start of each Interest Period if EURIBOR or euro LIBOR)
- Relevant Screen Page: []
(In the case of EURIBOR, if not Telerate Page 248 ensure it is a page which shows a composite rate or amend the fallback provisions appropriately)
- (vii) ISDA Determination:
- Floating Rate Option: []
- Designated Maturity: []
- Reset Date: []
- (viii) Margin(s): [+/-] [] per cent. per annum
- (ix) Minimum Rate of Interest: [] per cent. per annum
- (x) Maximum Rate of Interest: [] per cent. per annum
- (xi) Day Count Fraction: [Actual/365
Actual/365 (Fixed)
Actual/365 (sterling)
Actual/360
30/360
30E/360
Other]
(See Condition 4 for alternatives)

| | |
|---|--|
| (xii) Fall back provisions, rounding provisions and any other terms relating to the method of calculating interest on Floating Rate Notes, if different from those set out in the Conditions: | [] |
| 17. Zero Coupon Note Provisions | [Applicable/Not Applicable] <i>(If not applicable, delete the remaining sub-paragraphs of this paragraph)</i> |
| (i) Accrual Yield: | [] per cent. per annum |
| (ii) Reference Price: | [] |
| (iii) Any other formula/basis of determining amount payable: | [] |
| (iv) Day Count Fraction in relation to Early Redemption Amounts and late payment: | [Conditions 6(e)(iii) and 6(j) <i>apply/specify other</i>] <i>(Consider applicable day count fraction if not U.S. dollar denominated)</i> |
| 18. Index Linked Interest Note Provisions | [Applicable/Not Applicable] <i>(If not applicable, delete the remaining sub-paragraphs of this paragraph)</i> |
| (i) Index/Formula: | <i>[give or annex details]</i> |
| (ii) Calculation Agent responsible for calculating the principal and/or interest due: | [] |
| (iii) Provisions for determining coupon where calculation by reference to Index and/or Formula is impossible or impracticable: | [] |
| (iv) Specified Period(s)/Specified Interest Payment Dates: | [] |
| (v) Business Day Convention: | [Floating Rate Convention/Following Business Day Convention/Modified Following Business Day Convention/Preceding Business Day Convention/ <i>specify other</i>] |
| (vi) Additional Business Centre(s): | [] |
| (vii) Minimum Rate of Interest: | [] per cent. per annum |
| (viii) Maximum Rate of Interest: | [] per cent. per annum |
| (ix) Day Count Fraction: | [] |
| 19. Dual Currency Note Provisions | [Applicable/Not Applicable] <i>(If not applicable, delete the remaining sub-paragraphs of this paragraph)</i> |
| (i) Rate of Exchange/method of calculating Rate of Exchange: | <i>[give details]</i> |
| (ii) Calculation Agent, if any, responsible for calculating the principal and/or interest payable: | [] |
| (iii) Provisions applicable where calculation by reference to Rate of Exchange impossible or impracticable: | [] |

- (iv) Person at whose option Specified Currency(ies) is/are payable: []

PROVISIONS RELATING TO REDEMPTION

20. Issuer Call:

[Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)

- (i) Optional Redemption Date(s): []
- (ii) Optional Redemption Amount of each Note and method, if any, of calculation of such amount(s): [] per Note of [] Specified Denomination
- (iii) If redeemable in part:
- (a) Minimum Redemption Amount: []
- (b) Maximum Redemption Amount: []
- (iv) Notice period (if other than as set out in the Conditions): []

(N.B. If setting notice periods which are different to those provided in the Conditions, the Issuer is advised to consider the practicalities of distribution of information through intermediaries, for example, clearing systems and custodians, as well as any other notice requirements which may apply, for example, as between the Issuer and the Agent)

21. Investor Put:

[Applicable/Not Applicable]
(If not applicable, delete the remaining sub-paragraphs of this paragraph)

- (i) Optional Redemption Date(s): []
- (ii) Optional Redemption Amount of each Note and method, if any, of calculation of such amount(s): [] per Note of [] Specified Denomination
- (iii) Notice period (if other than as set out in the Conditions): []

(N.B. If setting notice periods which are different to those provided in the Conditions, the Issuer is advised to consider the practicalities of distribution of information through intermediaries, for example, clearing systems and custodians, as well as any other notice requirements which may apply, for example, as between the Issuer and the Agent)

22. Final Redemption Amount of each Note

[] per Note of [] Specified Denomination/specify other/see Appendix]

23. Early Redemption Amount of each Note payable on redemption for taxation reasons or on event of default and/or the method of calculating the same (if required or if different from that set out in Condition 6(e)):

[]

GENERAL PROVISIONS APPLICABLE TO THE NOTES

24. Form of Notes:

[Temporary Global Note exchangeable for a Permanent Global Note which is exchangeable for Definitive Notes [on 60 days' notice given at any time/only upon an Exchange Event]]

- [Temporary Global Note exchangeable for Definitive Notes on and after the Exchange Date]
- [Permanent Global Note exchangeable for Definitive Notes [on 60 days' notice given at any time/only upon an Exchange Event]]
25. **Additional Financial Centre(s) or other special provisions relating to Payment Dates:** [Not Applicable/give details] (Note that this item relates to the place of payment and not Interest Period end dates to which items 17(iii) and 19(vi) relate)
26. **Talons for future Coupons or Receipts to be attached to Definitive Notes and dates on which such Talons mature):** [Yes/No. If yes, give details]
27. **Details relating to Partly Paid Notes: amount of each payment comprising the Issue Price and date on which each payment is to be made and consequences of failure to pay, including any right of the Issuer to forfeit the Notes and interest due on late payment:** [Not Applicable/give details. NB: a new form of Temporary Global Note and/or Permanent Global Note may be required for Partly Paid issues]
28. **Details relating to Instalment Notes:**
- (i) Instalment Amount(s): [Not Applicable/give details]
- (ii) Instalment Date(s): [Not Applicable/give details]
29. **Redenomination applicable:** Redenomination [not] applicable [(If Redenomination is applicable, specify the applicable Day Count Fraction and any provisions necessary to deal with floating rate interest calculation (including alternative reference rates))] [(If Redenomination is applicable, specify the terms of the redenomination in an Annex to the Pricing Supplement)]
30. **Other terms or special conditions:** [Not Applicable/give details]
- DISTRIBUTION**
31. (i) If syndicated, names of Managers: [Not Applicable/give names]
- (ii) Stabilising Manager (if any): [Not Applicable/give name]
32. **If non-syndicated, name of relevant Dealer:** []
33. **Whether TEFRA D or TEFRA C rules applicable or TEFRA rules not applicable:** [TEFRA D/TEFRA C/TEFRA not applicable]
34. **Additional selling restrictions:** [Not Applicable/give details]
- OPERATIONAL INFORMATION**
35. **Any clearing system(s) other than Euroclear and CBL and the relevant identification number(s):** [Not Applicable/give name(s) and number(s)]
36. **Delivery:** Delivery [against/free of] payment
37. **Additional Paying Agent(s) (if any):** []
- ISIN: []
- Common Code: []

[Listing Application

This Pricing Supplement comprises the details required to list the issue of Notes described herein pursuant to the €750,000,000 Euro Medium Term Note Programme of BEZEQ — The Israel Telecommunication Corp., Limited]

Responsibility

The Issuer accepts responsibility for the information contained in this Pricing Supplement.

Signed on behalf of the Issuer:

BEZEQ — The Israel Telecommunication Corp., Limited

By: _____

Duly authorised

If the applicable Pricing Supplement specifies any modification to the Terms and Conditions of the Notes as described herein, it is envisaged that, to the extent that such modification relates only to Conditions 1, 4, 5, 6, 7 (except Condition 6(b)), 11, 12, 13, 14 (insofar as such Notes are not listed or admitted to trade on any stock exchange) or 16, they will not necessitate the preparation of a supplement to this Offering Circular. If the Terms and Conditions of the Notes of any Series are to be modified in any other respect, a supplement to this Offering Circular will be prepared, if appropriate.

USE OF PROCEEDS

The net proceeds from each issue of Notes will be applied by the Issuer for its general corporate purposes.

CAPITALISATION

The table below sets forth the consolidated capitalisation of Bezeq at 30th September 2003:

| | As at 30th September 2003 |
|---|--|
| | <i>(in NIS⁽¹⁾ thousands)</i> |
| Long-Term Debt | 4,142,269 |
| Short-Term Debt | 1,438,410 |
| Shareholders' Equity | 6,533,576 |
| Share capital | |
| — authorised: 2,435,000,000 ordinary shares of NIS 1 each | |
| — issued: 2,435,000,000 ordinary shares of NIS 1 each | |
| Total capitalisation and indebtedness | <u>12,114,255</u> |

Note:

(1) NIS of September, 2003.

On 23rd October, 2003, Bezeq's authorised share capital was increased to 2,625,000,000 and on 18th November, 2003 Bezeq's issued share capital was increased to 2,605,045,611. See "*Government Control and Privatisation*". Save as disclosed in this offering circular, there has been no material change in the consolidated capitalisation of the Issuer since 30th September, 2003.

THE ISSUER

Introduction

Bezeq was established in 1980 as a state-owned company and commenced its operations in 1984. Together with its subsidiaries, it is the principal telecommunications operator in Israel. Bezeq and its subsidiaries (the "**Group**") offer a wide range of telecommunications services, including domestic and international telephone services, data communication services, leased lines, corporate networks, mobile telephone services and telecommunications services to other telecommunications operators. The Israeli telecommunications market has in recent years been exposed to increasing competition pursuant to Government policy. Prior to 1994, Pelephone Communications Ltd. ("**Pelephone**"), a company currently owned in equal shares by Bezeq and Pelephone Holdings L.L.C. ("**PHL**"), a subsidiary of Shamrock Holdings, Inc., a company controlled by the Disney family ("**Shamrock**") was the sole mobile telephone network operator in Israel. Prior to 1997, Bezeq's wholly-owned subsidiary, Bezeq International Ltd. ("**Bezeq International**"), was the sole operator of international telecommunications services in Israel. Bezeq's wholly-owned subsidiary, BezeqCall Communications Ltd. ("**BezeqCall**"), provides installation and maintenance services for telecommunications equipment on customers' premises. Another wholly-owned subsidiary of Bezeq, Bezeq On-Line Ltd. ("**Bezeq On-Line**"), provides call centre outsourcing services. Bezeq is currently not allowed to offer the above-mentioned services, other than through its subsidiaries. Since 1994, telecommunications services have been gradually opened to competition. Bezeq's statutory exclusive right to provide domestic fixed-line telecommunications services was repealed in June 1999, with a view to opening the domestic fixed-line market to competition. However, certain difficulties delayed the issuance of licences to competitors and Bezeq continues to be the predominant operator of domestic fixed-line telecommunications services in Israel. Nevertheless, Bezeq is already subject to increasing competition in various fields in the domestic telecommunications fixed-line market (see "*Activities — Competition in Domestic Services*"). Bezeq also holds 49.8 per cent. of the share capital of D.B.S. Satellite Services (1998) Ltd. ("**DBS**"), a company licensed to provide direct broadcast satellite services, which commenced operations in July 2000 (see "*Group Structure*").

During 2003, the State of Israel reduced its holdings of Bezeq's ordinary shares from approximately 54.6 per cent. to approximately 49.1 per cent. as part of a process whereby the State is expected to privatise all or part of this holding. As a result, Bezeq was converted from a "Government Company" to a "Mixed Company" (related government company) and most of the provisions of the Government Companies Law 1975 (the "**GCL**") and other related laws ceased to apply to Bezeq. Nevertheless, as the State remains Bezeq's largest shareholder and pursuant to the provisions of Bezeq's articles of association, Bezeq is still subject to Governmental supervision (see "*Relationship with Government — Government Control and Privatisation*"). In addition, Bezeq operates under a licence to provide telecommunications services and is therefore highly regulated by the Ministry of Communications (the "**MoC**") (see "*Relationship with Government — Regulation*"). Bezeq's shares are listed and traded on the TASE and as a result Bezeq is subject to certain regulatory requirements, including reporting requirements, under Israeli securities laws.

History and Overview of the Telecommunications Industry in Israel

Since the foundation of the State of Israel in 1948, the Government, through the MoC and its predecessors, has designed, built and operated the Israeli telecommunications infrastructure and provided telecommunications services throughout Israel. In 1984, pursuant to an agreement between the Government and Bezeq (the "**1984 Agreement**"), the MoC transferred the national telecommunications infrastructure, operations and related properties to Bezeq in exchange for equity and debt, which has since been fully repaid (see "*Properties*"). Bezeq has operated and developed the infrastructure either directly or through subsidiaries, since the transfer.

At various stages since 1993, the Government has taken measures to introduce competition in the Israeli telecommunications market and the Group's statutory exclusive rights in all markets have been repealed. By the end of 1994, Cellcom Israel Ltd. ("**Cellcom**") joined Pelephone as a second mobile telephone operator. Partner Communications Company Ltd. ("**Partner**") began operating as a third mobile telephone operator in October 1998 and in February 2001, the MoC granted a licence to provide cellular services to MIRS Communications Ltd. ("**MIRS**") which had

already provided cellular services to closed user groups. In July 1997, two new international telecommunications operators, Golden Lines Ltd. ("**Golden Lines**") and Barak I.T.C. — The International Telecommunications Services Corporation Ltd. ("**Barak**"), began providing international telecommunications services in direct competition with Bezeq International. The anticipated arrival of full competition in the domestic telecommunications market and the fierce competition in both the cellular telecommunications market and the international telecommunications market may have an adverse effect on the Group's financial position. The Telecommunications Law (Telecommunications and Broadcasting), 1982 (the "**Telecommunications Law**") enables competition from the cable television operators in the domestic fixed-line telecommunications services market. In November 2003, the Minister of Communications (the "**Minister**") granted a limited partnership owned by the cable TV companies a general licence for the provision of domestic fixed-line services. Bezeq expects that its primary competitors in the domestic fixed-line telecommunications market will be Cellcom and the cable television operators (see "*Competition in Domestic Services*"). In the broadcasting sector, three cable television operators provide multi-channel broadcasting services in Israel, covering separate geographical areas. The cable television operators have commenced preparations for their expected merger by co-ordinating marketing and infrastructure activities and services. DBS is currently the only multi-channel broadcast provider to compete with these operators in broadcasting services.

Relationship with Government

Regulation

The telecommunications market in which the Group operates is highly regulated by various Government agencies, primarily the MoC. The provision of telecommunications services and the operation of telecommunications facilities require a licence, which is granted by the Minister under the Telecommunications Law. Bezeq has a licence to provide fixed-line domestic telephony, infrastructure and related services in Israel; Bezeq International has licences to provide international telecommunications services and Internet services; and Pelephone has a licence to provide cellular services. Licence holders need to comply with various conditions set out in laws, regulations, orders and their respective licences.

In addition, in accordance with their respective articles of association, Bezeq and its subsidiaries Bezeq International, BezeqCall and Bezeq On-Line will continue to be subject to further regulation which is not applicable to other operators. Such regulation will continue to apply as long as the State maintains its controlling interest in Bezeq. (see "*Relationship with Government — Government Control and Privatisation*"). The Group is also subject to the scrutiny of the Restrictive Trade Practices Commissioner (the "**Commissioner**").

Initially, Bezeq enjoyed a statutory exclusive right to provide telecommunications services and operate telecommunications facilities. The scope of this statutory exclusive right was gradually limited and competition was introduced into several segments of the telecommunications market. In June 1999, Bezeq's statutory exclusivity for the provision of domestic fixed-line services was repealed. The burden of regulation imposed on the Group has generally decreased as segments of the market have opened to competition and the Group's market share in these segments has declined. Hence, Bezeq International and Pelephone, which face fierce competition in international telecommunications and Internet services (Bezeq International) and cellular services (Pelephone), have benefited from a less extensive regulatory regime than Bezeq. Although the MoC has enabled competition in the market for domestic fixed-line services, such competition has not yet been introduced and at present Bezeq continues to be subject to extensive regulation. However, competition already exists in access services to Internet service providers, transmission services, and certain other areas of the telecommunications market. Bezeq believes that it shall continue to be subject to a high level of regulation in the foreseeable future despite the introduction of competition. The MoC forwarded to Bezeq a draft copy of an amendment to its licence designed to replace its existing licence in connection with the opening of the domestic fixed-line services market to competition. The amendment includes certain provisions unfavourable to Bezeq relating to the structural separation between Bezeq and its affiliated companies, supervision over Bezeq and its tariffs, reporting requirements, and other requirements relating to the provision of services by Bezeq. Bezeq has submitted its comments on the amendment to the MoC and is engaged in a hearing process regarding the final form of the amendment. In Bezeq's opinion, the draft licence does not meet its needs given the competitive

environment in which it operates. In September 2002, the Minister adopted, with certain changes, the recommendations of a committee that he appointed to form a policy to increase competition in the domestic services market (the "**Kroll Committee**"). Subsequently, in November 2002, the Minister expanded the licences of Cellcom and Med-1 permitting them to provide data communication services. Furthermore, in May 2003, the Telecommunications Law was amended in order to permit the granting of special general licences as of September 2004, for the provision of domestic fixed-line services with no universal service obligation and without a requirement for minimum geographical coverage. (see "*Domestic Fixed-Line Services — Competition in Domestic Services*" and "*Domestic Fixed-Line Services — Universal Service Obligation*").

Regulation by the Minister applies mainly to two areas — operations and tariffs.

Operations

Bezeq is under a continuing obligation to offer fixed-line telecommunications services to the entire Israeli population, regardless of whether it is profitable to provide these services. Bezeq is restricted to providing only those telecommunications services stipulated in its licence or approved by the Minister. It has differences of opinion with the MoC regarding the proper interpretation of other restrictions on its operations alleged by the MoC. To date, these differences of opinion have not had any material impact on Bezeq's operations. However, no assurance can be given that this will continue to be the case as Bezeq develops its business.

In addition, Bezeq is permitted to provide services in certain competitive markets such as international and cellular telecommunications and other services only through its subsidiaries, Bezeq International, Pelephone, BezeqCall and Bezeq On-Line. Bezeq's licence requires both a strict structural and operational separation between Bezeq and its subsidiaries. In general, transactions regarding telecommunications services between Bezeq and these subsidiaries should be done at arm's length, while allowing other operators to enter into similar transactions with Bezeq on a non-discriminatory basis. In addition, under the terms of Bezeq's licence, the management and operation of the subsidiaries must be separate from those of Bezeq itself, and Bezeq employees with access to sensitive market information concerning a subsidiary's competitors cannot be appointed to such subsidiary's board of directors.

Tariffs

The major tariffs for Bezeq's telecommunications services are regulated and require the approval of the Minister and of the Minister of Finance. In the past, tariffs were set with the result that certain services (such as international telecommunications) subsidised other services (such as domestic voice services). In 1990, a tariff framework was set for Bezeq's services. The framework was designed to produce a reasonable rate of return on Bezeq's shareholders' equity whilst taking into account costs and expenses.

Under the framework, tariffs for services such as domestic telecommunications are updated periodically by an efficiency factor, based on a price cap regulatory regime that is usually recommended once every five years by a public tariffs committee. Bezeq's tariffs were recently updated as of 1st September, 2003. As a result, tariffs were reduced by an average of 5.97% including elimination of the minimum charge per call. In addition, the efficiency factor was set at 2.5% (with the possibility for adjustment pursuant to changes in Bezeq's growth rates). Bezeq believes that the decrease in its tariffs is expected to have a materially adverse effect on its business results. (see note 1.B.1 to "*Unaudited Interim Financial Statements*").

Bezeq may offer alternative tariff baskets for service packages, subject to approval by the Minister and the Minister of Finance. Currently Bezeq offers basket rates for a limited number of services including Internet connectivity and reduced tariffs under tariff schemes such as unlimited calling during off-peak hours and family and friends packages. Bezeq is currently awaiting approval from the MoC for several new packages.

Royalties and Transactions with Government

Bezeq pays the Government a royalty of 4 per cent. of most of its revenues. On 1st January, 2004, such royalty will be reduced to 3.5 per cent.. Bezeq International (in common with the other

international operators) pays the Government a royalty of 4 per cent. and such royalty will be reduced to 3.5 per cent. in 2004. Pelephone (in common with the other cellular telecommunications providers) pays a royalty of 4 per cent. of most of its revenues and such royalty will be reduced to 3.5 per cent. in 2004.

Bezeq transacts a large volume of business with government ministries. Such Government business accounted for approximately 5 per cent. of Bezeq's revenues in 2002 and represents Bezeq's largest customer. In July 2002, Bezeq and the Ministry of Defense signed an agreement under which Bezeq will provide, during a four year period commencing 1st April, 2001, telecommunication services at certain discounts to the Israeli Defense Forces, and the Ministry of Defense undertook to purchase certain services from Bezeq. The above agreement also ended most of the disputes between Bezeq and the Ministry of Defense (see note 27 to the *"Audited Annual Financial Statements"*).

Government Control and Privatisation

The Government has a 49.1 per cent. shareholding in Bezeq. Until 18th November, 2003, the State held over 50 per cent. of Bezeq's share capital. As a consequence, Bezeq and those of its subsidiaries in which it held more than 50 per cent. of the share capital, namely Bezeq International, BezeqCall and Bezeq On-Line, were considered to be a "Government Company" and "Subsidiary Government Companies" respectively and, as such, were heavily regulated by the GCL. On 18th November, 2003, the State sold shares equal to approximately 5.8 per cent. of Bezeq's share capital and as a result, lowered its holdings to below 50 per cent. (47 per cent. at the first stage and 49.1 per cent. after Bezeq allotted new shares to the State). Consequently, Bezeq and its subsidiary companies are not considered to be Government Companies and Subsidiary Government Companies, respectively, and most of the provisions of the GCL as well as other related laws, do not apply to them. Nevertheless, pursuant to Bezeq's and those subsidiaries' respective articles of association, certain limitations continue to apply to them. Pursuant to Bezeq's articles of association, certain actions such as the establishment of subsidiary companies, acquisition of shares in an existing company, sale of shares in certain subsidiary companies, and the appointment of Bezeq's Chairman and CEO require Government approval. Other actions, such as a change in Bezeq's corporate purposes, increase in authorised share capital and a change in shareholder rights, require a special shareholder majority. The articles of association also establish the right of the Government Companies Authority to have a representative attend the meetings of Bezeq's and those wholly owned subsidiaries' boards of directors and their respective committees. The above limitations and requirements shall continue as long as the Government holds at least 10 per cent. of Bezeq's share capital but will expire once Bezeq is controlled by a third party. A general meeting of Bezeq's shareholders convened in order to receive shareholder approval for an amendment to Bezeq's articles of association modifying certain of the above limitations and requirements. However, the proposed modification was removed from the meeting's agenda due to comments raised among the shareholders as to certain amendments. As a result of Bezeq's status as a "Mixed Company", changes to wages and benefits that are in variance with civil servant pay scales will continue to require the approval of the Minister of Finance unless the Minister of Finance, with the approval of the Knesset Finance Committee, waives such requirement. The Ministry of Finance informed the Company that such a waiver shall not be granted prior to the completion of the Company's privatisation, but that granting the Company certain concessions may be considered. Furthermore, employee salaries were recently reduced pursuant to the Law for the Recovery of the Israeli Economy 2003, which continues to apply to Bezeq as a Mixed Company but not to its subsidiary companies.

On 27th August, 2003, the Ministerial Committee for Privatisation resolved to privatise the State's remaining holdings in Bezeq through a private sale of 30 per cent. – 40 per cent. of the shares of Bezeq held by the State as will be determined by the Ministerial Committee for Privatisation. The sale will be accompanied by a capital raising for Bezeq and the sale of the State's additional holdings through a public offering of shares issued by Bezeq and/or by a sale or sales of additional holdings of the State by way of a public offering or during stock exchange trading or through a private placement of share packages. Subsequently, the Government Companies Authority instructed Bezeq to prepare a prospectus based on the financial statements of Bezeq as at 30th September, 2003. Bezeq has commenced preparations for the publication of such prospectus. In July and November 2003, the State sold approximately 231.5 million shares

(equal to approximately 9.4 per cent. of Bezeq's share capital) and Bezeq allotted the State approximately 193.4 million shares amounting to NIS 890 million for the purpose of financing early retirement payments.

There is no certainty as to the time by which the privatisation will be completed. The privatisation may trigger certain pre-payment and event of default provisions in previous loans and debentures entered into by Bezeq (see notes 13(D) and 14(C) to the financial statements set out in "*Audited Annual Financial Statements*" and "*Liquidity and Capital Resources*").

Under the Telecommunications Order (determination of essential service provided by Bezeq — The Israeli Telecommunications Corp. Ltd.), 1997 as amended (the "**Bezeq Order**"), the Minister's approval is required to hold more than 5 per cent. of the share capital of Bezeq or to gain control of Bezeq. In addition, Bezeq may not, without the prior approval of the Minister, transfer or encumber certain assets, including its holdings in subsidiaries and cable and transmission networks, to third parties. If Bezeq ceases (or is likely to cease) to provide any "essential services" (which includes all basic telecommunications services and a substantial part of all other services provided by Bezeq), the Minister may appoint an external manager to direct Bezeq's operations. The Bezeq Order was amended in 2001 to enhance the Government's regulation of the shareholding of third parties in Bezeq, in preparation for the planned privatisation of Bezeq and following suspicions that a certain purchase of Bezeq's shares was financed, at least in part, by a third party who did not request or receive an approval under the Bezeq Order (prior to its recent amendment) in return for rights with respect to such shares. In May 2003, the Telecommunications Law was amended to allow further controls on Bezeq and its shareholders, including the appointment of a Government official as a security observer to attend meetings of the board of directors and its committees, as well as the imposition of additional conditions and limitations on purchasers of Bezeq's shares. In November 2003, the MoC sent Bezeq a proposed amendment to the Bezeq Order designed to implement the above-mentioned controls, as well as to adapt the definition of "control" of Bezeq to the recent amendment to the privatisation resolution, namely at least 30 per cent. Bezeq has recently forwarded its comments on the amendment to the MoC. In addition, the amendment to the Bezeq Order contains requirements regarding security classifications for directors and officers.

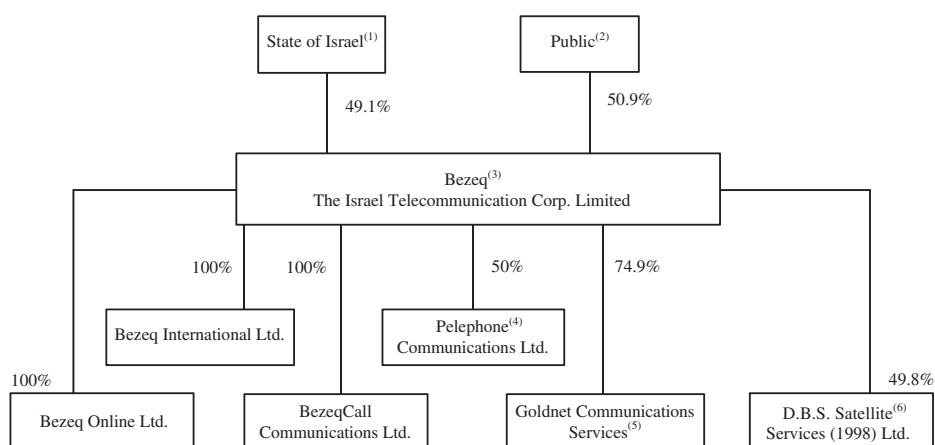
In preparation for Bezeq's planned privatisation, in September 2000 Bezeq, its employees and the Government entered into a collective labour agreement that extended Bezeq's former early retirement plans (see "*Employees*"). Following the amended privatisation resolution in August 2003, the employees raised additional demands regarding the privatisation process.

Anti-Trust Regulation

In 1995, the Commissioner declared Bezeq to have a monopoly in telecommunications infrastructure, basic telephony services and transmission of broadcasting services to the public and, as a monopoly, Bezeq is subject to certain legal restrictions. A request by Bezeq to repeal its declaration as a monopoly in the field of basic telephony services, on the grounds that Bezeq's share in the applicable market which includes, in Bezeq's opinion, both fixed and mobile lines is below 50 per cent., was rejected by the Commissioner in August 2001. In September 2001, Bezeq filed an appeal with the Restrictive Trade Practices Court. In December 2000, the Commissioner declared Bezeq to have a monopoly in the field of telecommunications infrastructure to provide broadband access. In January 2001, Bezeq appealed such declaration at the Restrictive Trade Practices Court. In 1997, the Commissioner determined that Bezeq International, which at such time was declared as a monopoly, had abused its power in the market for international telecommunications services in a manner that would be detrimental to the public interest, although he did not exercise his powers to issue directives to Bezeq International as to what actions it should take. By law, the determination of the Commissioner is considered *prima facie* evidence in legal proceedings. (See note 19A(5) to the financial statements set out in "*Audited Annual Financial Statements*" and note 7A(21) in the "*Unaudited Interim Financial Statements*".)

Group Structure

The following chart sets out the structure of Bezeq and its principal subsidiaries as of 18th December, 2003:



Notes:

- (1) In May 1999, the Shareholders resolved to amend Bezeq's articles of association to the effect that the State of Israel will continue to exercise certain measures of control over Bezeq for so long as it holds at least 10 per cent. of Bezeq's share capital and provided that no third party has acquired control of Bezeq (see "*Relationship with Government — Government Control and Privatisation*").
- (2) On 12th November, 2002, the district court appointed a receiver to the Ze'evi Group. At 18th November, 2003, the Ze'evi Group owned approximately 17.8 per cent. of Bezeq's share capital. The receiver is authorised to enforce the terms of the debenture issued by the Ze'evi Group to the banks that financed the purchase of Bezeq's shares by the Ze'evi Group, and as such exercises the rights attached to the Ze'evi Group shares in certain circumstances. Any disposition of the shares (or other actions in connection with the shares) by the receiver is subject to the court's approval, as well as to the Bezeq Order (see "*Relationship with Government — Government Control and Privatisation*").
- (3) At 18th November, 2003, Bezeq's share capital consisted of 2,625,000,000 ordinary shares of NIS 1 each, of which 2,605,045,611 were issued and fully paid up. The shares are listed on the TASE.
- (4) The remaining 50 per cent. of the shares of Pelephone are held by PHL (see "*Group Structure — Holdings in Pelephone*").
- (5) Goldnet Communications Services ("**Goldnet**") is a partnership between Bezeq and Malam Systems Ltd.
- (6) Bezeq's holdings in DBS do not reflect its capital contributions to DBS, which were not matched by some of the other shareholders in DBS. Pursuant to an agreement between the shareholders of DBS and DBS, the shareholders' respective ownership percentages will be adjusted to their investments in DBS whereby each shareholder may choose between receiving additional shares in DBS or warrants against its investment.

Pursuant to its licence, Bezeq is permitted to provide services in certain competitive markets only through subsidiaries. Accordingly, Bezeq transferred its international telecommunications operations to Bezeq International and established BezeqCall for the provision of installation and maintenance services for telecommunications systems and equipment. Goldnet provides a wide range of data communications services. Bezeq On-Line provides call centre outsourcing services. Recently, Bezeq's subsidiary companies, Pelephone, Bezeq International and BezeqCall established a partnership named "B one" for the sale and marketing of their services. The MoC approved the above cooperation under certain conditions.

Adanet

Adanet Business Group Ltd. ("**Adanet**") provides data networking services, as well as data security consulting and integration, sales of network equipment and database administrator services. Bezeq holds 50 per cent. of the shares of Adanet. In view of the uncertainty regarding the attainment of Adanet's business plan, as well as its future financing, there is considerable concern with respect to Adanet's continued existence as a going concern. As a result, Bezeq recorded in its unaudited interim financial statements a provision in the amount of approxi-

mately NIS 52 million. (See note 4.C in the *“Unaudited Interim Financial Statements”*.) On 10th November, 2003, Adanet filed an application for a stay of proceedings order while a recovery plan is formulated for the group. Further to such application, a stay of proceedings was granted and a trustee was appointed by the court. On 7th December, 2003 the court repealed the stay of proceedings order due to disagreements between the trustee and some of the banks holding the guarantees. Subsequently, pursuant to the request of certain creditors and employees, liquidators were appointed to Adanet and its subsidiaries.

The remaining shares of Adanet are held by Clal Technologies (45 per cent.) and the founders of Adanet (5 per cent.). Bezeq had an option to acquire from Clal Technologies and the founders, and Clal Technologies and the founders had the option, with effect from December 2004, or when Bezeq ceases to be a government company (a condition met on 18th November, 2003) to sell to Bezeq the remaining 50 per cent. of the shares of Adanet. Such purchase of shares by Bezeq was subject to the approval of the Government pursuant to Bezeq’s articles of association, the MoC and the Commissioner. On 18th November, 2003, Bezeq received notices from Clal Technologies and the founders of Adanet regarding the exercise of their put option. Bezeq believes that in light of Adanet’s current status as described above, there is no ground to answer such notice. The issue is currently being negotiated between the parties.

Holdings in Pelephone

Until February 2001, Pelephone was owned in equal shares by Bezeq and Motorola Israel, Ltd. (**“Motorola”**). Motorola’s shares in Pelephone were subsequently transferred to PHL. Bezeq holds an option to purchase all (but not part) of PHL’s stock and become the sole shareholder of Pelephone. Since Bezeq has ceased to be a Government Company, the option is exercisable at any time between 18th November, 2003 and nine months thereafter. The purchase of Motorola’s shares in Pelephone by PHL was financed with: (i) a US\$ 240 million loan made by Bezeq, which is convertible into 80 per cent. of the shares of PHL; (ii) a bank loan of US\$ 300 million; and (iii) US\$ 60 million by way of capital contribution from PHL. If Bezeq exercises its option to purchase PHL, in addition to converting its US\$ 240 million loan, Bezeq will be required to pay to Shamrock an exercise price equal to the higher of (a) the fair market value of 20 per cent. of PHL’s shares in Pelephone at the time of exercise; or (b) a cost value which is expected to be approximately US\$ 60 million. In addition, each of Bezeq and PHL has contributed US\$ 50 million to Pelephone. PHL financed its contribution by increasing the aforementioned bank loan to US\$ 350 million which Bezeq must repay or assume at the time of the exercise of the option (including accrued interest). PHL’s shares in Pelephone were pledged under a first ranking lien to secure the payment of the bank loan. This lien has prior claim over a lien that was granted to Bezeq as collateral for the convertible loan.

Following various indications in the beginning of 2003 of a decrease in the value of Pelephone, Bezeq commissioned a revised valuation of Pelephone. According to the valuation received in March 2003, the value of Pelephone was estimated at between US\$ 650 million and US\$ 850 million. As mentioned above, PHL’s purchase of shares in Pelephone was financed in part by a loan of US\$ 240 million extended by Bezeq, for which Bezeq received convertible debentures for 80 per cent. of the shares of PHL, representing 40 per cent. of Pelephone’s shares. These debentures, plus interest and exchange rate differentials, were presented in Bezeq’s balance sheet under the item Long-term investments, deposits and debit balances. In view of the revised valuation and the priority of PHL’s bank financing over the debenture issued to Bezeq, there was doubt as to the collection of the debentures in the event that Bezeq will decide not to exercise its option. Therefore, a provision of approximately NIS 1.2 billion was made in Bezeq’s 2002 financial statements. In August 2003, Bezeq received an update indicating a rise in Pelephone’s value to between US\$ 900 million and US\$ 1.1 billion. In view of the uncertainty as to the continuing existence of the factors that led to this update, no change was made in the provision for impairment recorded in 2002. Bezeq will re-examine the value of Pelephone. (See note 8.D(2) in the *“Audited Financial Statements”* and note 4.D in the *“Unaudited Interim Financial Statements”*).

Activities

The table below sets forth a breakdown of the consolidated revenues of each of the Group's main sectors of activity, in New Israeli shekels and as a percentage of Bezeq's total consolidated revenues, for each of the last five years:

| | Year ended 31st December, | | | | | | | | | |
|---|---------------------------|-------------|-----------------|-------------|-----------------|-------------|-----------------|-------------|-----------------|------------|
| | 1998 | | 1999 | | 2000 | | 2001 | | 2002 | |
| | NIS Millions | % | NIS Millions | % | NIS Millions | % | NIS Millions | % | NIS Millions | % |
| Domestic fixed-line communications ⁽²⁾ | 3,570 | 35 | 2,970 | 30 | 2,728 | 30 | 2,556 | 30 | 2,307 | 28 |
| Cellular telephone ⁽³⁾ | 2,892 | 28 | 3,065 | 31 | 2,317 | 25 | 2,206 | 25 | 2,135 | 26 |
| Fixed fees ⁽⁴⁾ | 1,700 | 16 | 1,965 | 20 | 2,148 | 24 | 2,209 | 25 | 2,147 | 26 |
| International communications and Internet services ⁽⁵⁾ | 1,223 | 12 | 976 | 10 | 914 | 10 | 835 | 10 | 676 | 8 |
| Installation and sale of equipment to subscribers ⁽⁶⁾ .. | 546 | 5 | 517 | 5 | 536 | 6 | 453 | 5 | 537 | 7 |
| Miscellaneous ⁽⁷⁾ | 373 | 4 | 394 | 4 | 431 | 5 | 422 | 5 | 433 | 5 |
| Total | <u>10,304</u> | <u>100%</u> | <u>9,887</u> | <u>100%</u> | <u>9,074</u> | <u>100%</u> | <u>8,681</u> | <u>100%</u> | <u>8,235</u> | <u>100</u> |

Notes:

(1) NIS of December 2002.

(2) Includes customer charges for domestic calls within Israel (including voice and Internet traffic, as well as interconnect charges for calls from a fixed-line to a cellular line) and revenues from calling card sales.

(3) Includes customer airtime charges for calls from a fixed-line to a cellular line transferred to the cellular operators (excluded as of 1st March, 2000), interconnect charges from the cellular operators (including Pelephone, net of adjustments) for use of Bezeq's network, 50 per cent. proportionate share of Pelephone's revenues (net of adjustments), payments from Pelephone in accordance with the shareholders' agreement dated October 1994 (net of adjustments) and fees for various services provided to the cellular operators including rental of transmission equipment (net of adjustments).

(4) Includes monthly line rental fees for basic telephone lines, data communications lines, ADSL services commencing 2001, private exchanges, customer premises equipment and leased lines and customer charges for value added services such as voice mail, conference calling and caller identification.

(5) Includes customer charges for outgoing international calls, gross settlement fees from foreign operators for incoming international calls, access fees until 2001, interconnect charges and transit fees from the international operators (other than Bezeq International) for use of Bezeq's network, fees for various services provided to the international operators (other than Bezeq International) including rental of transmission facilities and fees for Bezeq International's ISP services.

(6) Includes line and equipment installation charges and equipment sale charges.

(7) Includes revenues for certain services provided to cable television companies, other telecommunications operators, the Israeli Defense Forces and the Broadcasting Authority (such as billing or network construction) and revenues from the Palestinian telecommunications company, ships at sea and satellite services. In addition, includes other telecommunications revenues such as collection fees, Bezeqnet Service, detailed billing and Bezeqcard fees.

The activities of the Group can be divided into three main categories, namely domestic fixed-line services, international services and cellular services.

Domestic Fixed-Line Services

Domestic fixed-line telecommunications services ("**domestic services**") represent the Group's principal business and consist of basic voice services, such as switched voice and facsimile transmission, Internet services, data services and a variety of value-added ancillary services.

The following table sets out certain information regarding Bezeq's domestic services and key relevant changes in the Israeli economy for each of the last five years:

| | Year ended 31st December, | | | | |
|---|---------------------------|-------|-------|--------|--------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| Total number of active subscriber lines (in thousands) ⁽⁴⁾ | 2,807 | 2,878 | 2,974 | 3,033 | 3,006 |
| Lines used by residential customers (in thousands) ⁽¹⁾ .. | 1,804 | 1,866 | 1,919 | 1,928 | 1,930 |
| Lines used by business customers (in thousands) ⁽¹⁾⁽²⁾ .. | 1,003 | 1,012 | 1,055 | 1,105 | 1,076 |
| Number of subscriber lines per 100 inhabitants | 46 | 46 | 47 | 47 | 45 |
| Annual line growth rate | 5% | 3% | 3% | 2% | (1)% |
| Percentage of lines connected to digital exchanges | 100 | 100 | 100 | 100 | 100 |
| Growth in GDP of Israel ⁽³⁾ | 3.3% | 2.6% | 7.5% | (0.9)% | (0.8)% |
| Population of Israel (in thousands) ⁽³⁾ | 6,041 | 6,209 | 6,369 | 6,509 | 6,631 |
| Annual growth rate of Israeli population ⁽³⁾ | 2.4% | 2.8% | 2.6% | 2.2% | 1.9% |

Notes:

- (1) The split between residential and business customers is based on Bezeq's estimate as subscribers are not required to state if they are business or residential customers.
- (2) Including government authorities and public agencies.
- (3) Data from the Israeli Central Bureau for Statistics.
- (4) Changes in the definition of an active subscriber have led to adjustments in this series since the year 2000.

Domestic services generated revenues of NIS 5,424 million in 2002, representing approximately 66 per cent. of Bezeq's consolidated revenues. Domestic calls represented approximately 28 per cent. of Bezeq's consolidated revenues and fixed charges, such as fixed fees and installation charges, represented approximately 33 per cent. of such revenues.

In the past few years, Bezeq has made significant investments to meet subscriber demand for lines and to modernise its network. From 1998 to 2002, Bezeq added approximately 199,000 subscriber lines (including ISDN lines). However, during 2002, subscriber lines decreased due to increased cellular line penetration, the economic recession, and migration to ADSL which provides subscribers with Internet connectivity without occupying their line. Currently, the percentage of households with two or more subscriber lines is approximately 10 per cent.

Domestic Voice Services

Basic Services. As part of its basic switched telephony service package, Bezeq offers subscribers call waiting, call forwarding, repeat dialing, return calling (which allows a subscriber to dial the number from which the last call was placed to such customer), automatic call back (which establishes an automatic connection between a customer and a busy line as soon as the busy line is free), and line repair services.

Value-Added Services. Bezeq offers value-added services at an extra cost, such as voice mail, conference call, caller identification, toll-free numbers and calling cards. Bezeq is continuously looking to improve its existing services and add new value-added services to its service offering. Bezeq is currently planning the introduction of new Intelligent Network (IN) services for residential customers and advanced reminder and integrated voice mail services. Various new services will also be offered to business customers, subject to requisite approvals.

Public Payphones. Bezeq currently operates approximately 16,000 public payphones located throughout Israel, representing a penetration rate of approximately two public payphones per 1,000 inhabitants. All of Bezeq's public payphones are card-operated, accepting pre-paid calling cards. Bezeq's public payphones allow access to each of the three international telephone operators. Pursuant to applicable regulation, Bezeq is obliged to install public telephones in every local authority depending on the number of households in that local authority, as well as, *inter alia*, in schools, hospitals, ports, airports, railway stations and shopping malls.

Calling Cards. Bezeq offers Telecard, a pre-paid calling card, for use in public payphones in Israel, and Bezeqcard, a calling card for use in Israel and abroad with charged calls being billed to the customers as part of their fixed-line billing statement. Bezeq has a variety of advanced

security procedures in place which it believes significantly reduce calling card fraud and related expenses and, to date, Bezeq has experienced a relatively low reported fraud level.

Services to Telecommunications Providers

Bezeq provides services to other telecommunications providers, such as interconnect services and transmission services to connect other providers' networks to Bezeq's network, transmission services among other network sites, billing services, international network infrastructures, satellite services and rights to use submarine cables.

Domestic Data Services and Technologies

The Group provides a range of data communication and related services through a variety of networks and technologies. These services consist primarily of data transmission and network services for business customers, as well as on-line services for business and residential customers. The following are some of the principal data services and technologies offered by the Group:

Leased Lines. Bezeq offers point-to-point digital and analogue leased line services. These services provide direct point-to-point connection for data services as an alternative to the public switched network. For its leased lines, Bezeq charges an installation fee and a fixed fee based on the distance of the line, in the case of an analogue line, or based on the speed of the line, in the case of a digital line. At present, Bezeq installs only digital leased lines but provides maintenance to both existing analogue and digital leased lines.

Sifranet. Since 1986, Bezeq has designed and managed customised data networks under the name Sifranet. Sifranet combines digital point-to-point private lines, using a variety of interfaces and speeds (1200 — 1920 kbps), allowing for high performance and high capacity data transfer, particularly well-suited to meet the needs of customers with multiple locations. Sifranet provides access to various data and information services, including financial information, medical data banks and news services. As of 30th September, 2003, there were approximately 14,300 Sifranet lines.

ATM Services. In 2000, Bezeq introduced a data network based on asynchronous transfer mode ("ATM") technology. The ATM network allows high speed data transfers (max. STM-1 rate) and is particularly well-suited to meet the needs of customers having multiple locations. The ATM network supplies a variety of services including:

- Native ATM service — (CBR, UBR, VBRrt, VBRnrt) using a variety of speeds
- Frame Relay service
- Frame Relay to ATM service
- CES service

In addition, the ATM network provides transmission connectivity for the DSL and Frame Relay services. As of 30th September, 2003, there were approximately 450 ATM access lines installed.

Frame Relay. Since 1994, Bezeq has provided data transfer using frame relay technology. As of 30th September, 2003, Bezeq had approximately 12,200 Frame Relay lines.

ISDN Services. Since 1996, Bezeq has offered ISDN services, a digital telephone line (Basic Rate Interface and Primary Rate Interface) over copper access lines. As of 30th September, 2003, there were approximately 26,000 Basic Rate ISDN lines and 7,700 Premium Rate ISDN lines installed. The number of ISDN subscribers has decreased during the last two years as subscribers have migrated to ADSL (see "*Internet Services — ADSL Service*").

IP Services. Bezeq is building a network based on the Internet Protocol — MPLS technology. The IP-MPLS network is intended to provide a variety of services including:

- Intranet VPN
- Remote Access VPN
- Extranet VPN
- High-speed Internet access

Bezeq expects that at a later stage the IP network will serve as a transmission backbone for both the data and telephony networks.

Goldnet Services. Since 1992, Goldnet, a partnership in which Bezeq currently holds a 74.9 per cent. interest (see note 5 under "*Group Structure*"), has provided a wide range of data communications services, primarily for business customers. Goldnet maintains a communications node licence from EasyLink Services Corporation (one of four installed worldwide) that provides access to 160 countries and 40 communications networks worldwide. These services include local and international electronic mail, Internet access and related services, connections to financial institutions, on-line information services (such as access to the Israeli Registrar of Companies) and access to international databases. Bezeq has recently introduced new applications through Goldnet, such as e-commerce based on an Ariba platform and secured information services.

Internet Services

ADSL Service. In November 2000, Bezeq launched its ADSL services. ADSL is a broadband service which enables high-speed transmission of data through ordinary copper telephone lines. Bezeq offers differentiated pricing schemes aimed at increasing market penetration. As of 30th September, 2003, approximately 358,000 telephone lines had ADSL service, constituting approximately 70% of the broadband Internet access market in Israel.

Bezeqnet. Since 1997, Bezeq has offered Bezeqnet, a dial-up service which enables subscribers to access various ISPs providing direct access to the Internet on a per call basis. In addition to services aimed at occasional Internet users, Bezeqnet also provides connectivity services between permanent subscribers of ISPs and the ISPs.

Bezeq International's Internet Services. Since 1999, Bezeq International has provided direct Internet access services as part of its strategic decision to operate Internet-related services. Bezeq International is currently one of the three largest Israeli ISPs. By 31st December, 2002, Bezeq International had over 314,000 subscribers, most of which were residential customers who represented approximately 70 per cent. of Bezeq International's revenues from Internet activities. Bezeq International's Internet subscribers account for approximately 48 per cent. of all ADSL subscribers. At 30th September, 2003, Bezeq International held approximately 36.74 per cent. of the share capital of Walla! Communications Ltd. ("**Walla**"). Walla operates a portal to the Internet and constructs, develops and hosts Internet sites. In addition, Bezeq International is a web hosting services provider.

Pelephone's Internet Services. For a description of Pelephone's Internet and data services provided over its cellular network, see "*Cellular Services*".

Broadcasting Services

Bezeq operates and maintains technical transmission services for the public broadcasting system in Israel. Bezeq provides broadcasting services (other than programming) for two television stations and 11 radio stations in Israel. Currently, it also provides certain infrastructure services for two of the three cable television operators in Israel. Bezeq's subsidiary, DBS, (in which Bezeq has a 49.8 per cent. interest) was licensed for satellite television broadcasting in January 1999 and commenced operating in July 2000. DBS competes with three cable television operators in multi-channel services in Israel. In April 2002, the Commissioner approved the merger of the three cable television operators, subject to certain conditions. In May 2002, DBS filed an objection to the Commissioner's approval at the Restrictive Trade Practices Court and requested, alternatively, to strengthen the conditions to the merger stipulated by the Commissioner. The merger among the three cable television operators is expected to reduce their operating costs, thus increasing their competitive advantages, and resulting in an adverse effect on the business of DBS. The cable television operators have commenced preparations for their expected merger by co-ordinating marketing and infrastructure activities and services.

As of 30th September, 2003, Bezeq's share in the accumulated losses of DBS amounted to a total of approximately NIS 940 million and Bezeq expects DBS to continue incurring losses during the next few years of its operations. (See note 8.E and Appendix B to the financial

statements set out in "Audited Annual Financial Statements" and note 4.A to the "Unaudited Interim Financial Statements".)

The following table sets out certain information on DBS's business:

| | <u>2001</u> | <u>2002</u> | <u>Jan-Sept 2003</u> |
|---|-------------|-------------|----------------------|
| Number of subscribers (at end of period) | 266,000 | 378,000 | 408,000 |
| Market share ⁽¹⁾ | 19% | 27% | 29% |
| Average monthly revenue per subscriber ⁽²⁾ | 150 | 172 | 176 |
| Revenues ⁽³⁾ | 321 million | 663 million | 617 million |
| Net loss ⁽³⁾ | 881 million | 712 million | 416 million |

(1) Market share is determined by the number of subscribers at the end of each period, with respect to the overall number of subscribers in the Israeli multi-channel broadcasting market which includes DBS and the three Cable TV companies.

(2) In NIS, excluding VAT.

(3) In NIS of September 2003.

Domestic Traffic

The following table sets out certain information on Bezeq's domestic traffic for each of the last five years:

| | <u>Year ended 31st December,</u> | | | | |
|---|----------------------------------|---------------|---------------|---------------|---------------|
| | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> |
| Calls (completed connections)⁽¹⁾ | | | | | |
| Number of calls (in millions) | | | | | |
| Land-to-land | 6,590 | 6,548 | 6,562 | 6,226 | 5,867 |
| Land-to-mobile | <u>1,345</u> | <u>1,660</u> | <u>2,048</u> | <u>2,236</u> | <u>2,212</u> |
| Total | <u>7,935</u> | <u>8,207</u> | <u>8,610</u> | <u>8,462</u> | <u>8,079</u> |
| Annual growth rate | 6% | 3.5% | 5% | (2)% | (5)% |
| Usage minutes⁽¹⁾ | | | | | |
| Number of minutes (in millions) | | | | | |
| Land-to-land | 20,926 | 22,266 | 26,588 | 31,348 | 30,094 |
| Land-to-mobile | <u>2,163</u> | <u>2,656</u> | <u>3,341</u> | <u>3,692</u> | <u>3,556</u> |
| Total | <u>23,089</u> | <u>24,922</u> | <u>29,929</u> | <u>35,040</u> | <u>33,650</u> |
| Annual growth rate | 8% | 8% | 20% | 17% | (4)% |
| Average number of usage minutes per line ⁽²⁾ . . . | 8,382 | 8,785 | 10,133 | 11,668 | 11,145 |

Notes:

(1) As of May 2000, the definition of local calls was changed to include all calls within a single area code and all Internet calls. With effect from 14th May, 2002, the distinction between local and domestic long-distance calls was eliminated and all domestic calls are subject to a single charge.

(2) Calculated according to an annual average of connected lines.

From 1998 to 2000, the number of completed domestic calls increased by 9 per cent., mainly due to the increase in the number of fixed-lines installed to accommodate increased demand and population growth. In addition, call completion rates and average usage per line increased during this period due to the value-added services (such as voice mail, call waiting, call forwarding, call holding and last number redialling) offered by Bezeq over its digitalised network. During the same period, the aggregate number of call minutes increased by 30 per cent. from approximately 23,062 million to 29,932 million. This was due primarily to the increase in Internet traffic. However, Bezeq experienced a decline in the average number of land-to-land voice calls per line, as well as in the average number of outgoing voice minutes per line, primarily as the result of increased cellular phone usage and the installation of second lines in homes, which lines generally have a lower volume of traffic. This decline has continued in the intervening years. Since the fourth quarter of 2001, Internet call volume has also begun a rapid decline due to the migration from dial-up Internet access to broadband ADSL access.

Bezeq estimates that approximately 41 per cent. of traffic within Bezeq's network as at December 2002 (in terms of usage minutes) was attributable to Internet usage.

Domestic Tariff Structure

Bezeq's revenues from domestic services are derived primarily from domestic call charges (land-to-land, land-to-mobile and mobile to land), monthly line rental fees (fixed fees), one-time line installation charges and revenues from equipment sales and charges for value-added services. Pursuant to applicable regulations, Bezeq is generally not permitted to differentiate between business and residential customers in the fees it charges for line installation, monthly line rental and call charges.

Tariffs charged by Bezeq for most of its domestic fixed-line telephone services are generally established by regulations and are subject to Government approval (see "*Relationship with Government — Regulation*").

The following table sets out the initial line installation charges, monthly line rental fees and the cost of domestic local and long-distance calls for each of the last five years:

| | At 31st December, | | | | |
|---|--------------------------|-------------|-------------|-------------|-------------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| | (in NIS ⁽¹⁾) | | | | |
| Standard connection fee | 532 | 532 | 341 | 331 | 273 |
| Standard monthly line rental fee | 31.1 | 36.1 | 37.5 | 37.5 | 38.2 |
| Local call of up to five minutes ⁽²⁾⁽³⁾ | 0.265 | 0.208 | 0.385 | 0.385 | 0.593 |
| One minute domestic long-distance call ⁽²⁾⁽³⁾ | 0.53 | 0.42 | 0.222 | 0.222 | 0.191 |

Notes:

(1) In current NIS, excluding VAT.

(2) The tariffs for local and domestic long-distance calls shown in this table are the highest tariff rates within each category. Until 31st August, 2003, calls were subject to a minimum charge, which at such date was NIS 0.191. As of 1st September, 2003, this minimum charge was eliminated. The tariffs for 2000 - 2002 refer to a call for the duration of five minutes.

(3) With effect from 14th May, 2002, all domestic calls are charged at the same rate, excluding Internet calls, calls to cellular subscribers or to certain numbers (e.g. emergency calls and directory assistance calls). The rates shown for 2002 are for domestic calls at the peak rate.

Competition in Domestic Services

As from 1st June, 1999, Bezeq's statutory exclusive right to provide domestic fixed-line services was repealed. In March 2002, the Minister granted licences to the cable companies to provide broadband access services and subsequently expanded such licences to include data communication services and transmission services. In November 2003, the Minister granted the limited partnership owned by the cable TV companies a general licence for the provision of domestic fixed-line services. Such general licence replaced the licences described above. In November 2002, the Minister expanded the licences of Cellcom and Med-1 permitting them to provide certain data communication and transmission services to organisational customers, and in August 2003 it expanded such licences to provide access to high speed Internet (symmetric data line). In addition, the Telecommunications Law allows the Minister to grant special general licences, as of September 2004, for the provision of domestic fixed-line services with no universal service obligation and without a requirement for minimum geographical coverage. The Telecommunications Law also authorises the Minister to instruct operators of public telecommunications networks (including Bezeq) to allow the unbundling and co-location of network services. Bezeq believes that the introduction of competition in the domestic telecommunications sector will adversely impact its financial position.

Potential competitors for the domestic fixed-line market include cellular operators, the cable TV companies and entities holding fibre optic cable networks such as the Israeli Electric Corp., Israel Railroads and the Cross Israel Highway.

Government Policy on Competition. In September 2002, the Minister adopted, with certain changes, the recommendations of the Kroll Committee that he appointed to form a policy to

increase competition in the domestic services market. The main recommendations that may impact Bezeq, as adopted with certain modifications by the Minister, are as follows: the competition should be facility-based and Bezeq will not be required to unbundle its network, unless competition does not develop in which event the unbundling of Bezeq's network will be revisited; Bezeq's tariffs will continue to be subject to regulation which will be alleviated only in areas where effective competition develops; infrastructure, transmission, and data communications (except Internet access services) will be immediately opened for competition with no requirement for minimum geographical coverage and no requirement to provide such services to all persons, only Bezeq and the limited partnership owned by the cable TV companies will be subject to the universal service obligation; the strict structural and operational separation between Bezeq and its subsidiaries will continue and shall be reconsidered following development of competition (in Bezeq's estimation, the limited partnership owned by the cable TV companies and the cellular operators will likely be subject to less stringent separation requirements); entities holding fibre optic cable networks such as the Israeli Electric Corp., Israel Railroads and the Cross Israel Highway, will be allowed to lease their infrastructure to telecommunications licencees; the exclusivity of the three existing international operators will be extended until 1st January, 2004. Subsequent to the adoption of the recommendations of the Kroll Committee by the Minister, the Telecommunications Law was amended so that commencing September 2004, new telephony and Internet access providers (other than the cable TV operators) will not be required to cover any predetermined geographical areas, whereas until then such operators must commit to cover certain areas. The MoC published draft regulations regarding the granting of special licenses to domestic fixed-line operators with no universal service obligation as well as for the expansion of the competition in the international telecommunications market.

Competition from Cellular Operators. Bezeq already faces competition in the domestic telecommunications market from the cellular operators. The rapid growth of cellular usage in Israel has reduced the number of voice minutes in Bezeq's domestic network as subscribers often prefer to use their cellular telephone even when a fixed-line alternative is available. Bezeq continues to seek to reverse this trend through focused marketing campaigns aimed at informing customers of the lower cost and higher quality of fixed-line calls as compared to cellular calls. However, Bezeq believes that cellular operators may offer more competitive rate packages and thereby increase the competition with the fixed-line services offered by Bezeq. Revenue lost to cellular operators was partially offset for several years by revenues from interconnect fees. However, the cellular operators gradually connected their networks to each other, thus eliminating their need to pay Bezeq transit fees for calls between two cellular networks.

In addition, Bezeq already faces *de facto* competition to its fixed-line services as a result of direct connections made by each of the four cellular operators between the premises of their business customers and their own networks. These direct connections enable such customers to make calls from fixed-lines while circumventing Bezeq's network.

Competition from Cable TV Companies. The cable TV operators already benefit from an extensive cable infrastructure throughout Israel that may be modified to carry telecommunications services. The cable TV operators, which operate on a regional basis, do not compete against each other and in April 2002, the Commissioner approved their merger into a single company, subject to certain conditions. The merger of the three cable TV operators is expected to increase their market power and to reduce their operating costs. Hence, the entrance of the merged company into competition with Bezeq is expected to result in an adverse effect on the business of Bezeq. However, final approval of the merger has not yet been confirmed by the court hearing a DBS petition against the merger.

Under the Telecommunications Law, the Minister is authorised to issue to cable TV operators licences to provide telecommunications services, subject to certain conditions. Following the issue of the general licence to the limited partnership owned by the cable TV companies, each cable TV operator lost its exclusive right to provide cable TV services in its geographical area, and others may now request cable TV licences. The Telecommunications Law requires that the telecommunications services licences and the TV broadcasting licences be held separately by affiliated corporations. Subsequently, the new general licence granted to the limited partnership owned by the cable TV companies in November 2003 sets forth policies regarding structural separation upon the fulfillment of certain conditions.

Bezeq has taken, and is continuing to implement, various measures to prepare for the increasing competition in the market for domestic telecommunications services. These measures include improving and modernising Bezeq's network infrastructure to accommodate advanced telecommunications services; expanding the services offered to subscribers, such as data communication services; reorganising its operational structure (including cost and workforce reduction initiatives; streamlining internal processes; implementing IT systems; consolidating customer services divisions; and increasing marketing efforts, including improving Bezeq's price perception.

Universal Service Obligation

Under its licence, Bezeq is required to provide universal service, namely services to all persons in all regions of Israel, including installing telephone lines in any location, even if the provision of such services is not profitable. Similarly, Bezeq is generally prohibited from discriminating against subscribers in any manner, including through the price of services or the range of services provided. Bezeq submits alternative tariff baskets for service packages to the approval of the Minister and the Minister of Finance, which baskets enable subscribers that choose them to enjoy special rates, but there is no assurance that all such baskets shall be approved. The aforesaid obligations, also known as the universal service obligation, will continue following the introduction of competition in the market for domestic services. Pursuant to the amended Telecommunications Law, new operators entering the domestic fixed-line market other than the cable TV companies will not be subject to a universal service obligation and will not be required to cover any predetermined geographical areas. Under the Telecommunications Law, the Minister may set the means to fund the universal service obligation subsequent to the advent of effective competition.

Domestic Marketing and Customer Service

In response to the introduction of competition in the domestic telecommunications services market, Bezeq has significantly increased its marketing efforts, both in the residential and business sectors, and decided to implement certain organisational changes. In February 2001, Bezeq started to establish separate units in each of its four geographical districts specialising in marketing and managing the services to business customers. In addition, Bezeq has developed a targeted marketing strategy for each type of customer. For instance, each major account is assigned a dedicated account manager to interface with the customer and respond to customer questions and requests. During 2002, Bezeq began operating a support centre for broadband Internet customers.

Bezeq advertises its services in the press, on television, by radio, by direct mail and through its account managers with the aim to increase public awareness of Bezeq's services and to encourage increased use of its services. As part of its marketing campaign, Bezeq uses various promotions. Bezeq carries out surveys of its customers on a regular basis to identify customer concerns and satisfaction levels as well as to identify demand for new products and services. Bezeq believes that a highly efficient, responsive and prompt customer service is essential for its success, particularly in maintaining customer loyalty in an increasingly competitive market. Pursuant to the terms of its licence, Bezeq is required to meet certain service quality requirements.

Billing

In preparation for the opening of the domestic telephone services market to full competition, Bezeq is implementing a new billing system. In June 2001, Bezeq entered into an agreement with Amdocs Software Systems Ltd. for the provision of a billing system for its business customers. The overall cost of developing and implementing the new billing system is estimated at approximately US\$ 50 million, with maintenance and support for the first three years estimated at approximately US\$ 8 million. The billing system is currently expected to be operational by March 2004, at which time Bezeq intends to commence the migration of its business customers to the new billing system. Such migration process is expected to last several months.

International Services

International telecommunications services consist of incoming and outgoing international voice and data traffic and switched transit traffic through Israel. Historically, Bezeq has been the sole provider of direct international telecommunications services in Israel, although various companies have offered indirect calling services since 1988. In June 1996, Bezeq transferred its international telephone services to its wholly-owned subsidiary Bezeq International and, following the opening of the international telecommunications market to competition, Barak and Golden Lines commenced operations in July 1997 in direct competition with Bezeq International. Bezeq International estimates that as of 31st December, 2002, it held between 33 and 35 per cent. of the international voice services market, in terms of traffic.

International telecommunications services generated consolidated revenues of NIS 676 million in 2002, representing approximately 8 per cent. of Bezeq's consolidated revenues. These revenues consist of customer charges for outgoing international calls, gross settlement fees from foreign operators for incoming international calls, transit fees and interconnect charges from the international operators (other than Bezeq International) for use of Bezeq's network and fees for various services provided to the international operators (other than Bezeq International), including rental of transmission facilities, as well as fees for services provided to the international operators in their capacity as Internet service providers. In addition, these revenues include Bezeq International's income from Internet connectivity fees, which is expected to make increasing levels of contribution to Bezeq International's overall revenues. The international operators are required pursuant to the terms of their respective licences to pay Bezeq for the use of its domestic network and for the handling of the international operators' traffic originating or terminating on Bezeq's domestic network. Interconnect charges are paid to Bezeq for all traffic which originates or terminates on its network. Transit fees are paid to Bezeq for traffic transmitted to or from an international operator's system, originating from or, as the case may be, terminating on a cellular operator's system. Bezeq International and the other two international operators also pay Bezeq installation and fixed monthly fees for transmission lines between Bezeq's switches and the switches of the international operators.

International Voice Services

Bezeq International offers various voice services, such as international direct dialling, international toll-free numbers and international directory inquiries. Bezeq International also provides international calling cards such as Globus, Globus Business and a pre-paid calling card, Globus-card, for use in public payphones in Israel and abroad.

International Data Services

Bezeq International provides a range of international data communication and related services through a variety of networks and technologies, such as virtual private networks, frame relay services, video conferencing facilities, ISDN services and ATM technology.

International Traffic

Bezeq International provides dialling and transit services to approximately 220 countries. However, the majority of international traffic is generated by a limited number of destinations. Bezeq International's largest outgoing and incoming international traffic route is between Israel and North America. In 2002, approximately 34 per cent. of the volume of outgoing traffic consisted of calls to North America and approximately 44 per cent. of the volume of incoming traffic consisted of calls from North America.

The following table sets out certain information on the Group's international traffic for each of the last five years:

| | Year ended 31st December, | | | | |
|--|---------------------------|------------|------------|------------|------------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| Outgoing calls (in millions of minutes) | | | | | |
| North America | 124 | 140 | 142 | 138 | 143 |
| Other | 216 | 229 | 265 | 237 | 273 |
| Total | <u>340</u> | <u>369</u> | <u>407</u> | <u>375</u> | <u>416</u> |
| Annual growth in outgoing traffic | 9% | 8% | 10% | (8)% | 11% |
| Incoming calls (in millions of minutes) | | | | | |
| North America | 110 | 132 | 111 | 96 | 95 |
| Other | 144 | 128 | 132 | 139 | 121 |
| Total | <u>254</u> | <u>260</u> | <u>243</u> | <u>235</u> | <u>216</u> |
| Annual growth in incoming traffic | (34)% | 2% | (7)% | (3)% | (8)% |
| Ratio of incoming to outgoing traffic | 0.75 | 0.70 | 0.60 | 0.63 | 0.52 |

There is currently an imbalance between total outgoing international traffic and total incoming international traffic, with the amount of outgoing traffic being greater than the amount of incoming traffic and Bezeq expects this trend to continue. This is mainly due to the introduction of competition and the resulting decrease in tariffs for calls from Israel to other countries. As a result, the Group is a net payer of settlement fees to foreign operators.

Competition in International Telecommunications Services

Until 1997, the Group was the sole provider of direct international telecommunications services in Israel, although various companies have offered limited services since 1988. Following the opening of the international telecommunications market to competition in 1996, two new operators, Barak and Golden Lines, commenced operations in July 1997 in direct competition with Bezeq International. The MoC has undertaken to limit the number of international operators in Israel to three until January 2002. Bezeq and Bezeq International have raised objections to opening the market to additional competition, on the grounds of market saturation. The Minister adopted the Kroll Committee's recommendation that additional international operators be allowed to enter the market only in 2004, subject to the international operators not raising prices in real terms (see "*Relationship with Government — Regulation*"). In July 1997, in an effort to retain its market share and remain competitive, Bezeq International reduced its tariffs significantly. Although the entry of these new competitors into the international telecommunications market, particularly with their low tariffs, has resulted in a substantial increase in the size of the market, Bezeq International's market share, as well as its revenues and profits from this market, have decreased substantially. The MoC had initially decided to open the international telecommunications services market to additional applicants. However, to the best of Bezeq's knowledge, following a further examination, the MoC has not yet determined the exact timing for the implementation of the opening of the market to additional competition. This change is expected to have an adverse effect on the financial results of Bezeq International, *inter alia*, in tariffs, market share and traffic ratio.

Cellular Services

The Group provides mobile telephone services through Pelephone, which Bezeq holds in equal shares with PHL (see "*Group Structure — Holdings in Pelephone*"). In 1994, Bezeq was allotted 50 per cent. of the ownership and control of Pelephone, in exchange for certain infrastructure equipment. Cellular services generated consolidated revenues of NIS 2,135 million in 2002, representing approximately 26 per cent. of Bezeq's consolidated revenues. These revenues consist of interconnect charges from the cellular operators (including Pelephone, net of adjustments) for use of Bezeq's network, transmission charges, Bezeq's proportionate share of Pelephone's revenues (net of adjustments), payments from Pelephone in accordance with the shareholders' agreement dated October 1994 (net of adjustments), and fees for various services provided to the cellular operators, including rental of transmission equipment. Transmission

charges for mobile to land calls and land-to-mobile calls are collected according to rates per minute set in regulations. Pelephone's financial statements are proportionately consolidated with those of Bezeq.

From 1998 to 2002, Pelephone experienced subscriber growth, from approximately 810,000 at 31st December, 1997 to approximately 1,761,000 at 31st December, 2002. Pelephone believes that the cellular penetration rate in Israel at the end of 2002 was approximately 85 per cent., representing approximately 5,600,000 subscriber lines.

The following table sets out some information on Pelephone's activities for each of the last five years:

| | At 31st December, | | | | |
|--|-------------------|-------|-------|-------|-------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| Total subscribers (in thousands) ⁽¹⁾ | 930 | 1,110 | 1,505 | 1,866 | 1,761 |
| Pelephone's cellular subscribers per | | | | | |
| 100 inhabitants | 15.8% | 17.6% | 23.5% | 28.7% | 32.6% |
| Average number of subscribers (in thousands) ⁽²⁾ .. | 872 | 1,021 | 1,308 | 1,686 | 1,662 |
| Total revenues (in NIS millions of December 2002) | 3,252 | 3,213 | 3,717 | 3,801 | 4,008 |
| Average annual revenues per subscriber (in NIS of December 2002) ⁽³⁾ | 3,729 | 3,147 | 2,842 | 2,255 | 2,412 |

Notes:

(1) As of January 2002, Pelephone records subscriber data based on active subscribers. Therefore, the subscriber numbers relate to registered subscribers, including non-active subscribers, for the years 1998-2001, and active subscribers only for the year 2002. At 30th September 2003, Pelephone had approximately 1,911,000 active subscribers.

(2) Represents the average number of Pelephone subscribers during the period.

(3) Based on the average number of Pelephone subscribers during the period.

Pelephone's results in 2002 (a net loss of approximately NIS 158 million) were primarily affected by the amortisation of the subscriber acquisition costs in the net amount of NIS 315 million, whereas in past years similar costs were capitalised. In 2002, Pelephone's active subscriber base grew by 196,000 net new additions.

Pelephone offers a range of voice and value added services throughout Israel, as well as cellular telephone roaming services for use abroad. Until 1998, Pelephone used a Narrow Band Advanced Mobile Phone System ("N-AMPS") analogue technology platform operating with a total of 2 x 12 MHz in the range of 825 MHz to 892 MHz frequencies for its service. To accommodate future growth, as well as satisfy the condition in its licence that it upgrade its system, Pelephone began in October 1998 to deploy a digital network using Code Division Multiple Access ("CDMA") technology to operate alongside the existing N-AMPS network, while also continuing to operate the existing N-AMPS network. Pelephone is upgrading its CDMA network to CDMA2000 1XRTT ("CDMA 1X"). The CDMA 1X network will provide higher spectrum efficiency (capacity) and will support the data speeds required for wireless Internet access and portal applications (ringtone, picture and game downloads). Currently, the 1X network is operational in metropolitan areas.

Pelephone offers to both the mass market and the business sector a variety of value-added services in addition to basic cellular voice telephone service. As part of Pelephone's basic service package, subscribers receive services such as caller ID and voice mail, etc. For an extra charge payable to Pelephone and other content providers, subscribers receive premium services such as animations and ringtone downloading, java games downloading, business services (outlook services, organisation Internet portal), voice content (information and entertainment), SMS services and location based-applications.

Pre-paid Market

Pelephone offers a number of pre-paid cellular services which dispense with monthly fees and customer commitment to a certain subscription period. Pelephone's pre-paid service is available through both the analogue and digital networks.

Approximately one-third of the entire Israeli cellular market consists of pre-paid subscribers. As of December 2002, Pelephone had approximately 631,000 pre-paid subscribers which constituted approximately 29 per cent. of the entire pre-paid market.

Cellular Traffic

The following table sets out certain information on the Group's cellular traffic for each of the last five years:

| | Year ended 31st December, | | | | |
|--|---------------------------|-------|-------|-------|-------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| Number of usage minutes (in millions)..... | 3,342 | 3,645 | 4,455 | 5,543 | 6,582 |
| Annual growth rate | 9% | 12% | 22% | 24% | 19% |
| Average number of usage minutes per subscriber ... | 300 | 295 | 284 | 274 | 271 |

From 1997 to 2002, the number of cellular calls completed on Pelephone's service increased, mainly due to the increase in the number of Pelephone's subscribers.

Cellular Tariff Structure

Pelephone derives revenue from its cellular service from monthly service charges, traffic charges and fees for certain value-added services and handset sales. Pelephone offers its customers a wide variety of pricing plans with varied rates for "friends and family" and other preferred numbers. Pelephone also offers special rates to a wide range of segments: corporate, SME (Small Medium Enterprises), SOHO (Small Office Home Office), soldiers, youth through a separate brand name — Esc, and other segments.

The following table sets out certain information relating to Pelephone's peak tariffs for the periods indicated:

| | At 31st December, | | | | |
|---|-------------------|--------|----------|--------|--------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| | | | (in NIS) | | |
| Monthly service charge (per line) | 36.86 | 29.68 | 18.20 | 17.07 | 14.00 |
| Airtime rate (per outgoing + incoming minute).. | 0.5366 | 0.4986 | 0.4457 | 0.3848 | 0.3289 |

Pelephone determines its own airtime charges. However, the Minister can, under certain circumstances, regulate such charges. Under regulations, airtime tariffs for incoming calls were limited to NIS 0.54 per minute for October-December 2000, NIS 0.50 per minute for 2001 and 2002, and NIS 0.45 per minute as of 1st January, 2003. As a result of such regulations, Pelephone's revenues from incoming calls, net of royalties, decreased by approximately US\$ 54 million for 2001 and US\$ 48 million for 2002. The MoC has indicated that it intends to examine the regulation of interconnectivity charges for calls between networks. Changes to such regulation may further reduce the airtime tariffs for incoming calls.

Pursuant to regulations and the terms of their respective licences, Pelephone and each of the other cellular operators are required to pay royalties to the Government at a rate of 4 per cent. per annum of most of their revenues and such royalties will be reduced to 3.5 per cent. in 2004. In December 2000, the State of Israel filed a claim against Pelephone in the amount of approximately NIS 260 million in connection with royalties for the period between January 1994 and February 1996. Pelephone has filed a defence in which it claims, *inter alia*, that amounts previously paid by Bezeq to the State of Israel cover part of such disputed royalties. The parties have entered into a mediation procedure to resolve such dispute (see note 19A(18) to the financial statements set out in "Audited Annual Financial Statements").

Cellular Competition

In 1993, the Israeli cellular market was opened to competition and in 1994, Cellcom commenced offering cellular services in direct competition with Pelephone. A third cellular operator, Partner, commenced services in 1998. In February 2001, the MoC granted a licence to provide

cellular services to MIRS, a company controlled by Motorola specialising in cellular services to closed user groups.

The environment of intensive competition has resulted in reduced airtime tariffs and the erosion of programmes containing monthly fees and commitments of customers to a specific operator for a minimum period.

The cellular systems of the four cellular operators are based on different technologies, which means that handsets and telephone numbers must be replaced when switching from operator to operator. As of mid 2002, Cellcom is operating a GSM/GPRS network, similar to that of Partner, which will facilitate the migration of subscribers between those two operators. Pelephone believes that this development will not significantly affect the churn rates in the market.

Cellular Marketing and Customer Service

Pelephone is seeking to expand its customer base to both business and private customers, principally through innovative service offerings tailored to meet various subscriber group needs, value added services, effective advertising campaigns and innovative tariff structures. The penetration of cellular telephone services in Israel has increased substantially since 1995, partly due to a new calling party payment system and partly due to the entrance into the market of Cellcom, Partner and MIRS.

To increase sales, Pelephone has established a distribution network throughout Israel consisting of approximately 90 direct sales persons, 152 dealer points and 67 stores, which together represent 309 points of sale.

Pelephone maintains a 24 hours a day, seven days a week customer service hotline to provide subscribers with technical, billing and general information. To improve customer service, Pelephone has established 29 regional service centres offering repair, installation and sales services. These centres are strategically located throughout Israel. In addition, Pelephone assigns individual customer service representatives to business subscribers to ensure appropriate support to these generally larger and more sophisticated users. Pelephone markets a broad range of handsets made by various manufacturers.

Investments in Israel

As part of its strategy to expand its base of income, leverage its technological capabilities and increase its exposure to new technologies, Bezeq has invested in Israeli companies, including start-up companies and companies whose businesses may complement Bezeq's activities. Bezeq has not made such investments during 2003 and is reconsidering its policy on the matter.

In addition, Bezeq has committed to invest up to US\$ 32 million in venture capital funds, including US\$ 20 million in StageOne Ventures LP, of which it is a sponsor, and which focuses in seed investments in start-up companies in the field of telecommunications technology.

Principal Suppliers

The Group obtains telecommunications-related services and equipment from numerous suppliers. The Group is dependent on several main suppliers. If one of the main suppliers of a service or equipment were to be unwilling or unable to supply such service or equipment, the Group could experience disruptions in the operation of its business (see note 19A(6) to the financial statements set out in "*Audited Annual Financial Statements*").

Network Infrastructure and Technology

From 1998 to 2002, the Group invested approximately NIS 8,120 million to upgrade and modernise its telecommunications infrastructure, including, inter alia, the development of a modern signalling system for inter-exchange connections throughout the country, the development of advanced transmission systems using fibre optics and the expansion and enhancement of the access network. Bezeq has achieved full digitalisation of its switching network and, as a result, Bezeq is able to provide its customers with numerous value-added services, as well as reduce connection intervals and errors. In the last three years, Bezeq has substantially invested in the establishment of ADSL and IP networks that enable it to offer its customers fast Internet

access and in the future will provide access to other broadband services and applications. In addition, Bezeq has invested in advanced information systems to enable more informed managerial decisions, including a new billing system, ERP system and a data warehouse. During the next three years, Bezeq intends to invest in telecommunications infrastructure projects such as expansion of the optical network by using WDM technology, enhancing broadband access capabilities by deploying xDSL technologies and fibre to the curb and deploying an IP-based next-generation switching network (See — “*Domestic Fixed-Line Services — Domestic Data Services and Technologies*”). Bezeq’s investment strategy is to remain at the forefront of technological advancement in order to provide advanced and innovative services and to achieve efficiency targets. In recent years, Bezeq’s investments in fixed assets have materially decreased, resulting in a steady decline in its depreciation expense. The final depreciation of assets transferred to Bezeq from the Government following Bezeq’s establishment and of assets acquired during its first years of activity is expected to cause a further decrease in depreciation. (See note 5 to “*Unaudited Interim Financial Statements*”.)

Domestic Fixed-Line Telecommunications Network

Bezeq’s domestic fixed-line telecommunications network comprises numerous local access networks interconnected by a backbone network. By the end of 1996, Bezeq had completed an extensive programme to convert all of its switches to digital technology. Bezeq uses TMX-100 exchanges manufactured by Nortel and S.12 exchanges manufactured by Alcatel. Bezeq completed an upgrade of its Nortel TMX-100 exchanges to MMP15 in 2002, and is currently upgrading its Alcatel S.12 exchanges to Word Release.

Bezeq uses fibre optic cables throughout its domestic backbone network. Fibre optic cables provide enhanced service quality in terms of clarity and speed. At 31st December, 2002, Bezeq had expanded the use of fibre optic cable to 100 per cent. of its trunk network and at such time the connections of approximately 22 per cent. of Bezeq’s subscribers to exchanges utilised fibre optic technologies in its local network, representing approximately 6,200 kilometres of fibre optic cable in its trunk network and approximately 9,200 kilometres of fibre optic cable in its local network. Bezeq has also modernised and substantially upgraded its local access networks, increasing the number of access lines in its local network from approximately 2.81 million lines at the end of 1998 to approximately 3.0 million lines at the end of 2002. Less than 1 per cent. of Bezeq’s domestic infrastructure consists of microwave radio network used to carry video, voice and data.

International Telecommunications Network

Bezeq International provides international telephone service through international exchanges that serve as gateways between Bezeq’s domestic network and the global international network, consisting of submarine cables, terrestrial cables, microwave and satellite transmissions and international digital exchanges. In addition, Bezeq uses its domestic network to connect customers to the exchanges of the new international operators and to connect such operators’ exchanges to the international network. The international transmission network infrastructure has fully-digitalised international switching and transmission. Bezeq International uses submarine fibre optic cables providing connections to Palermo, Cyprus, London and other destinations through which international calls can be routed to over 50 countries. Bezeq International purchased rights of use on additional submarine fibre optic cables that are not directly connected to Israel for communications with Europe, North America and other countries. Bezeq International has 182 channels through its satellite connections.

Bezeq provides satellite capacity through Intelsat, in which Bezeq is a shareholder, as well as in New Skies Satellites Ltd. (which operates approximately one-fifth of Intelsat’s satellites). Bezeq owns a land earth station and provides Inmarsat services, pursuant to an operating agreement with Inmarsat. Bezeq’s satellite services provide access to Europe, America, Russia and the Far East. In September 2003, Bezeq decided to gradually cease to provide Inmarsat services and reduced the balance of its investment in property relevant to the station by approximately NIS 36 million. The MoC notified Bezeq that it was not authorised to decide on closure of the station. Bezeq is considering a solution that will be accepted by the MoC.

Cellular Telecommunications Network

Pelephone has made substantial investments in its cellular telephone network which provides nationwide coverage. Pelephone expects to continue to make substantial investments, including in connection with third generation technologies. Historically, Pelephone has used an advanced N-AMPS analogue technology platform but, to accommodate the anticipated continued expansion of Pelephone's subscriber base and traffic without adversely affecting service quality, in 1998 Pelephone began deploying a digital network using CDMA technology to operate alongside the existing N-AMPS analogue network.

Pelephone is upgrading its CDMA network to CDMA 1X, a technology that will provide higher spectrum efficiency (capacity) and will support the data rates required for the emerging usage of Internet access and portal applications. Pelephone expects to complete the system upgrade to CDMA 1X by the end of 2003.

Pelephone's cellular infrastructure is based on fourteen switches, which are in the process of being upgraded. Pelephone expects to install eight new CDMA Nortel MTX switches and four N-AMPS Motorola EMX switches by the end of March 2004. System coverage and capacity are based on over 1,155 radio sites nationwide and in-building repeaters in malls, hospitals and business centres. Each radio site covers a specific geographical area and includes an antenna for receiving and transmitting to a computerised control system. The sites are connected to a switch which includes a digital exchange responsible for connections among the sites as well as with Bezeq's and the other cellular operators' switches. Pelephone's N-AMPS infrastructure equipment is manufactured by Motorola, Inc. Pelephone's CDMA infrastructure is manufactured by Nortel (switches and the radio system in central urban areas) and Motorola (radio system in rural areas).

Pelephone has encountered difficulties in obtaining permits required for operating cellular sites. Should such difficulties continue, they might delay the planned development of the network. This could have an adverse effect on the range, quality and capacity of the network.

Pelephone participated in the third generation frequencies tender held by the MoC and acquired new frequencies in the sum of NIS 225 million, to be paid in several instalments until 2006. In addition, Pelephone provided the MoC with a guarantee in the amount of US\$ 20 million. Pelephone has recently commenced discussions with the MoC regarding its request to return such third generation frequencies to the State.

Pelephone's board of directors resolved to commence a process of installing EVDO technology, an advanced technology enabling the provision of third generation services. Pelephone expects to implement the process during 2004.

Employees

General

At 31st December, 2002, Bezeq had 8,896 employees: 5,060 permanent workers, employed under collective labour agreements, including approximately 1,638 workers who were transferred to Bezeq from the Moc after the establishment of Bezeq; 1,039 workers, including 97 senior managers, each employed under individual contract terms; 2,797 workers, employed in specific tasks under the sole terms of a special collective wage agreement which allows the employment of a worker for a period of up to six years, for tasks previously done by outsourced temporary staff provided by various employment agencies. More than one-third of Bezeq's employees at 31st December, 2002 were technicians. At that date, 52 per cent. of Bezeq's employees performed administrative functions, 6 per cent. were engineers and an additional 7 per cent. were university graduates.

The table below sets out information regarding Bezeq's positions (FTE) for each of the last five years:

| | Year ended 31st December, | | | | |
|----------------------------|---------------------------|--------------|--------------|--------------|--------------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| Number of employees | | | | | |
| Permanent contracts | 6,629 | 5,989 | 5,409 | 5,219 | 4,989 |
| Temporary contracts | 248 | 135 | 61 | 2,150 | 2,304 |
| Individual contracts | 607 | 692 | 833 | 1,068 | 1,029 |
| Total | <u>7,484</u> | <u>6,816</u> | <u>6,303</u> | <u>8,437</u> | <u>8,322</u> |

The general terms and conditions of employment for all of Bezeq's employees are determined by the Israeli labour laws, which regulate working conditions such as minimum wages, working hours, wage protection, annual leave, social security, health insurance and severance pay. In addition, as long as Bezeq is a mixed company, it is subject to Government regulation under which any changes in wages and benefits at variance with those applicable to civil servants require approval by the Minister of Finance. However, the Minister of Finance, with the approval of the Knesset Finance Committee, may exempt Bezeq from such limitation. The Ministry of Finance informed Bezeq that the Minister of Finance shall not grant such an exemption prior to the completion of Bezeq's privatisation, but that the Ministry will consider granting Bezeq certain concessions. Bezeq's subsidiary companies are not subject to such Government regulation.

Voluntary Early Retirement Plans

In a continuing effort to increase efficiency and streamline its workforce with a view to enhancing Bezeq's ability to compete, particularly in the domestic telephone market following the introduction of competition, on 23rd November, 1997 special collective labour agreements were entered into between Bezeq, the Histadrut (the national labour union) and the employees' representatives to regulate the terms of an early retirement plan and to alter the organisational structure of Bezeq. The terms of this early retirement plan provided for the retirement of approximately 1,800 employees by 31st December, 1999. The number of employees who retired within the framework of this plan exceeded Bezeq's forecasts and reached approximately 2,050. In March 2000, Bezeq further extended the plan to include 530 additional employees, all of which have already retired as of 31st December, 2001. As a result of the extensions, an expense of approximately NIS 398 million was provided for in Bezeq's 1999 financial statements. In September 2000, a special collective labour agreement was signed which effectively extended the retirement plan to the end of 2006 (with an option to extend the final retirement date of certain employees to the end of 2008), and under which up to approximately 1,770 employees may retire. In 2000, Bezeq reserved approximately NIS 1.4 billion in connection with the extension of the early retirement plan. Under the extension, approximately 838 employees had retired as of 30th September, 2003, a number which far exceeded Bezeq's forecasts and which was achieved, in part, as a result of impending legislation designed to curtail preferential pension rights offered by the pension fund covering Bezeq's workers. (See note 6.A to the "Unaudited Interim Financial Statements"). Following a dispute that arose as a result of new legislation, Bezeq is currently negotiating with the Ministry of Finance and *Keren Makefet* (Pension Fund) regarding the retirement arrangements of its employees, as derived from the new legislation. Should the negotiations end without reaching an agreement, Bezeq will consider taking the necessary legal action.

Pension Benefits

Pursuant to certain collective labour agreements, Bezeq provides certain pension benefits to its employees and has contributed to funds to cover severance pay liabilities. Employees who were transferred to Bezeq from the MoC in 1984 may elect to receive pension benefits in accordance with either the *Keren Makefet* (Pension Fund) rules or the Government Service Law (Pension), 1970.

Labour Relations

During the past five years, Bezeq has experienced several work stoppages and strikes which disrupted its business. Since 2000, there have been four strikes as part of national labour

disputes. Such strikes were spread intermittently over extended periods and included partial or total work stoppages. As a result approximately 25 working days were disrupted in one way or another. Most of the strikes and work stoppages occurred as protests against Government policies rather than against Bezeq. Due to a dispute regarding the retirement arrangements of Bezeq's employees, the employees commenced work disruptions on 17th December, 2003. On 18th December, 2003 Bezeq applied to the Labour court against such disruptions.

Properties

Bezeq's principal properties consist of numerous plots of land, buildings and telecommunications facilities, including exchanges, transmission equipment, office facilities and retail outlets, located throughout Israel. At 30th September, 2003, Bezeq owned, leased or used approximately 514,072 developed square metres on approximately 6,989,884 square metres of land in Israel.

A considerable portion of Bezeq's real estate was transferred to Bezeq pursuant to the 1984 Agreement. Properties subject to long-term leases granted to Bezeq by the State of Israel, typically for terms of up to 49 years renewable for an additional term of 49 years and properties held by Bezeq jointly with the postal authority, which like Bezeq originated from the MoC, are also subject to a 1993 agreement between the Israel Land Administration ("ILA") and Bezeq (the "**1993 Agreement**"). Pursuant to the 1993 Agreement, Bezeq may use these two types of properties for the purpose of telecommunications operations and related purposes. The 1993 Agreement also contains limitations on the modification, transfer and use of such properties. Bezeq had been in disagreement with the Government on the validity of the 1993 Agreement and certain of its terms, as well as with respect to the validity of those provisions of the 1984 Agreement affording Bezeq lesser rights than those held by the Government prior to the 1984 Agreement. In addition, the Government has transferred to Bezeq significant properties for automatically renewable leases of two years. The 1984 Agreement stipulates that the Government may terminate any renewable lease, at one year's notice, if the land is required by it for a preferable use. In such event, the Government must offer Bezeq, to Bezeq's satisfaction, an appropriate substitute property within a reasonable distance and cover the costs of transfer to such substitute property. Among the other issues that had been in dispute with the Government, Bezeq viewed its rights in the properties subject to renewable leases to be tantamount to full rights of ownership. In 1997, the Government gave Bezeq notice that all renewable leases were to be terminated as of the end of January 1998 (a similar notice was given and rejected in 1994). Bezeq believed that the action taken by the Government was unlawful and therefore rejected it. In June 2002, the State of Israel filed a claim against Bezeq requesting the court to declare, *inter alia*, (i) that the State of Israel is the sole owner of the real estate properties transferred to Bezeq pursuant to the 1984 Agreement and that Bezeq has only limited rights of use in such property; (ii) that the Government has a right to immediately repossess properties subject to the renewable leases of two years, provided that the Government is of the opinion that there is a preferable use for such properties, and subject to providing to Bezeq alternative property if Bezeq proves that such alternative property is required for the provision of its services; (iii) that the Government has the right to repossess, without reimbursement to Bezeq, including giving alternative property, any property not being used for the purposes for which it was leased or if the Government is no longer interested in such purpose; (iv) that Bezeq must immediately transfer to the State of Israel certain properties. Bezeq filed a statement of defence in which it alleges, *inter alia*, that the claim should be struck out or clarified and amended and that in any case the claim should also be dismissed on its merits.

On 15th May, 2003, Bezeq, the Government and the ILA signed an agreement which settles the said disputes (as well as other disputes) (the "**2003 Agreement**"). According to the 2003 Agreement, Bezeq shall return to the State of Israel a number of properties held by Bezeq in automatically renewable leases of two years, as well as several properties held by Bezeq under long-term leases as described above. All the other properties that had been subject to the dispute will remain in Bezeq's hands for a 49 year lease period, commencing in 1993, which may be extended at Bezeq's option for an additional term of 49 years. In addition, Bezeq may use these properties for any purpose permitted under the relevant zoning plans. In addition, the ILA will lease to Bezeq a 70,000 square metre plot for the purposes of operating warehouses and offices. Bezeq will also lease from the ILA three properties for the purpose of telecommunications

operations and related purposes, in substitution for four properties to be returned by Bezeq to the State of Israel under the 2003 Agreement. According to the 2003 Agreement, the 1993 Agreement shall be terminated, and the parties will sign a separate lease agreement for each property.

The 2003 Agreement will be effective upon obtaining the following: (1) approval of Bezeq's authorised bodies — which has already been given; and (2) approval of the Israel Land Council, which has already been given although it has not yet been signed by all the relevant authorities; and (3) an approval of the court presiding over the said ILA claim against Bezeq, granting the 2003 Agreement the status of a court ruling.

In addition to the properties transferred under the 1984 Agreement, Bezeq owns, leases and uses other properties.

Bezeq's rights in certain of the properties it uses are not properly documented or registered. However, Bezeq has taken steps to protect its rights in part of those properties.

Legal Proceedings and Tax Assessments

Legal Proceedings

Bezeq and other members of the Group are party to lawsuits and administrative proceedings incidental to the ordinary course of business. Except for the proceedings referred to elsewhere in this Offering Circular, including the notes to the financial statements set out in "*Audited Annual Financial Statements*" (in particular notes 9.C and 19.A) and in "*Unaudited Interim Financial Statements*" (in particular note 7), no member of the Group is a party to any legal proceeding and no such proceeding is known by Bezeq to be contemplated by Governmental authorities or third parties which, if adversely determined, could have a material adverse effect on Bezeq or the Group. Bezeq believes that adequate provision has been recorded in its financial statements to the extent deemed necessary in respect of such claims. In December 2003, a class action was filed against Pelephone in the amount of NIS 317 million for the reimbursement of monthly subscription fees due to charges for disconnected calls from June 2003 until the date of the claim. Pelephone and its legal counsel are studying the claim documents and are unable, at this stage, to assess the claim's likely outcome.

Tax Assessments

Bezeq has received final tax assessments up to and including 1998. Pelephone has received final tax assessments up to 1994 and for the years up to 1998 as a result of the statute of limitations having elapsed. Bezeq International has received final tax assessments up to 1999. BezeqCall has received final tax assessments up to 1998. Bezeq's other subsidiaries have not yet received any final tax assessments.

Environmental Issues

There have been allegations concerning the risks associated with the transmission of radiowaves from telecommunications infrastructure, mobile telephones, transmitters and associated equipment. There can be no assurance that Bezeq or other members of the Group may not be affected by the actual or perceived risks associated with radiowave transmission.

There are alleged health risks related to base transceiver stations and the use of handsets which could expose Pelephone, as well as other cellular operators, to liability, and lead to reduced usage of mobile phones and increased difficulties in obtaining sites for base stations.

Liquidity and Capital Resources

Bezeq generates significant operating cash flow which, together with debt financing, it uses to finance its capital expenditure and working capital needs. With the completion of the digitalisation of its switches in 1996, Bezeq's capital expenditure requirements have gradually reduced, although its subsidiaries continue to require significant capital resources to fund investments in technology. The Group's capital expenditure budget for the year ended 31st December, 2003 is approximately NIS 1.4 billion.

As at 30th September, 2003, Bezeq had approximately NIS 5.6 billion of interest bearing debt outstanding, approximately NIS 1.2 billion of which contains provisions requiring or allowing early repayment in the event that the State of Israel's shareholding in Bezeq is reduced to below 26 per cent. Bezeq expects that some of its lenders will seek repayment of their debt in such circumstances and Bezeq may consider replacing or refinancing a portion of these debts, although there can be no assurance that Bezeq will succeed in such plans. DBS will require additional funding to finance its operations and capital expenditure programmes.

RECENT DEVELOPMENTS AND OUTLOOK

Whilst Bezeq cannot predict with any certainty the Group's results for the year ending 31st December, 2003, it expects sales volumes in the domestic fixed-line market to decrease as revenues continue to be impacted by the tariff changes introduced on 1st September, 2003. Furthermore, the continued migration of calls from the fixed-line to the cellular networks will continue to adversely impact revenues.

The anticipated opening of fixed domestic telecommunications services to competition in September 2004, and the expected further opening of the international services market to additional competitors in 2004, in addition to the growing competition in the cellular and broadcasting communications sectors, is expected to continue to have a material adverse effect on the Group's business results. During 2003, Bezeq has continued to provide significant financial assistance to some of the other group companies. Bezeq expects that DBS will continue to make losses through 2003, as a consequence of the competitive environment in which it operates.

In October 2001, the Israeli Institution for Standardization in Accounting published Accounting Standard No. 12, which deals with the termination of inflationary adjustments in financial statements. The standard is scheduled to come into effect as of 1st January, 2004. Until 31st December, 2003, Bezeq will continue to prepare inflation-adjusted financial statements, and the adjusted amounts in Bezeq's reports as of 31st December, 2003 will become the basis for the nominal reports starting 1st January, 2004. The standard may have a material adverse effect on the reported results of Bezeq, the extent of which depends on the rate of inflation and on Bezeq's financing structure (see note 2(1)(a) to the "*Unaudited Interim Financial Statements*").

Bezeq is currently engaged in a privatisation process whereby the State has resolved to sell all or part of its holdings in Bezeq. The continued privatisation as well as the granting of concessions in its general licence is essential to Bezeq in order to remove some of the legal and operational limitations. In addition, the complete privatisation will provide Bezeq with additional managerial flexibility to enable it to better compete in the competitive markets in which it operates.

Bezeq believes that its existing infrastructure and network will give it an advantage in competing with any new operator in the domestic fixed-line market and, if privatised, that Bezeq would benefit from more flexibility to compete. To meet the demands of increasing competition, Bezeq has continued to increase efficiency and streamline its workforce. In addition, the Group continues to invest in maintaining and developing infrastructure and technology, improving customer services and marketing and exploring new telecommunications and related projects with the aim of maintaining its strength and leadership in the market.

MANAGEMENT

Board of directors

Bezeq's Articles of Association provide that the board of directors of Bezeq consists of no more than 17 members at any time (subject to two additional directors being appointed as described below). The Articles of Association provide that members of the board of directors of Bezeq are elected at the general meeting of shareholders by a majority of 60 per cent. of the shareholders represented and voting at such meeting. In addition, pursuant to the Articles of Association, so long as the State holds at least 10 per cent. of Bezeq's ordinary shares or it continues to control Bezeq (or it ceases to control Bezeq but no other entity has control) the Minister and the Minister of Finance together may appoint two additional directors from Bezeq's employees. If such additional two directors are appointed, the general meeting of shareholders may appoint an additional two directors (thus bringing the maximum overall number of directors to 19).

Bezeq, as a publicly-traded company, is required to elect at its general meeting of shareholders two "external directors" that are unaffiliated with it or with any entity controlling Bezeq or any entity controlled by Bezeq. Such external directors are included in the maximum overall number of directors, are appointed for an initial term of three years that may be extended for one additional term of three years and are not subject to early termination except under specific circumstances. In November 2003, the terms of the two external directors ended. Currently, no replacements have been appointed. It should be noted that, according to the Companies Law, resolutions that are subject to the approval of the Audit Committee of the board, require two external directors to be serving on the board.

Each director on behalf of the State is appointed for three years by the Minister and the Minister of Finance, but such appointment is subject to such director being elected in each of the following annual general meetings. A director may be removed either by a resolution of the shareholders of Bezeq at a general meeting, or for reasons such as the director becoming bankrupt or being found guilty of certain offences. Bezeq's board of directors currently consists of 13 members (of which 12 are on behalf of the State and one is from among Bezeq's employees).

Bezeq's board of directors establishes the principles of strategy, organisation and financing to be used by Bezeq. The board of directors appoints the executive officers of Bezeq.

The members of the board of directors of Bezeq are as follows:

| <u>Name</u> | <u>Name</u> |
|----------------------------|----------------------------|
| Miriam Mazar (Chairperson) | Shimon Levi |
| Yoram Aridor | Shiloh Lifschitz |
| Amal Assad | Rami Nomkin ⁽¹⁾ |
| Avi Barak | Hava Shechter |
| Dalit Braun | Benny Vaknin |
| Ido Dissentshik | Shoshana Weinshal |
| Rachel Kremmerman-Meridor | |

(1) Director from among Bezeq's employees.

The business address of each of the members of the board of directors of Bezeq is 2 Azrieli Center, Bezeq Building, Tel Aviv 61620, Israel.

Senior Management

The members of the senior management of Bezeq are as follows:

| <u>Name</u> | <u>Position</u> |
|-----------------------------|--|
| Amnon Dick..... | President & Chief Executive Officer |
| Paul Weissbach | Deputy Chief Executive Officer and Vice President, Engineering & Planning |
| Ron Eilon | Chief Financial Officer |
| Erez Hasdai | Acting Vice President, Economics |
| Pnina Shenhav | Vice President, Marketing & Sales |
| Michal Even-Chen* | Vice President, Business Development |
| Raz Heiferman | Vice President, Information Technology |
| Gideon Kadusi | Vice President |
| Alik Romm | Vice President, Human Resources |
| Bosmat Chelouche | General Counsel |
| Danny Friedman | Internal Auditor |
| Shimon Netzer | Corporate Secretary |
| Nati Bialistock-Cohen | Anti-Trust Compliance Officer |
| Yotam Yakir | Spokesperson |
| Abraham Shlomovitz | Head of Tel Aviv & Sharon Operating Division |
| Rafi Rahat | Head of Central Area Operating Division |
| Yossi Malka | Head of Haifa & North Operating Division |
| Menachem Avinoam | Head of Jerusalem & South Operating Division |

* Ms. Michal Even-Chen has announced her resignation from Bezeq, effective 1st January, 2004. As of such time, Mr. Ari Bronshtein will be responsible for business development and will report directly to the President & CEO.

ISRAELI TAXATION

The following is a summary of the Issuer's understanding of current law and practice in Israel relating to certain aspects of the taxation of the Notes. Some aspects do not apply to certain classes of taxpayer (such as dealers). The summary assumes that the Noteholder is not a resident of Israel. Prospective holders of Notes who may be subject to tax in a jurisdiction other than Israel or who may be unsure as to their tax position should seek their own professional advice.

Generally, interest under the Notes which accrues from 1st January, 2003 onwards is subject to an Israeli withholding tax of 25 per cent. in the case of corporate Noteholders and 15 per cent. in the case of individual Noteholders, depending on the terms of the Notes. Withholding tax may, however, be reduced by (i) an appropriate double taxation treaty to which Israel is a party and the "interest" article of which provides for a full or partial exemption from withholding on interest payments, or (ii) a ruling which the Israeli Ministry of Finance may, in its discretion, make and which provides for a full or partial exemption from withholding on interest payments. Bezeq has been granted an exemption from withholding tax on interest under the Notes by the Israel income tax authority, provided that tax at the rate of 2.5 per cent. of the interest is paid directly by Bezeq to the Israel income tax authority.

Pursuant to the Terms and Conditions of the Notes the Issuer will, subject to certain exceptions, pay such additional amounts as shall be necessary in order that the net amounts received in respect of the Notes after the withholding, if any, shall equal the amounts which would otherwise have been receivable in respect of the Notes in the absence of such withholding.

SUBSCRIPTION AND SALE

The Dealers have, in an amended and restated Programme Agreement dated 18th December, 2003 (the "**Programme Agreement**") agreed with the Issuer a basis upon which they or any of them may from time to time agree to purchase Notes. Any such agreement will extend to those matters stated under "*Form of the Notes*" and "*Terms and Conditions of the Notes*". In the Programme Agreement, the Issuer has agreed to reimburse the Dealers for certain of their expenses in connection with the establishment of the Programme and the issue of Notes under the Programme and to indemnify the Dealers against certain liabilities incurred by them in connection therewith.

United States

The Notes have not been and will not be registered under the Securities Act and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons except in certain transactions exempt from the registration requirements of the Securities Act.

The Notes are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. tax regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code of 1986 and regulations thereunder.

Each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that it will not offer, sell or deliver Notes (i) as part of their distribution at any time or (ii) otherwise until 40 days after the completion of the distribution, as determined and certified by the relevant Dealer or, in the case of an issue of Notes on a syndicated basis, the relevant lead manager, of all Notes of the Tranche of which such Notes are a part, within the United States or to, or for the account or benefit of, U.S. persons. Each Dealer has further agreed, and each further Dealer appointed under the Programme will be required to agree, that it will send to each dealer to which it sells any Notes during the distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Notes within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

Until 40 days after the commencement of the offering of any Series of Notes, an offer or sale of such Notes within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act if such offer or sale is made otherwise than in accordance with an available exemption from registration under the Securities Act.

Each issuance of Index Linked Notes or Dual Currency Notes shall be subject to such additional U.S. selling restrictions as the Issuer and the relevant Dealer may agree as a term of the issuance and purchase of such Notes, which additional selling restrictions shall be set out in the applicable Pricing Supplement.

United Kingdom

Each Dealer has represented and agreed, and each further Dealer appointed under the Programme will be required to represent and agree, that:

- (i) in relation to Notes which have a maturity of one year or more, it has not offered or sold and, prior to the expiry of the period of six months from the issue date of such Notes, will not offer or sell any such Notes to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended);
- (ii) in relation to any Notes having a maturity of less than one year, (a) it is a person whose ordinary activities involve it in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of its business and (b) it has not offered

- or sold and will not offer or sell any Notes other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or as agent) for the purposes of their businesses or who it is reasonable to expect will acquire, hold, manage or dispose of investments (as principal or agent) for the purposes of their businesses where the issue of the Notes would otherwise constitute a contravention of Section 19 of the FSMA by the Issuer;
- (iii) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any Notes in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer; and
 - (iv) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to any Notes in, from or otherwise involving the United Kingdom.

Germany

Each Dealer has represented and agreed that Notes have not been offered, sold or publicly promoted or advertised by it in the Federal Republic of Germany otherwise than in compliance with the German Securities Selling Prospectus Act (*Wertpapierverkaufsprospektgesetz*) of 13th December, 1990 (as amended) and any other laws applicable in the Federal Republic of Germany governing the issue, offering and sale of securities.

Israel

The Issuer has not filed an application with the Israel Securities Authority for the publication of this Offering Circular as would have been required by the Securities Law 1968 ("**Securities Law**") in order to permit a public offering of Notes in Israel. Accordingly, Notes shall not be offered to the public in Israel.

Each of the Dealers has agreed, and each further Dealer appointed under the Programme will be required to agree, that it will only offer, sell, or distribute Notes in Israel in compliance with the Securities Law and any other applicable Israeli laws and regulations.

Japan

The Notes have not been and will not be registered under the Securities and Exchange Law of Japan (the "**Securities and Exchange Law**") and each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will not offer or sell any Notes, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organised under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

The Netherlands

Each Dealer has represented and agreed and each further Dealer appointed under the Programme will be required to represent and agree that it has not, directly or indirectly, offered or sold and will not, directly or indirectly, offer or sell in The Netherlands any Notes with a denomination of less than €50,000 (or its foreign currency equivalent) other than to persons who trade or invest in securities in the conduct of a profession or business (which include banks, stockbrokers, insurance companies, pension funds, other institutional investors and finance companies and treasury departments of large enterprises) or in compliance with any other applicable laws and regulations in The Netherlands.

General

Each Dealer has agreed and each further Dealer appointed under the Programme will be required to agree that it will comply with all applicable securities laws and regulations in force in any jurisdiction in which it purchases, offers, sells or delivers Notes or possesses or distributes this Offering Circular and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of Notes under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries and neither the Issuer nor any of the other Dealers shall have any responsibility therefor.

None of the Issuer and the Dealers represents that Notes may at any time lawfully be sold in compliance with any applicable registration or other requirements in any jurisdiction, or pursuant to any exemption available thereunder, or assumes any responsibility for facilitating such sale.

With regard to each Tranche, the relevant Dealer will be required to comply with such other restrictions as the Issuer and the relevant Dealer shall agree and as shall be set out in the applicable Pricing Supplement.

GENERAL INFORMATION

Authorisation

The establishment of the Programme and the issue of Notes have been duly authorised by a resolution of the Public Offering and Privatisation Committee of the board of directors of the Issuer dated 31st July, 2000. The first update of the Programme has been duly authorised by a resolution of the board of directors of the Issuer dated 23rd October, 2001. The second update of the Programme has been duly authorised by a resolution of the board of directors of the Issuer dated 12th December, 2002. The third update of the Programme has been duly authorised by a resolution of the board of directors of the Issuer dated 18th December, 2003.

Listing of Notes on the Luxembourg Stock Exchange

Application has been made to list Notes issued under the Programme on the Luxembourg Stock Exchange. A legal notice relating to the Programme and the constitutional documents of the Issuer are being lodged with the Luxembourg trade and companies register (*Registre de commerce et des sociétés, Luxembourg*) where such documents may be examined and copies obtained. The Luxembourg Stock Exchange has allocated the number 12413 to the Programme for listing purposes.

Documents Available

So long as Notes are capable of being issued under the Programme, copies of the following documents will, when signed or published, be available free of charge from the registered office of the Issuer and from the specified offices of the Paying Agents for the time being in London and Luxembourg:

- (i) the Memorandum and Articles of Association (with an English translation thereof) of the Issuer;
- (ii) the consolidated audited financial statements of the Issuer in respect of the financial years ended 31st December, 2001 and 2002. The Issuer currently prepares audited consolidated accounts on an annual basis;
- (iii) the most recently published audited annual financial statements of the Issuer and the most recently published unaudited interim consolidated and non-consolidated (if any) financial statements of the Issuer (with an English translation thereof). The Issuer currently publishes unaudited consolidated interim accounts on a quarterly and semi-annual basis. The Issuer does actually not publish non-consolidated interim accounts;
- (iv) the Programme Agreement, the Agency Agreement, the Trust Deed and the forms of the Global Notes, the Notes in definitive form, the Receipts, the Coupons and the Talons;
- (v) a copy of this Offering Circular;
- (vi) any future offering circulars, prospectuses, information memoranda and supplements including Pricing Supplements (save that a Pricing Supplement relating to an unlisted Note will only be available for inspection by a holder of such Note and such holder must produce evidence satisfactory to the Issuer and the Paying Agent as to its holding of Notes and identity) to this Offering Circular and any other documents incorporated herein or therein by reference; and
- (vii) in the case of each issue of listed Notes subscribed pursuant to a subscription agreement, the subscription agreement (or equivalent document).

Clearing Systems

The Notes have been accepted for clearance through Euroclear and CBL. The appropriate Common Code and ISIN for each Tranche of Notes allocated by Euroclear and CBL will be specified in the applicable Pricing Supplement. If the Notes are to clear through an additional or alternative clearing system the appropriate information will be specified in the applicable Pricing Supplement.

Significant or Material Change

Save as disclosed in this Offering Circular, there has been no significant change in the financial or trading position of the Issuer or its subsidiaries (the "**Group**") since 30th September, 2003 and there has been no material adverse change in the financial position or prospects of the Group since 31st December, 2002.

Litigation

Save as provided herein and in the notes to the financial statements set out herein, neither the Issuer nor any other member of the Group is or has been involved in any legal or arbitration proceedings (including any proceedings which are pending or threatened of which the Issuer is aware) which may have or have had in the 12 months preceding the date of this document a significant effect on the financial position of the Issuer or the Group.

Auditors

The auditors of the Issuer are KPMG Somekh Chaikin, who have audited the Issuer's accounts, without qualification, in accordance with generally accepted auditing standards in Israel for each of the three financial years ended on 31st December, 2002.

EU Savings Directive

On 3rd June, 2003, the European Council of Economics and Finance Ministers adopted a Directive on the taxation of savings income under which Member States will be required, from a date not earlier than 1st January, 2005, to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State, except that, for a transitional period, Belgium, Luxembourg and Austria will instead be required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries).

“BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2002

Contents

| | <u>Page</u> |
|--|-------------|
| Auditors’ Report | 76 |
| Financial Statements | |
| Balance Sheets | 77 |
| Statements of Operation | 79 |
| Statements of Changes in Shareholders’ Equity..... | 80 |
| Statements of Cash Flows | 81 |
| Notes to the Financial Statements..... | 83 |
| Appendix A — List of Group Companies | 155 |
| Appendix B — Financial Statements of DBS Satellite Services (1998) Ltd. | 156 |

**Auditor's Report to the Shareholders of
"Bezeq" The Israel Telecommunication Corp. Limited**

We have audited the accompanying balance sheets of "Bezeq" The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2002 and 2001, and the consolidated balance sheets as at such dates and the related statements of income, shareholders' equity and cash flows for each of the three years the last of which ended December 31, 2002. These financial statements are the responsibility of the Company's Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of consolidated subsidiaries, including those consolidated by the proportionate method whose assets constitute approximately 20% and approximately 17% of the total consolidated assets as at December 31, 2002 and 2001, respectively, and whose revenues constitute approximately 34%, 28%, and 9% of the total consolidated revenues for the years ended December 31, 2002, 2001, and 2000, respectively. The financial statements of those subsidiaries were audited by other auditors whose reports thereon were furnished to us. Our opinion, insofar as it relates to amounts emanating from the financial statements of such subsidiaries, is based solely on the said reports of the other auditors. Furthermore, the data included in the financial statements relating to the net asset value of the Company's investments in affiliates and to its equity in their operating results is based on the financial statements of such affiliates, some of which were audited by other auditors.

We conducted our audits in accordance with generally accepted auditing standards, including standards prescribed by the Auditors' Regulations (Manner of Auditor's Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the abovementioned other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and the consolidated financial position of the Company and its subsidiaries as at December 31, 2002 and 2001 and the results of their operations, the changes in the shareholders' equity and their cash flows for each of the three years the last of which ended December 31, 2002, in conformity with generally accepted accounting principles. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of Annual Financial Statements), 1993.

As explained in Note 2, the abovementioned financial statements are stated in values adjusted for the changes in the general purchasing power of the Israeli currency, in accordance with opinions of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters the maximum possible exposure of which is significant:

1. The anticipated opening of the communications sector to competition, changes in the tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for a early retirement, as described in Note 16D (3).
3. Claims made against the Company and against investee companies, as described in Note 19A.
4. The financial condition of an affiliated company and the financing agreement between the affiliated company and banking corporations. As described in Note 8E the activity of the affiliated company is dependent upon the continued execution of the financing agreement, including the formulation of the Addition to the Financing Agreement as detailed in the aforementioned note, and receipt of additional loans from shareholders.

Somekh Chaikin
Certified Public Accountants (Isr.)
A member firm of KPMG International

March 6, 2003

Balance Sheets

In terms of shekels of December 2002

| | Note | Consolidated | | Company | |
|---|------|---------------------|---------------------|---------------------|---------------------|
| | | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Current assets | | | | | |
| Cash and cash equivalents | 3 | 992,454 | 1,387,644 | 917,365 | 1,352,890 |
| Short-term investments | 4 | 1,180,081 | 469,279 | 1,179,989 | 452,206 |
| Trade receivables | 5 | 1,751,988 | 1,795,814* | 1,126,358 | 1,219,959 |
| Other receivables and debit balances | 6 | 514,756 | 308,678* | 476,795 | 269,157 |
| Inventory | | 167,381 | 123,570 | — | — |
| | | <u>4,606,660</u> | <u>4,084,985</u> | <u>3,700,507</u> | <u>3,294,212</u> |
| Materials and spare parts | | <u>122,188</u> | <u>161,667</u> | <u>122,188</u> | <u>161,667</u> |
| Investments and long-term payables | | | | | |
| Investments, deposits and debit balances | 7 | 768,811 | 1,788,166* | 675,684 | 1,725,152 |
| Investments in investee companies | 8 | 390,074 | 491,018 | 1,742,474 | 1,704,081 |
| | | <u>1,158,885</u> | <u>2,279,184</u> | <u>2,418,158</u> | <u>3,429,233</u> |
| Fixed assets | | | | | |
| Cost | 9 | 29,956,427 | 29,995,478 | 24,987,523 | 25,534,628 |
| Less — accumulated depreciation | | <u>19,986,463</u> | <u>19,092,610</u> | <u>16,946,977</u> | <u>16,427,787</u> |
| | | <u>9,969,964</u> | <u>10,902,868</u> | <u>8,040,546</u> | <u>9,106,841</u> |
| Other assets | | | | | |
| Deferred charges and other assets | 10 | 282,798 | 362,512 | 15,414 | 18,086 |
| Deferred taxes | 11 | 402,076 | 477,037* | 236,979 | 346,331 |
| | | <u>684,874</u> | <u>839,549</u> | <u>252,393</u> | <u>364,417</u> |
| | | <u>16,542,571</u> | <u>18,268,253</u> | <u>14,533,792</u> | <u>16,356,370</u> |

| | Note | Consolidated | | Company | |
|-------------------------------------|------|---------------------|---------------------|---------------------|---------------------|
| | | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Current liabilities | | | | | |
| Bank credit | 12 | 528,825 | 451,081 | — | — |
| Current maturities of: | | | | | |
| Long-term bank loans | 13 | 545,063 | 593,104 | 373,184 | 390,866 |
| Other debentures | 14 | 210,294 | 198,851 | 210,294 | 198,851 |
| Trade payables | 15 | 1,153,363 | 1,084,858 | 676,213 | 607,589 |
| Employee severance benefits | 16 | 212,631 | 280,028 | 212,631 | 280,028 |
| Other current liabilities | 17 | <u>1,118,102</u> | <u>1,227,173*</u> | <u>883,240</u> | <u>1,015,843</u> |
| | | <u>3,768,278</u> | <u>3,835,095</u> | <u>2,355,562</u> | <u>2,493,177</u> |
| Long-term liabilities | | | | | |
| Long-term loans | 13 | 2,103,365 | 2,677,226 | 1,510,434 | 2,101,737 |
| Other debentures | 14 | 2,769,127 | 2,688,244 | 2,769,127 | 2,688,244 |
| Employee severance benefits | 16 | | | | |
| Prepaid income | 18 | 1,139,820 | 1,358,795 | 1,128,812 | 1,347,258 |
| | | <u>44,639</u> | <u>61,804</u> | <u>53,090</u> | <u>78,865</u> |
| | | <u>6,056,951</u> | <u>6,786,069</u> | <u>5,461,463</u> | <u>6,216,104</u> |
| Minority rights | | <u>575</u> | <u>—</u> | <u>—</u> | <u>—</u> |
| Contingent liabilities | 19 | | | | |
| Shareholders' equity | 20 | <u>6,716,767</u> | <u>7,647,089</u> | <u>6,716,767</u> | <u>7,647,089</u> |
| | | <u>16,542,571</u> | <u>18,268,253</u> | <u>14,533,792</u> | <u>16,356,370</u> |

* Reclassified

Adv. Miriam (Miki) Mazar
Chairperson of the Board

Ilan Biran
CEO

Danny Oz
Deputy Chief Financial
Officer

Date of approval of the financial statements: March 6, 2003

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

Statements of Operation for the Year Ended December 31
In terms of shekels of December 2002

| | Note | Consolidated | | | Company | | |
|---|------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | | 2002 NIS thousands | 2001 NIS thousands | 2000 NIS thousands | 2002 NIS thousands | 2001 NIS thousands | 2000 NIS thousands |
| Revenues from | | | | | | | |
| telecommunications services . . . | 21 | <u>8,234,543</u> | <u>8,681,397</u> | <u>9,074,166</u> | <u>5,567,854</u> | <u>6,277,572</u> | <u>6,752,258</u> |
| Costs and expenses | | | | | | | |
| Operating and general expenses . . | 22 | 4,624,490 | 4,757,761 | 4,626,413 | 2,461,929 | 2,680,870 | 2,738,998 |
| Depreciation | 9 | 2,318,357 | 2,765,209 | 2,916,227 | 1,924,816 | 2,290,770 | 2,425,936 |
| Royalties to the State of Israel . . . | | 254,955 | 287,952 | 339,711 | 182,469 | 201,612 | 216,938 |
| | | <u>7,197,802</u> | <u>7,810,922</u> | <u>7,882,351</u> | <u>4,569,214</u> | <u>5,173,252</u> | <u>5,381,872</u> |
| Operating income | | 1,036,741 | 870,475 | 1,191,815 | 998,640 | 1,104,320 | 1,370,386 |
| Financing expenses, net | 23 | <u>168,494</u> | <u>153,435</u> | <u>370,680</u> | <u>119,386</u> | <u>77,481</u> | <u>317,877</u> |
| Earnings after financing expenses | | 868,247 | 717,040 | 821,135 | 879,254 | 1,026,839 | 1,052,509 |
| Other expenses, net | 24 | <u>1,243,243</u> | <u>115,257*</u> | <u>1,374,430</u> | <u>1,230,389</u> | <u>2,665</u> | <u>1,331,449</u> |
| Earnings (loss) before income tax | | (374,996) | 601,783 | (553,295) | (351,135) | 1,024,174 | (278,940) |
| Income tax (tax benefit) | 11 | <u>211,319</u> | <u>245,571</u> | <u>(165,584)</u> | <u>234,056</u> | <u>369,283</u> | <u>(149,891)</u> |
| Earnings (loss) after income tax . . | | (586,315) | 356,212 | (387,711) | (585,191) | 654,891 | (129,049) |
| Equity in losses of investee | | | | | | | |
| companies | 8 | 347,072 | 233,847* | 210,766 | 345,131 | 525,902 | 464,144 |
| Minority share in losses of | | | | | | | |
| consolidated company | | (3,065) | (6,624) | (5,284) | — | — | — |
| Net earnings (loss) | | <u>(930,322)</u> | <u>128,989</u> | <u>(593,193)</u> | <u>(930,322)</u> | <u>128,989</u> | <u>(593,193)</u> |
| Earnings (loss) per share | | | | | | | |
| Primary and diluted earnings | | | | | | | |
| (loss) per NIS 1 par value of | | | | | | | |
| common shares (in NIS) | 25 | <u>(0.386)</u> | <u>0.053</u> | <u>(0.244)</u> | <u>(0.386)</u> | <u>0.053</u> | <u>(0.244)</u> |

* Reclassified

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

Statements of Changes in Shareholders' Equity
In terms of shekels of December 2002

| | Share capital | Capital reserve for distribution of bonus shares | Capital reserve — share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Dividend offered after the balance sheet date | Retained earnings | Total |
|---|------------------|---|--|---|--|----------------------|------------------|
| Balance as at January 1, 2000 | 4,463,375 | — | 703,987 | 38,500 | — | 2,632,550 | 7,838,412 |
| Changes in 2000 — | | | | | | | |
| Erosion of dividend proposed in a previous year and paid this year | — | — | — | — | — | (1,535) | (1,535) |
| Net loss | — | — | — | — | — | (593,193) | (593,193) |
| Tax benefit in respect of shares to employees | — | — | 23,500 | — | — | — | 23,500 |
| Conversion of convertible debentures ⁽¹⁾ | 15,826 | — | 161,528 | — | — | — | 177,354 |
| Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares | — | 1,726,332 | — | — | — | (1,726,332) | — |
| Balance as at December 31, 2000 | 4,479,201 | 1,726,332 | 889,015 | 38,500 | — | 311,490 | 7,444,538 |
| Changes in 2001 — | | | | | | | |
| Net earnings | — | — | — | — | — | 128,989 | 128,989 |
| Conversion of convertible debentures ⁽²⁾ | 6,408 | — | 67,154 | — | — | — | 73,562 |
| Distribution of bonus shares ... | 1,748,350 | (1,726,332) | — | — | — | (22,018) | — |
| Balance as at December 31, 2001 | 6,233,959 | — | 956,169 | 38,500 | — | 418,461 | 7,647,089 |
| Changes in 2002 — | | | | | | | |
| Net loss | — | — | — | — | — | (930,322) | (930,322) |
| Dividend proposed subsequent to balance sheet date | — | — | — | — | 190,000 | (190,000) | — |
| Balance as at December 31, 2002 | 6,233,959 | — | 956,169 | 38,500 | 190,000 | (701,861) | 6,716,767 |

(1) 147,652,429 par value convertible debentures were converted into 14,590,161 ordinary shares with a par value of NIS 1 each.

(2) 59,754,681 par value convertible debentures were converted into 5,904,612 ordinary shares with a par value of NIS 1 each.

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

Statements of Cash Flows for the Year Ended December 31
In terms of shekels of December 2002

| | <u>Consolidated</u> | | | <u>Company</u> | | |
|--|-----------------------|-------------------------|-------------------------|-----------------------|-------------------------|-------------------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| | NIS thousands | | | NIS thousands | | |
| Cash flows from operating activities | | | | | | |
| Net earnings (loss) | (930,322) | 128,989 | (593,193) | (930,322) | 128,989 | (593,193) |
| Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below) | 3,744,985 | 3,296,047 | 4,119,535 | 3,286,813 | 2,880,406 | 3,812,823 |
| Net cash flows provided by operating activities | <u>2,814,663</u> | <u>3,425,036</u> | <u>3,526,342</u> | <u>2,356,491</u> | <u>3,009,395</u> | <u>3,219,630</u> |
| Cash flows from investing activities | | | | | | |
| Investment in fixed assets | (1,379,944) | (1,346,056) | (1,863,641) | (892,879) | (954,329) | (1,192,543) |
| Proceeds from disposal of fixed assets | 25,165 | 87,324 | 37,361 | 13,143 | 66,823 | 31,491 |
| Proceeds from disposal of investment in affiliated companies | 119,062 | 31,656 | 184,805 | 97,973 | 31,656 | 184,805 |
| Investment in long-term deposits and investments | (221,848) | (1,174,162) | (64,610) | (179,346) | (1,151,533) | (27,527) |
| Proceeds from long-term deposits and investments | 162,816 | 38,952 | 64,819 | 187,745 | 32,916 | 25,428 |
| Decrease (increase) in short-term investments, net | (768,812) | (255,375) | 124,956 | (784,359) | (260,899) | 138,443 |
| Decrease in materials and spare parts | 23,207 | 52,076 | 62,594 | 23,207 | 52,076 | 62,594 |
| Acquisition of a partnership consolidated for the first time (see "B" below) | (3,935) | — | — | — | — | — |
| Investment in investee companies | (366,428) | (557,831) | (350,688) | (481,496) | (835,204) | (289,216) |
| Investments in other assets | (128,757) | (208,585) | (284,034) | (8,993) | (5,952) | — |
| Net cash used in investment activities | <u>(2,539,474)</u> | <u>(3,332,001)</u> | <u>(2,088,438)</u> | <u>(2,025,005)</u> | <u>(3,024,446)</u> | <u>(1,066,525)</u> |
| Cash flows from financing activities | | | | | | |
| Repayment of debenture issued to the State of Israel | — | — | (509,334) | — | — | (509,334) |
| Issuance of other debentures (after deduction of issuance expenses) | 109,043 | 543,719 | 1,181,315 | 109,043 | 543,719 | 1,181,315 |
| Repayment of other debentures | (225,642) | (240,991) | (244,348) | (225,642) | (240,991) | (244,348) |
| Receipt of long-term loans | 211,318 | 781,806 | 867,148 | — | 461,703 | 637,026 |
| Repayment of long-term loans | (842,496) | (1,102,540) | (1,968,612) | (650,412) | (1,040,033) | (1,772,046) |
| Receipt (repayment) of short-term bank credit Dividend paid | 77,398 | (342,850) | 501,252 | — | — | — |
| Dividend paid | — | — | (327,216) | — | — | (327,216) |
| Net cash used in financing activities | <u>(670,379)</u> | <u>(360,856)</u> | <u>(499,795)</u> | <u>(767,011)</u> | <u>(275,602)</u> | <u>(1,034,603)</u> |
| Increase (decrease) in cash and cash equivalents | (395,190) | (267,821) | 938,109 | (435,525) | (290,653) | 1,118,502 |
| Cash and cash equivalents at beginning of year | 1,387,644 | 1,655,465 | 717,356 | 1,352,890 | 1,643,543 | 525,041 |
| Cash and cash equivalents at end of year | <u>992,454</u> | <u>1,387,644</u> | <u>1,655,465</u> | <u>917,365</u> | <u>1,352,890</u> | <u>1,643,543</u> |

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

Statements of Cash Flows for the Year Ended December 31 (contd.)
In terms of shekels of December 2002

| | <u>Consolidated</u> | | | <u>Company</u> | | |
|---|---------------------|------------------|------------------|------------------|------------------|------------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| | NIS thousands | | | NIS thousands | | |
| A — Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities | | | | | | |
| Revenues and expenses not involving cash flows: | | | | | | |
| Depreciation | 2,318,357 | 2,765,209 | 2,916,227 | 1,924,816 | 2,290,770 | 2,425,936 |
| Provision for impairment of fixed assets | — | 108,654 | 11,893 | — | — | — |
| Deferred taxes | 30,729 | (124,521) | (332,840) | 65,056 | (2,207) | (309,890) |
| Company's equity in losses of investee companies, net | 347,072 | 233,847* | 210,766 | 345,131 | 525,902 | 464,144 |
| Minority share in net losses of a consolidated company | (3,065) | (6,624) | (5,284) | — | — | — |
| Increase (decrease) in employee severance benefits, net | (286,372) | (91,524) | 1,276,903* | (291,772) | (98,445) | 1,264,381* |
| Loss (gain) on disposal of fixed assets | (12,984) | (9,270) | (1,448) | (12,490) | 2,665 | (2,869) |
| Loss (gain) on disposal of investment in an affiliate | — | 3,706 | (149,831) | — | — | (149,831) |
| Provision for decrease in value of investments | 1,256,352 | 8,173* | — | 1,243,012 | — | — |
| Erosion (appreciation) of and interest on long-term deposits and investments | (302,365) | (211,169) | 16,658 | (39,707) | (211,169) | 16,658 |
| Erosion (appreciation) of short-term investments, net | 58,010 | (10,471) | (3,166) | 56,576 | (9,465) | (2,279) |
| Appreciation (erosion) of long-term liabilities: | | | | | | |
| Debenture issued to the State of Israel | — | — | 718 | — | — | 718 |
| Other debentures | 208,926 | 17,640 | 29,094 | 208,926 | 17,640 | 29,094 |
| Long-term loans | (13,637) | 136,743 | (79,689) | 14,219 | 139,385 | (77,600) |
| Depreciation of deferred expenses and other adjustments | 224,175 | 261,484 | 162,493 | 11,664 | 4,529 | 1,173 |
| Changes in asset and liability items: | | | | | | |
| Decrease (increase) in trade receivables | 59,540 | (429,574) | 269,732* | 99,513 | (442,929) | 302,172 |
| Decrease (increase) in other receivables and debit balances | 4,979 | 339,427 | (89,190) | (298,939) | 305,872 | (95,226) |
| Decrease (increase) in inventory | (45,664) | 23,666 | (15,890) | — | — | — |
| Increase (decrease) in trade payables | 52,039 | 85,135 | (200,124)* | 112,689 | 182,649 | (115,648) |
| Increase (decrease) in other current liabilities | (133,942) | 209,095 | 112,211* | (126,106) | 197,320 | 80,126* |
| Decrease in prepaid income | (17,165) | (13,579) | (9,698) | (25,775) | (22,111) | (18,236) |
| | <u>3,744,985</u> | <u>3,296,047</u> | <u>4,119,535</u> | <u>3,286,813</u> | <u>2,880,406</u> | <u>3,812,823</u> |
| B — Affiliated partnership consolidated for the first time | | | | | | |
| Working capital (excluding cash and cash equivalents) | 6,629 | | | | | |
| Fixed assets | (6,134) | | | | | |
| Long-term liabilities | 809 | | | | | |
| Minority rights as at the acquisition date | 737 | | | | | |
| Investment in an affiliated company | 1,087 | | | | | |
| Goodwill | (7,063) | | | | | |
| | <u>(3,935)</u> | | | | | |
| C — Non-cash transactions | | | | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit | 212,256 | 174,410 | 325,106 | 128,912 | 116,826 | 196,215 |
| Sale of fixed assets on credit | 5,912 | — | 9,567 | 5,912 | — | 9,567 |
| Transfer of fixed assets against an investment in a consolidated company | — | — | — | — | 12,786 | — |

* Reclassified

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

Notes to the Financial Statements as at December 31, 2002

NOTE 1 — GENERAL

- A. "Bezeq" The Israel Telecommunication Corp. Limited (hereinafter — the Company) is controlled by the State of Israel and as such, is subject to the provisions of the Government Companies Law, 5735 — 1975. The Company operates under a general license awarded under the Telecommunications Law (Telecommunications and Broadcasting), 5742 — 1982 (the Telecommunications Law), which authorizes it to engage in the telecommunication business and provide telecommunication services. The Company's license, which was granted on March 1, 1994, (and which replaced an earlier license which was subsequently amended on various dates), sets out the terms under which the Company shall operate, and provides, *inter alia*, that the Company shall continue to provide telephone and related services, infrastructure services and shall operate through subsidiaries which will engage in providing services in areas which were opened to competition. Under the license, the management of the subsidiaries is to be separate from the management of the Company, and the provision of new services by the Company is contingent upon receipt of a license from the Ministry of Communications. Additionally, limits were also imposed on the extent of the Company's financial exposure in projects undertaken outside Israel.

In March 2002 the Company received a draft amendment to its general license from the Ministry of Communications. The draft includes the imposition of new provisions and limitations on the Company (some of which are reflected in the Telecommunications Law and/or the Telecommunications Order and/or in other laws and some of which are new), as well as expansion of existing provisions and restrictions on various matters. The Company submitted its objections and remarks to the Ministry of Communications and several meetings have been held on the matter.

- B. The Company's operations are supervised by the Government and most of the tariffs for its services are determined in accordance with Section 15 of the Telecommunications Law and are updated according to regulations.

The Company's tariffs are updated according to the recommendations of the committee for arrangement of the Company's tariffs, which were adopted by the Minister of Communications and Minister of Finance with certain amendments. Those recommendations set the efficiency factor of the Company's tariffs ("the efficiency factor"), which averaged 6% in 1999 and 7% in 2000. Commencing 2001, this factor is 3.5% per year.

The Company's tariffs were most recently changed on May 14, 2002, with these changes updating tariffs for various services, among them the call tariffs, installation fees and additional services. The change in the call tariffs included a change in peak and off-peak hours and unification of local and long distance calls at all hours of the day.

In March 2002 a new committee was appointed to examine the structure and method of updating Company's tariffs and included a mandate to examine and recommend a new tariff arrangement for the Company which will be suited to the changing environment of the communications sector. The committee has not yet completed its work.

- C. The Group companies are required to pay royalties to the Government of Israel. Commencing January 2001 the revenue base on which the royalties are calculated was broadened, together with a gradual reduction the royalty percentage, until a uniform rate is attained for all communications operators.

| | For the year ended December 31 | | |
|---|-----------------------------------|------|------|
| | 2002 | 2001 | 2000 |
| | % | % | % |
| Fixed-line domestic telecommunications services | 4.0 | 4.0 | 5.0 |
| Cellular services | 4.5 | 5.0 | 8.0 |
| Bezeq International services | 4.0 | 4.5 | 5.0 |
| DBS Satellite services | 4.0 | 1.5 | 1.5 |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

In 2003 the percentage of royalties in respect of cellular services will decrease to 4%. In 2004 the percentage of royalties in respect of all communications operators will decrease to 3.5%.

- D. In June 1995, the Commissioner of the Anti-Trust Authority declared the Company a monopoly in a number of areas: basic telephone service, communications infrastructure services, two-way unrestricted international telephone services, including the provision of international telephone service for incoming calls and relay transfer and transmission services for public broadcasting. In December 2000 the Anti-Trust Commissioner declared the Company a monopoly in the field of telecommunications infrastructure for providing high-speed Internet access services by means of Internet providers.

Two appeals filed by the Company are pending in the Anti-Trust Tribunal. One concerns non-cancellation of the Company's monopoly status in basic telephone services and the other concerns its declaration as a monopoly in telecommunications infrastructure for providing high-speed access services.

In April 2001 the Anti-Trust Commissioner cancelled the notice naming Bezeq International Ltd. a monopoly in the provision of international telephone services.

- E. Below are the significant changes which have occurred in recent years regarding Company exclusivity in providing communications services in Israel:

(1) Cellular services

Cellular services are currently provided by four cellular communications providers (hereinafter "the Operators") of which one — Pelephone Communications Ltd. (a proportionally consolidated company) (hereinafter: Pelephone) — is 50% owned by the Company.

Commencing March 1, 2000, the Company introduced a new billing arrangement whereby the Company transferred only the amounts it actually collected in respect of airtime, less a collection fee, to the Operators (in contrast to the previous arrangement, which was based on customer charges without deduction of a collection fee). The Company came to agreements with Pelephone and with MIRS Communications Ltd. (hereinafter — "MIRS") regarding the period from March 1, 2000 to December 31, 2002.

Following the objections of some of the Operators to the change in the arrangement (one of them even filed a legal claim in court, which was dismissed, and an appeal on the dismissal is pending in the Supreme Court) the Minister of Communications intervened and in November 2001 he determined that until the dispute between the Company and cellular operators Cellcom and Partner is settled, the Company must pay those Operators according to the actual volume of traffic minutes, irrespective of collection, less an amount agreed upon by the parties and in the absence of such agreement — as the Minister will decide, for the period from October 2, 2000 to January 1, 2003. In accordance with the Minister's directive, the Company transferred an immediate interim payment to the Operators, relating to traffic from October 2000, with a 2.5% deduction. The Company's financial statements for 2001 included an expense of NIS 83 million deriving from the above.

In December 2002 the Minister of Communications announced that he is considering setting a reduced deduction rate of 1.1% for the above period, while for the period from January 1, 2003 the Company will pay the Operators in full, irrespective of collection and that the matter will be reflected, to the extent required in the regulation of the Company's tariffs. In February 2003, the Minister subsequently announced that in the light of the allegations made, he is allowing the parties to complete the submission of information before making a final decision on the matter of the percentage of deduction. The Minister also defined an interim arrangement for four months (from January 1, 2003) during which the percentage would be 1.1%, since the committee charged with setting the Company's tariffs has not completed its work (such decision

Notes to the Financial Statements as at December 31, 2002 (cont'd)

is not meant to influence the final decision on the matter). The Minister further clarified that his decisions apply to all the cellular Operators (i.e. including Pelephone and MIRS, with whom the Company had reached an arrangement).

The Company will decide on which steps it will take on the matter when the final determinations are received. As a result of the aforementioned, the Company recorded an additional expense of approximately NIS 56 million in the financial statements.

Commencing on March 1, 2000, the revenues and expenses of the Company from cellular services do not include airtime. The airtime included in its revenues and expenses in 2000 were approximately NIS 313 million.

(2) International communication services

At the beginning of July 1997, two new companies commenced provision of international communication services. As a result, international call tariffs were significantly lowered, including those of the consolidated company Bezeq International Ltd. At that time, regulations were promulgated to obligate the international operators to pay the Company a fee for "interconnect services". In addition, the general license awarded to the international operators obligates them to pay a fee to the Company for "access services" until December 31, 2001.

Pursuant to the decision of the Minister of Communications, the period of exclusivity of the international communications operators will be extended to January 1, 2004 (the Minister gave notice that he is considering a further extension until August 2004), subject to the international call tariffs not rising in real terms during the term of the extension.

(3) Domestic communication services

In February 1999, Section 50 of the Telecommunications Law was cancelled. Section 50 had granted the Company exclusivity in providing telecommunications services in a nationwide telephone network under the general license.

In July 2001 the Telecommunications Law was amended. The amendment regulates, *inter alia*, the opening of the domestic communications market and cable broadcasting to competition by means of granting licenses for providing communications services. The amendment covers a large number of matters which affect the Company and the Group companies. The law enables the cable companies to transfer from a regime of franchises to one of licenses, so that they or companies with an interest in them will be able to obtain a general license for providing telecommunications services.

In March 2002 the Ministry of Communications commenced granting domestic operator licenses to the cable companies. At this stage, the licenses are valid for providing broadband internet services on the cable infrastructure and for data and transmission services, with certain restrictions. During 2002 the cable companies started to provide these services. The application of the cable companies to merge was approved by the Anti-Trust Commissioner and by all the regulatory bodies. The matter is currently pending in the Anti-Trust Tribunal, as part of an appeal filed by D.B.S. Satellite Services (1998) Ltd.

After the adoption of the recommendations of the committee appointed to examine the rules and policy of opening fixed-line communications to competition, the Ministry of Communications announced that it had broadened the special licenses of Cellcom and MED-1 so as to permit them to provide high-speed data communication and transmission services to business customers.

A cellular company filed a petition in the High Court of Justice against the Company and the Minister of Communications, seeking cancellation of the directive it received

Notes to the Financial Statements as at December 31, 2002 (cont'd)

to disconnect direct connections that bypass the Company's network, which it makes for business customers. On February 11, 2002, the High Court of Justice issued an interlocutory injunction retaining the *status quo*. As a result of that injunction, on February 27, 2002, the Ministry of Communications issued instructions to all the cellular companies not to make any additional direct connections. On December 19, 2002 the High Court of Justice issued an interim order and granted the respondents 60 days to respond. In the Company's opinion, relying on the legal adviser who is handling the claim on its behalf, the chances that the petition will be allowed, cannot be estimated.

On August 8, 2002 the committee formulating policy and rules for opening the domestic fixed-line communications market to competition submitted its recommendations to the Minister of Communications. The recommendations set out the proposed policy, the principles of opening the market to competition and recommendations for the removal of barriers against the entry of new operators. The Company submitted its comments regarding the committee recommendations to the Minister of Communications. The Company expressed its position that adoption of the committee's recommendations on the matters of, *inter alia*, structural separation, universal service, splitting transmission, data communication and infrastructure and the immediate permit for the selective provision of such services as well as the supervision of the Company's tariffs, would be extremely harmful to the Company, consumers and the economy. The Minister adopted the recommendations of the committee with certain changes which are mainly related to the postponement of the date of granting internet providers a permit for access services, to a date when a permit will be granted for services to the general public and keeping in place the duty of corporate separation for a domestic operator. The Company filed a petition in the High Court of Justice against the Minister's decision insofar as it relates to the separation of data communications and transmission from telephony (which the Company believes is impracticable) and to the immediate selective granting of a permit for providing data and transmission services without a universal obligation, in which it alleged, *inter alia*, that the decision of the Minister is unreasonable and was issued without authority. The Company consented to retract the petition following a statement in court by the legal representative of the Ministry of Communications that the Ministry of Communications would enforce the terms of the licenses already granted and that will be granted and that the Ministry of Communications does not intend to expand the use of those special licenses beyond the appropriate objectives for which the law was passed and that the Ministry of Communications intends to initiate an amendment of the regulations so that the Company will also be exempted from payment of royalties in respect of some of the data and transmission services, starting from January 1, 2004.

As a result of the various changes in the communications market as described above, a significant deterioration has occurred in the business results of the Group. A further deterioration which cannot be estimated at this stage is expected to continue with the opening of fixed-line domestic communication services to full competition.

- F. On August 27, 2000, the Ministerial Committee for Privatization decided to sell the State's holdings in the Company by way of a private sale which would be accompanied by a raising capital for the Company. The sale will include shares comprising at least 50.01% of the Company's share capital. The Government Companies Authority was authorized to take the actions necessary for implementing the decision, including those actions set out in the decision.

Thereafter, the Ministerial Committee for Privatization reached a number of decisions designed to advance implementation of the above resolution. In addition, the Company's license, Articles and the Telecommunications Order were amended. On November 13, 2001, the Government of Israel published a notice stating that it was considering the sale of the State's holdings, comprising 50.01% of the share capital of the Company by way of a private sale.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Following the notice, several entities expressed their interest in participating in the sale process. To the best of the Company's knowledge, some of those entities have since given notice of their withdrawal from the process.

On January 13, 2002, a framework agreement was signed between the State and the Company, concerning the raising of up to NIS 890 million in capital for the Company in accordance with the decision of the Ministerial Committee for Privatization, while concurrently, the Company will allot shares to the State in the same amount as those sold by the State. The process of raising capital has not yet commenced as the conditions required for its implementation do not exist. (see Note 20B).

NOTE 2 — SIGNIFICANT ACCOUNTING PRINCIPLES AND REPORTING POLICIES

A. Definitions

In these financial statements —

- (1) *Subsidiaries* — Companies whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Corporation.
- (2) *Proportionately consolidated companies* — Companies whose financial statements are partially (proportionately) consolidated, directly or indirectly, with the financial statements of the Corporation.
- (3) *Affiliated companies* — Companies, other than subsidiaries or proportionately consolidated companies and including a partnership, the Corporation's investment in which is stated, directly or indirectly, on the equity basis.
- (4) *Investee companies* — Subsidiaries, proportionately consolidated companies or affiliated companies.
- (5) *Related parties* — As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel (hereinafter — "ICPAI").
- (6) *Interested parties* — As defined as the definition of "interested party" in the Securities Law, Section 1 Paragraph (1)
- (7) *Controlling shareholder* — As defined in the Securities Regulations (Presentation of transactions between a company and its controlling interest in the financial statements), 5756 — 1996.
- (8) *CPI* — the Consumer Price Index published by the Central Bureau for Statistics.

B. Financial statements in adjusted values

- (1) The Company prepares its financial statements on the basis of historical cost adjusted for the effect of changes in the general purchasing power of the Israeli currency (data on the Company in nominal values appear in Note 30).
- (2) The adjusted value of non-monetary assets does not necessarily reflect their market or economic value, but rather, their cost adjusted for the effect of the changes in the general purchasing power of the shekel.
- (3) The terms "cost" as used in the adjusted reports means "adjusted cost".
- (4) All the comparative figures for preceding periods (including those of monetary items) have been adjusted to the CPI of the end of the current reporting period.

C. Use of estimates

Preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure relating to contingent assets and liabilities, as well as amounts of revenues and expenses for the reporting period. Actual results may differ from these estimates.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

D. Classification of statement of operations items

The items of the statements of operations have been reclassified and are presented in the order arising from the nature of the Company's business as a communications company.

E. Principles of adjustment

(1) *Balance sheet*

Non-monetary items (mainly fixed assets, materials and spare parts, investments stated at cost) have been adjusted on the basis of the changes in the CPI from the index in respect of the month in which the item was acquired or arose, to the index in respect of the balance sheet month. Monetary assets are stated in the adjusted balance sheet at their nominal value at that date. The net asset value of the investments in investee companies is determined on the basis of the adjusted financial statements of those companies.

(2) *Statement of operations*

Statement of operation items were adjusted on the basis of changes in the CPI as follows:

- (a) Income and expenses deriving from non-monetary items (such as depreciation, amortization, changes in materials and spare parts, prepaid expenses, Prepaid income, etc.) or from provisions included in the balance sheet (such as for vacation pay, employee vacation expense allowance, etc.), were adjusted on the basis of the same specific indices as were applied to the related balance sheet items.
- (b) Other statement of operation items (such as sales, purchases, current production costs, etc.), other than the components of the financing item, were adjusted on the basis of the CPI from the date of receipt of payment or making payment, through the index in respect of balance sheet month.
- (c) The Company's equity in operating results of investee companies was included on the basis of the adjusted financial statements of those companies.
- (d) The financing item reflects interest income and expenses in real terms, erosion of monetary items during the year, earnings and losses from the disposal and revaluation of marketable securities, and earnings and losses from derivatives.
- (e) Income tax:

Current income tax expense is comprised of advance payments made during the year plus amounts payable (or less amounts refundable) at the balance sheet date. The advance payments were adjusted on the basis of the CPI at the time of making each payment, while the amounts payable (or refundable) were not adjusted. Therefore, the current income tax expense also includes the expenses deriving from erosion in value of the advance tax payments from the date of payment until the balance sheet date. See Notes 2O and 11D relating to deferred taxes.

(3) *Statement of changes in shareholders' equity*

A dividend that was declared and actually paid during the reporting year was adjusted on the basis of the CPI at date of payment. A dividend that was declared in the reporting year but had not been distributed by the balance sheet date is stated unadjusted.

F. Consolidation of the financial statements

- (1) The consolidated financial statements include the financial statements of those companies over which the Company has control. Jointly controlled companies are consolidated by the proportionate consolidation method.
- (2) Lists of the subsidiaries, the affiliates and the other companies and percentage holding in them are included in an appendix to the financial statements.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (3) For the purpose of the consolidation, the amounts appearing in the financial statements of the companies which were consolidated were taken after adjustments required in order to apply uniform accounting policies used by the Group.
- (4)
 - a. The excess cost of investment over the fair value of its identified assets less the fair value of identified liabilities (after the attribution of taxes deriving from temporary differences) at the date of acquisition is recorded as goodwill.
 - b. Excess cost attributed to assets and liabilities is recorded under the relevant items in the balance sheet.
 - c. Excess adjusted equity value over the cost of the investment was deducted initially from intangible assets. The negative excess cost remaining after the attribution to intangible assets was deducted from non-monetary assets proportionally to the fair value of those assets according to the Company's share. The balance of the negative excess cost, after attribution as aforesaid, is stated in the consolidated balance sheet as deferred revenues and will be amortized at equal annual installments over 10 years. Any amortized balances of goodwill and negative goodwill should be offset from those in the balance sheet for presentation purposes only.
- (5) Goodwill is presented in the consolidated balance sheet under "Other assets and deferred charges" and is amortized in equal annual installments over ten years, commencing in the year of acquisition.
- (6) Inter-company balances and transactions between subsidiaries and earnings from inter-company sales not yet realized outside the Group, were eliminated.
- (7)
 - a. The consolidated financial statements include the proportional part of the items of the assets, liabilities, expenses and revenues of the proportionally consolidated companies according to the percentage of the holding in those companies.
 - b. Earnings from the sales of the holding company to proportionally consolidated companies not yet realized outside the Group — were eliminated at a rate proportional to the holding.
 - c. Earnings from the sales of the proportionally consolidated companies to the holding company, not yet realized outside the Group — were eliminated at the full share of the earnings relating to the holding company.

G. Investments in affiliated companies

- (1) Investments in affiliates are accounted for by the equity method. In determining the equity of the investments in these companies, the amounts are taken into account as they are included in the financial statements of the companies.
- (2) On goodwill amortization policy — see Note F(5) above.

H. Decrease in value of investments in investee and non-investee companies

The Company periodically checks whether a change of a non-temporary nature has occurred in its investments. The review is carried out upon the existence of signs indicating that the value of permanent investments has been impaired, including falling stock exchange prices, ongoing losses in the investee, the sector in which the investee operates, the goodwill value included in the investment and other parameters. The deductions for adjusting the value of these investments, which management estimates is based on examination of all the relevant aspects and giving them their proper weight and which are not of a temporary nature, are recorded in the statement of operations.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

I. Securities

(1) *Marketable securities*

Marketable securities held for the short-term as a current investment are stated at the realizable value on the stock exchange at the balance sheet date.

Marketable securities held as a permanent investment are stated at cost (regarding debentures — including the accumulated interest) unless they are subject to a reduction in value of a non-temporary nature (see also paragraph I(3) below). The changes in the values of securities are charged to the statement of operations in full.

(2) *Non-marketable securities*

Non-marketable securities are presented at the cost which, in the opinion of management, does not exceed the realization value (see also paragraph I(3) below).

(3) *Decrease in value of investments*

The Company periodically checks to see whether a non-temporary decrease has occurred in the value of its permanent investments in other companies. The review is carried out upon the existence of signs indicating that the value of permanent investments has been impaired, including falling stock exchange prices, the business of the investee, the sector in which the investee operates and other parameters. The deductions for adjusting the value of these investments, which management estimates is based on examination of all the relevant aspects and giving them their proper weight, and which are not of a temporary nature, are recorded in the statement of operations.

J. Provision for doubtful debts

The financial statements include specific provisions for doubtful debts which, in the opinion of management, properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining whether the provisions are appropriate, Management considers, among other matters, the assessment of risk concerning the financial situation of the debtors as derived from the information in its possession, the scope of their operations, and the period of arrears in clearing their debt. Doubtful debts which Management believes cannot be collected are written off in the Company's books following a Management decision. The financial statements also contain a general provision in respect of doubtful debts.

K. Inventory

Inventory of subscriber equipment and user equipment is presented at the lower of cost or value to the business, where the cost is determined by the moving average method.

As part of its current operations, a proportionately consolidated company upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers, as well as spare parts which are used by the company for the repair of user equipment in the framework of the repair service it provides for its customers.

L. Materials and spare parts

Materials and spare parts are valued at the lower of cost (which is determined by the moving average method) or market. Materials are intended primarily for use as components of fixed assets.

M. Fixed assets

(1) Fixed assets are stated at cost.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (2) The cost of an asset which the Company is constructing includes materials, subcontractors, wages and financing expenses in the construction period, but not exceeding their value to the business.
- (3) Improvements and enhancements are added to the cost of assets while maintenance and repairs are charged to the statement of operations as incurred.
- (4) In the event of a decrease in the value of assets to the business a provision is accordingly recorded in respect of the decrease in value.
- (5) Commencing January 1, 2000, real financing expense for loans and credit used for financing the construction or purchase of fixed assets is attributed to the cost of those assets in accordance with Accounting Standard No. 3 — Capitalization of Credit Costs. See Note 9A.
- (6) Depreciation is calculated by the straight-line method, based on the estimated useful lives of the assets.

Annual depreciation rates:

| | <u>% depreciation</u> | <u>Principal depreciation %</u> |
|---|-----------------------|---------------------------------|
| Buildings | 4 | 4 |
| Digital switching equipment | 5-10 | 10 |
| Transmission and power equipment | 10-20 | 20 |
| Network equipment | 5-25 | 5 |
| Subscriber equipment and public telephones | 20 | 20 |
| Motor vehicles | 15 | 15 |
| Office equipment | 10-20 | 10 |
| Computers | 20-33 | 33 |
| Cellular telephone infrastructure equipment | 10-20 | 20 |

Improvements to leased premises are amortized over the term of the lease (including the Company's option to extend the lease period) which does not exceed the economic life of the asset.

- (7) Changes of estimates — see Note 9B.

N. Deferred expenses and other assets

(1) Cost of issue of debentures and raising loans

These costs (treated as a non-monetary item) are amortized over the term of the debentures, pro rata to the balance of the debentures in circulation.

(2) Cost of acquiring a subscriber

Since 1999, Pelephone Communications Ltd. (a proportionately consolidated company) has been capitalizing its net direct costs paid to a third party (hereinafter: "subscriber acquisition") in respect of a sale to subscribers who signed an undertaking to remain customers of Pelephone. Violation of the undertaking leads to payment of a penalty by the customer and the immediate charging of the amortization of the asset to the statement of operations. These costs are amortized throughout the period of the subscribers' undertaking, which is 36 months.

(3) Frequencies

For Pelephone Communications Ltd.'s (a proportionately consolidated company) investment in cellular communication frequencies in third generation technology and its amortization, see Note 8D(6).

(4) Rights of representation of a communications corporation

The rights of representation of a communications corporation are amortized for the period of economic benefit over 10 years.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

(5) **Customer recruitment expenses**

Customer recruitment expenses incurred by a consolidated company in connection with recruiting customers from whom revenues are received over a period exceeding one year are amortized by the straight line method over the period of the contract with the customer (usually three years).

(6) **Rights in channels**

Rights in channels are amortized over the period of use, which are 5 and 10 years.

(7) **Acquisition of operations (resources)**

- a. The components of an operation acquired by a consolidated company from Nortel Networks Israel (Sales & Marketing) Ltd. (see Note 19C(3)), are stated at cost and in accordance with the present value of the future payments to a long-term supplier.
- b. Acquisition of the operation is stated under Other assets.
- c. The cost of acquisition of the operations is amortized at actual realization of the relevant components, as well as at the estimated useful life of those components.
- d. The consolidated company will regularly review the value of the components of the acquired operation and in the event of a decrease in value will record a provision accordingly.

O. Deferred Taxes

The Group companies allocate taxes for temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value in the balance sheet. Such allocation of taxes is made for differences relating to assets whose consumption or depreciation is deductible for tax purposes. Deferred tax balances (asset or liability) are calculated according to the liability approach using the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, as they are known close to the date of approval of the financial statements.

The main factors for which deferred taxes were not calculated are these:

- (1) The amounts of the adjustment for changes in the purchasing power of the shekel which relate mainly to buildings and private cars, in accordance with the principles stated by the ICPAI.
- (2) Investments in investee companies, since the Company intends to hold these investments and not to realize them.
- (3) A tax receivable benefit in respect of losses carried forward and timing differences, where the likelihood of realizing the benefit is in doubt.

P. Income Recognition

Income is attributed to the statement of operations upon being generated on the accrual basis. Income from the sales of user equipment, exchanges and business systems are included upon delivery of the goods to the customer. Income from sales of subscriber equipment by installments are recorded at their present value upon delivery to the customer.

Q. Capitalization of credit costs

The Company capitalizes credit costs in accordance with Standard No. 3 — Capitalization of Credit Costs, which requires the capitalization of specific and non-specific credit and credit costs to qualified assets. Nonspecific credit costs are capitalized to the investment or part thereof which was not financed by specific credit, at a rate which is the weighted average of the cost in respect of those credit resources whose cost was not specifically capitalized and

Notes to the Financial Statements as at December 31, 2002 (cont'd)

in accordance with the Standard Credit costs attributed to assets under construction are capitalized until the date on which all significant activities required to prepare it for its intended use have been completed. See Note 9A.

R. Derivative financial instruments

- (1) Forward currency contracts intended to hedge foreign currency exposure of assets and liabilities are included in the financing item in the statement of operations, in parallel with the accounting treatment of the hedged item.
- (2) Derivative financial instruments not designated for hedging are presented in the balance sheet at their fair value. Changes in the fair value are attributed to the statement of operations in the period in which they occurred. The fair value of derivative financial instruments is determined according to their market prices and in the absence of a market price, according to a valuation model.

S. Foreign currency and linkage

Assets (excluding securities) and liabilities denominated in or linked to a foreign currency are stated at the representative exchange rates published by the Bank of Israel on the balance sheet date. Assets (excluding securities) and liabilities linked to the CPI are stated on the basis of the linkage terms of each balance.

Details of the CPI and the U.S. dollar exchange rates are as follows:

| | December 31 2002 | December 31 2001 | % of change 2002 | % of change 2001 | % of change 2000 |
|-------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| CPI — in points | 108.2 | 101.6 | 6.496 | 1.397 | 0.00 |
| US dollar exchange rate | | | | | |
| \$1 — in NIS | 4.737 | 4.416 | 7.269 | 9.279 | (2.69) |
| Euro exchange rate | | | | | |
| 1 Euro — in NIS | 4.969 | 3.907 | 27.182 | 3.827 | (9.87) |

T. Earnings per share

Earnings per share is calculated in accordance with Opinion No. 55 of the ICPAI. Fully diluted earnings per share are not presented as the effect of dilution is not significant.

U. Reporting by sector

Reporting by sector is presented in accordance with Accounting Standard No. 11, which requires the inclusion of information about business sectors and geographical sectors, and also gives detailed instructions for the identification of business and geographical sectors. See also Note 26.

V. Disclosure of the effect of accounting standards in the period prior to their application

- (1) In July 2001 the Israeli Accounting Standards Board ("IASB") published two new standards:
 - (a) Accounting Standard No. 12 — Discontinuance of Adjustment of Financial Statements. This standard provides for the discontinuance of the adjustment for the effects of the purchasing power of the shekel in financial statements, commencing January 1, 2003.

In December 2002, the IASB published Standard No. 17, postponing the commencement of the application of Standard No. 12 to January 1, 2004. Accordingly, the adjustment of the financial statements will end on that date. Until December 31, 2003 the Company will continue to prepare statements adjusted in accordance with Opinion No. 36 of the ICPAI. The adjusted amounts included in the financial statements as at December 31, 2003 will serve as the starting point

Notes to the Financial Statements as at December 31, 2002 (cont'd)

for the nominal reporting which will commence on January 1, 2004. Implementation of Standard No. 12 is liable to have material implications for the reported business results of the Company, the extent of which depends on the rate of inflation, the composition of assets and the Company's financing sources.

- (b) Accounting Standard No. 13 — Effects of Changes in Foreign Currency Exchange Rates. The standard deals with the translation of foreign currency transactions and the translation of the financial statements of overseas operations for integration in the financial statements of the reporting corporation, and supersedes the provisions of Clarifications 8 and 9 to Opinion No. 36, which will become null and void when Accounting Standard No. 12, described above, takes effect.
- (2) In August 2002 the IASB published Standard No 14 — Financial Reporting for Interim Periods, setting the minimum content of financial reports for interim periods, including the disclosure required in the notes and the accounting principles for the recognition and measurement to be applied in financial reports for interim periods. This standard will apply to financial statements for periods starting on January 1, 2003 or thereafter. Restatement of comparative data for interim periods prior to that date is not required under the standard. However, if financial statements include comparative data for interim periods prior to that date, not in accordance with the provisions of the standard, the notes to the financial statements must include a description of the main differences between the requirements laid down in this standard and the requirements under which the comparative data were prepared. The Company believes that the effects of the new standard on the results of its operations, financial position and cash flows will not be material.
- (3) In February 2003 the IASB published Standard No. 15 — Impairment of Assets. The standard prescribes sets out procedures which a corporation must follow in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their fair value which is the higher of the net selling price and the present value of the estimated future cash flows expected to be derived from the use and disposal of the asset. The standard also lays down the rules of presentation and disclosure for assets whose value has decreased. Through December 31, 2002, the Company assessed the requirement for a provision in respect of impairment of assets according to international accounting principles similar to the provisions of Standard 15 and therefore the application of this standard is not expected to affect its financial statements.

Bezeq International Ltd., a consolidated company, is examining the effects of Standard 15, but at this stage is unable to estimate its implications, if any, on its financial position and the results of its operations.

A proportionately consolidated company is preparing to apply the standard, commencing from its first statements in 2003 and is assessing the implications, if any, that can be expected for its financial statements.

W. First-time consolidation of a partnership

- (1) During the reporting year the financial statements of Goldnet Communications Services — a registered partnership, in which the Company's holding increased from 49% to 54% were consolidated for the first time (through the reporting year, the investment in this partnership was stated at equity value). See Note 8H.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (2) Following are the data of the partnership in the consolidated financial statements:

| | At the date of acquisition of control | On December 31, 2002 and for the period from the acquisition to the above date |
|---|---|--|
| | NIS thousands | NIS thousands |
| Balance Sheet | | |
| Cash and cash equivalents | 3,935 | 1,216 |
| Working capital (excluding cash and cash equivalents) | (6,629) | (4,526) |
| Fixed assets, after deduction of accumulated depreciation | 6,134 | 4,989 |
| Goodwill created upon acquisition | — | 7,063 |
| Minority rights at the date of acquisition | 737 | 575 |
| Long-term liabilities (less current liabilities) | 809 | 837 |
| Statement of Operations | | |
| Revenues | 31,444 | 41,289 |
| Net loss | (1,693) | (2,037) |
| Group's equity in the loss | (779) | (937) |

- (3) The value of goodwill created following acquisition of an investment in the partnership, consolidated for the first time, amounts to approximately NIS 7,063,000.

NOTE 3 — CASH AND CASH EQUIVALENTS

| | Consolidated | | Company | |
|------------------------|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Israeli currency | 963,851 | 1,343,338 | 913,273 | 1,332,587 |
| Foreign currency | 28,603 | 44,306 | 4,092 | 20,303 |
| | 992,454 | 1,387,644 | 917,365 | 1,352,890 |

Cash equivalents include bank deposits with an original maturity at the time of making the investment that did not exceed three months.

NOTE 4 — SHORT-TERM INVESTMENTS

| | Consolidated | | Company | |
|--|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Marketable securities: | | | | |
| Government debentures | | | | |
| Linked to the CPI | 715,743 | 135,627 | 715,743 | 132,055 |
| Linked to the U.S. dollar exchange rate | 17,944 | 17,860 | 17,944 | 16,086 |
| Unlinked | 115,203 | 54,219 | 115,203 | 49,068 |
| Convertible debentures | 17,700 | 16,822 | 17,700 | 16,628 |
| Other debentures | 187,544 | 59,945 | 187,544 | 59,945 |
| Mutual fund participation certificates | 110,855 | 180,952 | 110,855 | 178,424 |
| | 1,164,989 | 465,425 | 1,164,989 | 452,206 |
| Short-term bank deposits: | | | | |
| Linked to the CPI | — | 3,672 | — | — |
| Unlinked | 15,092 | 182 | 15,000 | — |
| | 1,180,081 | 469,279 | 1,179,989 | 452,206 |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 5 — TRADE RECEIVABLES

| | Consolidated | | Company | |
|---|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| For domestic services: | | | | |
| On open account | 1,520,282 | 1,642,308* | 966,591 | 1,080,105 |
| Income receivable | 317,364 | 336,259 | 246,750 | 267,681 |
| Credit cards and checks receivable | 243,589 | 181,518 | 128,530 | 95,879 |
| Investee companies | 4,168 | 1,277 | 4,168 | 1,277 |
| For international services | 32,351 | 40,466 | 10,354 | 8,617 |
| | <u>2,117,754</u> | <u>2,201,828</u> | <u>1,356,393</u> | <u>1,453,559</u> |
| Less provision for doubtful debts | <u>365,766</u> | <u>406,014</u> | <u>230,035</u> | <u>233,600</u> |
| | <u>1,751,988</u> | <u>1,795,814</u> | <u>1,126,358</u> | <u>1,219,959</u> |

* Reclassified

NOTE 6 — OTHER RECEIVABLES AND DEBIT BALANCES

| | Consolidated | | Company | |
|---|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Deferred tax receivable (see Note 11D) | 202,832 | 158,600* | 200,744 | 156,448 |
| Income tax refundable | 91,192 | 5,335 | 84,471 | — |
| Prepaid expenses | 39,381 | 37,260 | 24,857 | 21,024 |
| Forward exchange contracts | 155,766 | 86,485 | 155,766 | 83,346 |
| Other receivables and debit balances | 25,585 | 20,998 | 10,957 | 8,339 |
| | <u>514,756</u> | <u>308,678</u> | <u>476,795</u> | <u>269,157</u> |

* Reclassified

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 7 — INVESTMENTS, DEPOSITS AND DEBIT BALANCES

| | Consolidated | | Company | |
|---|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Investment in companies that are not investee companies: | | | | |
| Investment in convertible debentures ⁽¹⁾ | — | 1,178,774 | — | 1,178,774 |
| Investments in shares | 57,430 | 62,189 | 57,430 | 62,189 |
| Other investments ⁽²⁾ | 243,761 | — | 243,761 | — |
| Bank deposit for granting loans to employees ⁽³⁾ | 215,937 | 237,948 | 215,937 | 237,948 |
| Investment in venture capital funds | 26,654 | 23,342 | 26,654 | 23,342 |
| Income tax refundable | 100,000 | 214,507 | 100,000 | 214,507 |
| Forward exchange contracts | 31,902 | 8,392 | 31,902 | 8,392 |
| Long term trade receivables ⁽⁴⁾ | 93,127 | 63,014* | — | — |
| | <u>768,811</u> | <u>1,788,166</u> | <u>675,684</u> | <u>1,725,152</u> |

* Reclassified

(1) See Note 8D(2).

(2) Other investments

a. Linkage and interest terms

| | Interest rate | Consolidated and Company |
|----------------------|-----------------------|--------------------------|
| | | December 31, 2002 |
| | % | NIS thousands |
| Long-term deposits | Libor 6 months + 3.4 | 33,159 |
| Linked to the dollar | Libor 3 months + 1.65 | 33,159 |
| | Libor 3 months + 1.75 | 33,159 |
| Unlinked | Variable 10.3 | 20,000 |
| CPI-linked | | |
| Galil* | 4 | 79,136 |
| Matrix ET Ltd. ** | 4.95 | 45,148 |
| | | <u>243,761</u> |

* In May 2002 the Company purchased corporate convertible debentures in a total amount of approximately NIS 77.4 million. The debentures are payable in a lump sum on August 31, 2011.

** In August 2002 the Company purchased convertible debentures of Matrix ET Ltd. (hereinafter — Matrix) for a total amount of approximately NIS 43.57 million. The purchase was made in accordance with a prospectus issued at the Tel Aviv Stock Exchange as part of an issue of Matrix. The debentures are payable in a lump sum on August 5, 2005.

The Debentures are convertible from the first day of trading on the stock exchange until July 17, 2005, at a conversion rate of 1:8 (commencing August 5, 2003, at a conversion rate of 1:9).

b. Repayment dates

| | NIS thousands |
|---------------------|----------------|
| 2004 | 33,159 |
| 2005 | 65,148 |
| 2006 | — |
| 2007 | 66,318 |
| 2008 and thereafter | 79,136 |
| | <u>243,761</u> |

(3) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.33%. The Company is responsible for the loans to the employees. Withdrawal of the deposit is contingent upon repayment of the loans.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

(4) Long-term receivable

a. Linkage and interest terms

| | Interest rate % | Consolidated | |
|------------------|--------------------|---------------------|---------------------|
| | | December 31 2002 | December 31 2001 |
| | | NIS thousands | |
| CPI linked | 5.5 — 9.4 | 13,543 | 12,982 |
| Unlinked..... | 7 | 79,584 | 50,032 |
| | | 93,127 | 63,014 |

b. Repayment dates

| | NIS thousands |
|--------------------------|---------------|
| 2004 | 60,217 |
| 2005 | 28,691 |
| 2006 | 2,318 |
| 2007 and thereafter..... | 1,901 |
| | 93,127 |

The balance of long-term receivables constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue, less the revenue from deferred interest.

NOTE 8 — INVESTMENTS IN INVESTEE COMPANIES

A. Composition:

| | Consolidated | | Company | |
|---|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Affiliated companies | | | | |
| Investment in shares — | | | | |
| Cost | 49,936 | 132,545* | (22,089) | 83,027* |
| Post-acquisition losses | (763,878) | (411,965)* | (708,086) | (396,077) |
| Increase in the rate of holding — partnership consolidated for the first time | (1,087) | — | (1,087) | — |
| Provision for a decrease in value in respect of an affiliated company | (21,513) | (8,173)* | — | — |
| Amortization of goodwill | (22,462) | (27,303) | (22,279) | (1,183) |
| | (759,004) | (314,896) | (753,541) | (314,233) |
| Other investments — | | | | |
| Long-term loans ⁽¹⁾ | 1,149,078 | 805,914* | 1,133,041 | 801,431* |
| | 390,074 | 491,018 | 379,500 | 487,198 |
| Consolidated companies | | | | |
| Shares — | | | | |
| Cost | | | 415,103 | 407,960 |
| Loans | | | 171,569 | 169,085 |
| Increase in the rate of holding — a partnership consolidated for the first time | | | 1,087 | — |
| Post-acquisition losses | | | (168,770) | (229,198) |
| Amortization of goodwill | | | (161) | — |
| | | | 418,828 | 347,847 |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

| | Consolidated | | Company | |
|--|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Proportionally consolidated company | | | | |
| Shares — | | | | |
| Cost | | | 513,489 | 366,086 |
| Post-acquisition earnings | | | 390,760 | 463,053 |
| Amortization of surplus equity over cost attributed to fixed assets..... | | | <u>39,897</u> | <u>39,897</u> |
| | | | <u>944,146</u> | <u>869,036</u> |
| | | | <u>1,742,474</u> | <u>1,704,081</u> |

* Reclassified

(1) Loan balances of approximately NIS 110 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has been set (preferred loans — see also Section E below).

Loan balances of approximately NIS 30 million linked to the CPI ("known"), bearing annual interest of approximately 7%, and repayable by 2012.

Loan balances of a proportionately consolidated company amounting to approximately NIS 4.5 million, bearing annual interest at Prime less 0.3% and for which no repayment date has been set.

The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has been set.

The market and book values of an affiliated company listed on the stock exchange as at December 31, 2002, are approximately NIS 4.8 million.

| | Consolidated | | Company | |
|---|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Balance of goodwill not yet amortized | <u>260,977</u> | <u>15,949</u> | <u>260,977</u> | <u>4,573</u> |

A list of the companies in the Group appears in a schedule attached to the financial statements.

B. Investment activity in 2002 as follows (not including long-term loans):

| | Consolidated NIS thousands | Company NIS thousands |
|--|-------------------------------|--------------------------|
| Balance as at the beginning of the year | (314,896) | 733,565 |
| Activity during the year: | | |
| Investment in shares | 28,223 | 160,711 |
| Increase in percentage of holding — a partnership consolidated for the first time..... | 7,143 | 7,143 |
| Realization of investment | (119,062) | (118,424) |
| Provision for a decrease in value in respect of an affiliated company | (13,340) | — |
| Equity in losses | <u>(347,072)</u> | <u>(345,131)</u> |
| Balance as at the end of the year | <u>(759,004)</u> | <u>437,864</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

C. Summary of company equity in assets, liabilities, income and expenses of a proportionally consolidated company, as included in the consolidated statements

| | <u>December 31</u> <u>2002</u> | <u>December 31</u> <u>2001</u> |
|-----------------------------|-----------------------------------|-----------------------------------|
| | NIS thousands | NIS thousands |
| Current assets | <u>613,896</u> | <u>554,980</u> |
| Other assets | <u>1,924,705</u> | <u>1,796,930</u> |
| Current liabilities | <u>975,136</u> | <u>977,909</u> |
| Long-term liabilities | <u>554,172</u> | <u>548,863</u> |

| | <u>For the year ended December 31</u> | | |
|-------------------------|---------------------------------------|------------------|------------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues..... | <u>1,858,317</u> | <u>1,894,147</u> | <u>1,793,642</u> |
| Costs and expenses..... | <u>1,921,538</u> | <u>1,943,869</u> | <u>1,898,723</u> |

D. Pelephone Communications Ltd. ("Pelephone")

- (1) In September 2000 a notice was received from Motorola Israel Ltd. ("Motorola"), informing the Company of negotiations between Motorola and a third party for the sale of its holdings in Pelephone. Under the Pelephone shareholders' agreement, if one party to the agreement wishes to sell its shares in Pelephone, it must offer them to the other party and the other party is entitled, *inter alia*, to propose an alternative offeree to buy the shares. At its meeting on November 22, 2000, the Board of Directors of the Company selected Shamrock Holdings of California Inc. (Shamrock") as the alternative offeree to purchase the shares of the Pelephone shareholder and sign an option agreement with the Company. The share purchase transaction was subsequently made by a corporation registered in the U.S.A. (hereinafter — "the Corporation") indirectly owned by Shamrock.

On February 27, 2001, after approval by the Ministry of Communications and the Anti-Trust Commissioner the transaction was completed. The main points of the transaction are as follows:

- a. Motorola's shares in Pelephone were transferred to the Corporation for a consideration of approximately \$591 million. The consideration was partially financed by a loan of \$240 million extended by the Company, for which it received debentures linked to the U.S. dollar exchange rate, bearing interest (LIBOR) which are paid by redemption or constitute part of the converted amount and are convertible for up to four years, for 80% of the shares of the Corporation. These debentures are presented in the balance sheet under the Investments, deposits and long-term debit balances item.
 - b. The Company was given a call option to purchase the remaining 20% of the share capital of the Corporation together with conversion of the debentures to shares as aforesaid ("the Options"). In the event of conversion of the debentures to shares the Company must exercise the aforementioned option.
 - c. The Company can exercise the Options within six months of the date of purchase of the shares ("the Short Option"), or starting from the end of 24 months from the date of purchase of the shares until the elapse of four years from the date of the purchase ("the Long Option"). As at the date of the financial statements the Company had not exercised the Short Option and it expired.
 - d. The exercise price of the Long Option is the higher of the return of the nominal investment or a market valuation of the 20% of the Corporation's shares.
- (2) Following various indications of a decrease in the value of Pelephone Communications Ltd. (hereinafter — Pelephone) in which the Company owns 50% and the other 50% are held by

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Pelephone Holdings L.L.C. of the Shamrock Holdings of California, Inc, Group (hereinafter — Shamrock) the Company commissioned a valuation of Pelephone (for its financial statements as at September 30, 2002). According to the valuation, the estimated value of Pelephone was between U.S.\$ 1.0 billion and U.S.\$ 1.2 billion.

As described in sub-section (1) above, the consideration for the purchase of Shamrock's share in Pelephone was partially financed by a loan of \$240 million extended by the Company to Shamrock, in exchange for which the Company received debentures convertible during a period of four years (commencing February 27, 2001), for 80% of Shamrock's shares (and since Shamrock holds 50% of Pelephone's shares, conversion of the debentures means purchase of 40% of the shares in Pelephone).

Part of the financing for purchase of the Pelephone shares by Shamrock and other investments made by Shamrock in Pelephone after purchasing the shares, were made by means of bank loans, the balance of which on December 31, 2002, was approximately \$380 million (including interest), and against which a first ranking lien was imposed on Shamrock's shares and the shares it holds in Pelephone. The lien has priority over a lien given to the Company against the above debt, of which the balance is approximately \$254 million (including interest).

In view of the valuation the value of Shamrock's holding in Pelephone as at September 30, 2002, was approximately \$550 million (based on the mid-range of the valuation). Since the amount of the bank loans is secured under a first ranking lien, the available balance remaining for repayment of the debt as at September 30, 2002, was only approximately \$175 million. In other words, there was doubt as to collection of the \$80 million balance of the debentures (approximately NIS 390 million). This being the case, the Company recorded a provision of approximately NIS 353 million in its financial statements as at September 30, 2002 for impairment of assets (after deduction of the tax saving of NIS 36 million) in respect of its holdings in the debentures.

Subsequently, and following additional indications of a further decrease in the value of Pelephone, the Company commissioned an updated valuation, which it received on March 4, 2003, and which assessed the value of Pelephone at between \$650 million and \$850 million.

In view of this update, the value of Shamrock's holding in Pelephone was approximately \$375 million (based on the mid-range of this latest valuation). Since the bank loan extended to Shamrock for purchasing the Pelephone shares (approximately \$380 million, including interest) is secured as aforesaid under a first ranking lien, no available balance remained for payment of the debentures issued to the Company by Shamrock. This being the case, the financial statements include a provision for impairment of assets (in addition to the provision made in the financial statements as at September 30, 2002) of approximately NIS 844 million, thereby writing off, in practical terms, the balance of the investment in the debentures.

All these reductions were included together under the item Other expenses, net for 2002 (see Note 24). Consequently, net earnings for 2002 were reduced by approximately NIS 1,197 million.

- (3) During the year, the Company and Shamrock invested approximately NIS 148 million each against a premium on Pelephone shares issued in the past (in 2001 they each invested approximately NIS 92 million).
- (4) On March 16, 2000, Pelephone signed an agreement for the establishment of GoNext Ltd. ("GoNext"). The operations of GoNext focus mainly on the setting up and operation of the portal with a link to cellular communication. On December 31, 2001, Pelephone held 51% of the shares of GoNext.

On October 29, 2002, Pelephone signed an agreement with Suny.Com Ltd. ("Suny"), for the purchase of all Suny's shares in GoNext (49% of the share capital), in consideration of their par value. Suny also assigned to Pelephone its rights in all the loans it had extended or

Notes to the Financial Statements as at December 31, 2002 (cont'd)

which were extended on its behalf, amounting to approximately NIS 42 million, which were transferred to Suny by Pelephone on the date of closing the transaction. The consolidated financial statements for the years 2002 and 2001 include consolidation of the financial statements of GoNext, in which Pelephone holds the controlling interest.

- (5) Until October 2000 Pelephone held 51% of the shares of Safe Com Car Communication Ltd. ("Safe Com"). The financial statements of Safe Com, were not consolidated as part of the consolidated financial statements as Pelephone held neither control nor joint control of Safe Com, pursuant to that company's founding agreement whereby which significant resolutions would be adopted by a 75% majority.

In October 2000 an agreement was signed between Pelephone and the other shareholders of Safe Com and Eden Telecom Ltd. ("Eden") and its shareholders, whereby the operation of Safe Com was merged with the operation of Eden by way of a transfer of net assets from Safe Com to Eden.

Subsequent to the merger, Pelephone holds 22.95% of Eden. Eden's operations focus on locating and identifying vehicles, similar to the operations of Safe Com.

- (6) On December 18, 2001, the Minister of Communications notified Pelephone that it had won a tender for an additional band of frequencies which it would use for cellular communications in third generation technology. Following the win, Pelephone's existing license will be amended so as to extend its term to run (concurrently with the license for the use of the new frequencies) until 2017. The granting of the frequencies and the changes in Pelephone's license was made contingent upon preconditions that include, *inter alia*, payment of NIS 225 million (plus Accountant General's interest except for the first payment, which is linked to the CPI) for the new frequency ranges, and a guarantee of \$20 million (proportionally consolidated — \$10 million). The payment determined at the win is to be paid in six installments on various dates through 2006. To date, Pelephone has paid approximately NIS 110 million on account of the frequencies (proportionally consolidated — NIS 56 million).

As a result of the changes in Pelephone's license as described above, the cost of the license frequencies will be amortized from the date Pelephone begins to use them until the end of 2017, subject to the period of use.

E. D.B.S. Satellite Services (1998) Ltd. ("DBS")

At the beginning of May 2002 the Company was allotted additional shares in DBS, so that its holdings in DBS increased to 44.9%. As a result, an excess cost of NIS 269 million was generated to the Company. Another allotment of shares in DBS is currently under way, which is expected to increase the Company's holdings to approximately 49.9% and which will generate a further surplus cost to the Company. For depreciation of the surplus cost, see Note 2F.

In January 1999 DBS received a license from the Ministry of Communications in respect of satellite television broadcasts and commenced provision of services in July 2000. DBS suffers from considerable losses and negative cash flows. Its loss for 2002 amounts to approximately NIS 723 million and its negative operating cash flows from current activities amounts to approximately NIS 70 million. As a result of these losses the capital deficit and working capital deficit of DBS amount to approximately NIS 2,294 million and NIS 1,627 million respectively. The working capital deficit includes bank credit amounting to NIS 1,126 million.

The Company's investment in DBS (mainly shareholder's loans) as at the balance sheet date was approximately NIS 1,101 million. The Company's share in the accumulated losses of DBS is approximately NIS 762 million of which approximately NIS 290 million was recorded in the account year. The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 56 million.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

On May 23, 2002, a financing agreement (hereinafter — the Financing Agreement) was signed between DBS and certain banking institutions (hereinafter — the Banks), prescribing, *inter alia*, undertakings by DBS to meet the suspending conditions, cumulative milestones and various financial requirements (hereinafter — the Conditions). A financial assessment made by the Banks at the beginning of 2002 determined that in order to finance the operations of DBS further financing would be required in significant amounts greater than those requirements defined in the Financing Agreement.

On December 30, 2002, DBS, its shareholders and the Banks signed an agreement increasing the credit line from the Banks (hereinafter — the Interim Credit Line) which will be implemented concurrently with additional investments of the shareholders of not less than a sum equal to 150% of the amount to be injected by the Banks. Receipt of the Interim Credit Line is subject, *inter alia*, to DBS meeting the financial and operative conditions prescribed in the financing agreement.

As at the date of approval of these financial statements, the shareholders and the Banks had transferred to DBS approximately \$30 million and \$20 million respectively, on account of the Interim Credit Line. As at the date of approval of these financial statements, some of the conditions laid down in the Financing Agreement and the Interim Credit Line had not been met. The credit from the Banks was classified accordingly under Current liabilities.

In addition, discussions were held by the parties on increasing the Interim Credit Line (hereinafter — Addition to the Financing Agreement). The main shareholders of DBS notified the Banks of their intention to invest, at the same time as the Banks, their proportional share in the Addition to the Financing Agreement. As at the date of approval of these financial statements, the Banks had not yet decided on the Addition to the Financing Agreement.

Under the interim Financing Agreement, it was determined that if by March 31, 2003 —

- 1) it is not proved to the Banks that the total financing needs of DBS do not exceed the Interim Credit Line plus the Addition to the Financing Agreement (including the proportional part of the shareholders), and additionally
- 2) DBS, the shareholders and the Banks have not signed the Addition to the Financing Agreement,

then the Banks will be entitled to take the necessary steps, at their exclusive discretion, to collect all the amounts payable to them and to act in accordance with their rights under the Financing Agreement upon the occurrence of a violation as defined in that agreement.

The granting of additional loans by the Company to DBS requires the approval, *inter alia*, of the Ministerial Committee for Privatization (hereinafter — the Committee). On January 14, 2003, the Committee approved an increase in the Company's investment in DBS up to the amount of the product of the percentage of its holding in DBS shares multiplied by \$600 million, up to an exposure ceiling of \$300 million. The management of DBS estimates that the total investments approved for the Company by the Committee covers the proportional part of the Company in the Interim framework plus its proportional part in the Addition to the Financing Agreement.

The continued operation of DBS is contingent upon the ongoing implementation of the Financing Agreement and the Interim Credit Line, together with the Addition to the Financing Agreement as aforesaid and the receipt of additional loans from the shareholders in accordance with those agreements.

The management of DBS believes there is a good chance that the discussions between DBS, the shareholders and the Banks will lead to the implementation of the Addition to the Financing Agreement and the arrangement of the financial resources that DBS requires in the coming year.

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS on July 10, 2002 (hereinafter —

Notes to the Financial Statements as at December 31, 2002 (cont'd)

the New Shareholders' Loans) would have priority over the shareholders' loans to DBS which were made earlier (hereinafter — the Old Shareholders' Loans). Under the agreement, the New Shareholders' Loans would be entitled to repayment in full by DBS before any distribution of dividends at DBS and/or the repayment of the Old Shareholders' Loans, subject to DBS's cash flow and its obligations under the agreements with the Banks (including the priority of repayment of their financing). The new Shareholders' Loans are linked to the CPI ("known") and bear interest at 5.5%. In addition, under the same agreement, the shareholders who contribute to the New Shareholders' Loans are permitted to choose between an allotment of shares and options for shares deriving from their investments. The Old Shareholders' Loans are linked to the CPI ("known") and are interest-free. A change in the interest rate is subject to the consent of all the shareholders.

The Company has signed a perpetual guarantee for the banks, for payment of DBS's debts. The guarantee is up to a maximum amount equal to the percentage of the Company's holding in DBS multiplied by the value of DBS as derives from disposal of the pledged shares of the remaining shareholders. If the Company joins the sale under the framework of disposing the pledged shares of the remaining shareholders, the amount of the guarantee will not exceed the proceeds which the Company will receive from disposal of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company with respect to disposing of its shares, and sets out violations which, if perpetrated, will enable the banks to call in the guarantee.

F. Walla! Communications Ltd.

Bezeq International Ltd. invested in Walla! Communications Ltd. (hereinafter "Walla"), an Israeli company whose shares are listed on the Tel Aviv Stock Exchange and which provides internet services and operates internet portals. As at December 31, 2002, Bezeq International held 36.74% of the rights in Walla. During 2000, Bezeq International purchased approximately 38.5% of the rights in Walla in consideration of NIS 52,515,000.

On December 31, 2000, Walla entered into a merger agreement with IOL Israel Online (2000) Ltd. ("IOL"). Following the merger, the percentage of Bezeq International's holding in Walla decreased from 38.5% to 24.8%, generating a loss of NIS 3,706,000, which was included under the Other expenses item in the statement of operations for the year ended December 31, 2001.

On March 14, 2002 Walla issued a prospectus for a rights issue. Bezeq International invested approximately NIS 11,186,000 in exercise of the rights and approximately NIS 3,293,000 in the acquisition and exercise of additional rights from the public. After acquisition and exercise of the rights from the public and the acquisition of additional shares in Walla from a shareholder during 2002, Bezeq International's holding in Walla increased from 24.83% on December 31, 2001 to 36.74% on December 31, 2002.

In accordance with the investment agreement of Bezeq International Ltd. in Walla and pursuant to the prospectus for an rights issue of Walla, Bezeq International undertook to invest a total of \$6 million in Walla, either directly or through a strategic investor. Through December 31, 2002, Bezeq International had invested NIS 74.3 million in Walla by way of an investment in shares and extending loans. These investments, on the dates they were made, constitute the total investment approved by the Government of Israel for Bezeq International to invest in Walla. On December 31, 2002, the balance of the prospectus and contractual undertaking of the Company amounts to approximately \$0.6 million.

As part of its investment in Walla as described above, Bezeq International extended CPI-linked, interest-free loans to Walla during 2002 amounting to approximately NIS 11,485,000. Repayment of the loans will be on a date soon after the date on which Bezeq International invests in Walla's capital.

Following the valuation ratios determined for IOL and Walla on the eve of the merger and the amortization of goodwill in Walla following the merger with IOL, Bezeq International revalued its investment in Walla and amortized NIS 8,173 thousand in 2001, in accordance

Notes to the Financial Statements as at December 31, 2002 (cont'd)

with the valuation ratios and other components relating to the investment. The amortization was included under Other expenses, net for 2001.

During 2002, Bezeq International wrote down its investment in Walla by NIS 13,340,000. In the opinion of the management of Bezeq International, the balance of its investment after that write-down, plus its additional investments by way of loans reflect the fair economic value of Walla to Bezeq International.

G. Adanet for Business Group Ltd. ("Adanet")

The Company invested approximately NIS 48 million in Adanet Business Group Ltd. (hereinafter "Adanet"), of which approximately NIS 17 million in exchange for 50% of Adanet's capital and NIS 31 million as a shareholders' loan. Upon fulfillment of certain conditions, the Company, Clal Information Technologies Ltd. and the managers of Adanet have a call and put option respectively for the remaining 50% of Adanet's shares, subject to the approvals required by law.

Adanet is a private company which installs and services networks and computer equipment.

H. Goldnet Communications Services — a registered partnership

On June 14, 2000 the Company signed an agreement with AT&T Middle East Ltd. ("AT&T"), whereby, *inter alia*, AT&T was granted a put option to sell the balance of its holdings in a partnership (a 5% holding at December 31, 2001 and 2000) to the Company.

On September 19, 2002, AT&T gave notice of exercise of the put option. Following this change, the Company's holdings in the partnership on December 30, 2002, increased to 54% and AT&T ceased to be a partner in the partnership.

On September 26, 2000 an agreement was signed between the Company and Malam Systems Ltd. ("Malam"), whereby, *inter alia*, Malam was granted a put option to sell up to 20.9% of its share in the partnership and Malam granted the Company a call option to purchase up to 20.9% of Malam's share in the partnership.

The holdings of the partners as at December 31, 2002, are as follows:

| | |
|---|-----|
| "Bezeq" The Israel Telecommunication Corp Ltd. | 54% |
| Malam Systems Ltd. | 46% |

The option is valid until March 31, 2003. Subsequent to the balance sheet date, Malam gave notice of its wish to exercise the option, and as a result, the holdings of the Company in the partnership are expected to increase to 74.9% (subject to the approvals required by law).

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 9 — FIXED ASSETS

A. Composition and activity

Consolidated

| | Land & buildings | Switching, transmission and power equipment | Network equipment | Subscriber equipment and public telephones | Motor Vehicles | Office equipment and computers | Total |
|---|------------------|---|-------------------|--|----------------|--------------------------------|-------------------|
| | NIS thousands | | | | | | |
| Cost — | | | | | | | |
| Balance as at January 1, 2002 | 2,276,156 | 13,803,295 | 11,751,696 | 686,500 | 301,697 | 1,176,134 | 29,995,478 |
| Additions | 31,761 | 812,514 | 180,722 | 81,089 | 10,296 | 277,671 | 1,394,053 |
| Cost additions in respect of a company consolidated for the first time | 1,387 | — | — | — | 948 | 44,855 | 47,190 |
| Disposals ⁽¹⁾ | 18,006 | 1,151,940 | 9,084 | 106,911 | 76,797 | 117,556 | 1,480,294 |
| Balance as at December 31, 2002 | <u>2,291,298</u> | <u>13,463,869</u> | <u>11,923,334</u> | <u>660,678</u> | <u>236,144</u> | <u>1,381,104</u> | <u>29,956,427</u> |
| Accumulated depreciation — | | | | | | | |
| Balance as at January 1, 2002 | 1,263,621 | 8,358,644 | 8,298,633 | 406,235 | 170,120 | 595,357 | 19,092,610 |
| Depreciation charge | 100,393 | 1,436,620 | 402,256 | 117,211 | 36,113 | 221,264 | 2,313,857 |
| Accumulated depreciation in respect of a company consolidated for the first time ⁽²⁾ | 1,349 | — | — | — | 520 | 39,187 | 41,056 |
| Cancellation in respect of disposals ⁽¹⁾ | 14,813 | 1,149,646 | 9,084 | 105,745 | 66,078 | 115,694 | 1,461,060 |
| Balance as at December 31, 2002 | <u>1,350,550</u> | <u>8,645,618</u> | <u>8,691,805</u> | <u>417,701</u> | <u>140,675</u> | <u>740,114</u> | <u>19,986,463</u> |
| Net book value — | | | | | | | |
| As at December 31, 2002 | <u>940,748</u> | <u>4,818,251</u> | <u>3,231,529</u> | <u>242,977</u> | <u>95,469</u> | <u>640,990</u> | <u>9,969,964</u> |
| As at December 31, 2001 | <u>1,012,535</u> | <u>5,444,651</u> | <u>3,453,063</u> | <u>280,265</u> | <u>131,577</u> | <u>580,777</u> | <u>10,902,868</u> |

Company

| | Land & buildings | Switching, transmission and power equipment | Network equipment | Subscriber equipment and public telephones | Motor Vehicles | Office equipment and computers | Total |
|---|------------------|---|-------------------|--|----------------|--------------------------------|-------------------|
| | NIS thousands | | | | | | |
| Cost — | | | | | | | |
| Balance as at January 1, 2002 | 2,196,461 | 10,058,416 | 11,751,696 | 660,332 | 246,273 | 621,450 | 25,534,628 |
| Additions | 27,331 | 386,373 | 180,722 | 78,608 | 1,551 | 196,413 | 870,998 |
| Disposals ⁽²⁾ | 17,581 | 1,137,446 | 9,084 | 98,205 | 69,866 | 85,921 | 1,418,103 |
| Balance as at December 31, 2002 | <u>2,206,211</u> | <u>9,307,343</u> | <u>11,923,334</u> | <u>640,735</u> | <u>177,958</u> | <u>731,942</u> | <u>24,987,523</u> |
| Accumulated depreciation — | | | | | | | |
| Balance as at January 1, 2002 | 1,235,571 | 6,005,015 | 8,298,633 | 394,988 | 148,457 | 345,123 | 16,427,787 |
| Depreciation charge | 92,358 | 1,162,363 | 402,256 | 109,859 | 27,545 | 130,435 | 1,924,816 |
| Cancellation in respect of disposals ⁽¹⁾ | 13,684 | 1,137,446 | 9,084 | 98,205 | 61,286 | 85,921 | 1,405,626 |
| Balance as at December 31, 2002 | <u>1,314,245</u> | <u>6,029,932</u> | <u>8,691,805</u> | <u>406,642</u> | <u>114,716</u> | <u>389,637</u> | <u>16,946,977</u> |
| Net book value — | | | | | | | |
| As at December 31, 2002 | <u>891,966</u> | <u>3,277,411</u> | <u>3,231,529</u> | <u>234,093</u> | <u>63,242</u> | <u>342,305</u> | <u>8,040,546</u> |
| As at December 31, 2001 | <u>960,890</u> | <u>4,053,401</u> | <u>3,453,063</u> | <u>265,344</u> | <u>97,816</u> | <u>276,327</u> | <u>9,106,841</u> |

(1) Fixed assets are written off the books at the end of the year in which they became fully depreciated, except for land, buildings and vehicles, which are written off the books when sold. In 2002, fully depreciated fixed assets at a cost of approximately NIS 1,331 million (2001 — NIS 2,445 million) were written off the books.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

(2) The cost includes the amount of NIS 2,092,000 in the Company and NIS 6,883,000 consolidated, which constitute real financing expenses in respect of loans and credit during the foundation period, calculated at a real interest rate of approximately 2.9% per annum (prior year — 4%).

- B.** In October 2001, pursuant to the Company's policy of periodically reviewing the useful lives of its assets, a committee was appointed to examine whether there was a need to revise the useful lives of the assets and make recommendations to Management. The review included only fixed assets of the Company and was based on the balance of its fixed assets as at December 31, 2001. On May 28, 2002, the Board of Directors of the Company resolved to adopt Management's recommendations that were based on the report of the committee.

According to the recommendations of the committee, which were based, *inter alia*, on technological changes, changes in the investment plans of the Company (including providing broadband Internet service in ADSL technology on the existing copper infrastructure), and based on customary practices among the world's communications companies, the remainder of the useful lives of certain investments in the Company's copper cable network was extended, effective from January 1, 2002, while conversely, the useful lives of certain switching systems was shortened.

The aforementioned changes reduced the depreciation charge and increased the Company's net earnings by approximately NIS 259 million and NIS 166 million, respectively, for the year ended December 31, 2002. In addition, earnings per share in the year ended December 31, 2002 increased by approximately NIS 0.069 per NIS 1 par value.

Had the new depreciation rates been applied in 2001, the depreciation charges in that year would have been reduced by approximately NIS 228 million and the balance of the fixed assets would have increased by the same amounts.

In addition, net earnings in 2001 would have increased by approximately NIS 146 million and earnings per share would have increased by NIS 0.061 par value.

- C.** Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31, 1984. Some of these assets are leased for 49 years with an option for an extension for another 49 years and some are rented for renewable periods of two years each.

As at the time of the preparation of the financial statements, the Company's rights in a considerable part of its real estate assets are not registered at the Lands Registry Office.

The Accountant General of the Ministry of Finance notified the Company in January 1998 that the State intends to terminate the lease of those assets rented for the renewable two-year periods and that the Ministry of Finance will examine the use actually made by the Company of each specific asset and will take appropriate action with respect to the matter of making available alternative land and the payment of the relocation expenses. Company Management opposed implementation of the plan. In May 1999, representatives of the Company and the Israel Lands Administration held a meeting in the presence of representatives of the Government Companies Authority in the office of the Attorney General. In summing up the meeting, the Attorney General said that the Company could not carry out a public offering of its shares before clarification of the factual basis and the questions in dispute, so that the discussions could be held on the best way for settling the dispute. Further to the decision of the Ministerial Committee for Privatization of August 27, 2000 concerning the privatization of the Company, the Attorney General confirmed, in February 2001, the description of the land dispute which was described in an immediate report issued by the Company. The description includes the positions of the parties in their own words, to which was attached a list of the properties which are the subject of the dispute. The main points of the Company's position are, *inter alia*, that it is entitled to receive rights of ownership or "quasi-ownership" rights in those assets which are rented for renewable two-year periods. Regarding the leased part of the assets, the Company also believes that it is entitled to ownership rights or rights of lease for the maximum period that the State could offer.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

The State does not agree with these claims of the Company, and asserts, *inter alia*, that it is authorized, with notice to the Company, to terminate the renewable rental and in any case not to renew it. In the opinion of the State, the Company's refusal to accede to the demands of the State has harmed and continues to harm the State's ability to make financially sound and efficient use of the land, and as an example the State mentions the value of two assets which, according to its preliminary estimates, are worth (together) approximately \$440 million. Regarding leased assets, the State's position is that the Company's rights therein are rights of lease as stipulated in the agreements signed by the parties on this matter.

On June 23, 2002, the Company received a statement of claim which was filed in the Jerusalem District Court against the Company by the Development Authority, the Jewish National Fund and the State of Israel (Israel Lands Administration, the Ministry of Communications and the Ministry of Finance) (all referred to below as "the State").

The claim sues for declaratory relief, whereby the interpretation of the "Asset Transfer Agreement" signed between the State and the Company in connection with the transfer of real estate assets ("the Real Estate") to the Company before it commenced operations in 1984 and the of "umbrella contract" signed in 1993 in connection with some of those assets, requires, *inter alia*, the following conclusions:

1. The State is the sole and exclusive owner of the Real Estate and the Company has no rights of ownership in the Real Estate and is not entitled to act as if it were the owner.
2. At most, the Company has a right to use the Real Estate which is limited by conditions and by objectives defined in the aforementioned agreements, and if it fails to comply with those conditions and objectives — then all the Real estate should revert to the State immediately and unconditionally.
3. The State is entitled to immediately deny the Company the right of use of the Real Estate leased to it in bi-annual contracts referred to in the Asset Transfer Agreement, even where the Company is using the Real Estate for the purpose for which it was transferred, as long as the State believes that there is another preferable use for the Real Estate and as long as alternative real estate is made available to the Company so that it can continue to provide services as defined in the agreements and to the extent that the Company proves that it is in need of such real estate.
4. The Company must restore to the State immediately, certain assets in the Rishpon region (480 dunams), in the Sakia region (1,300 dunams), and parts of parcels in the Givat Mordechai and Ramat Beit Hakerem neighborhoods in Jerusalem.

In the opinion of the Company, relying on its legal advisers, it has meritorious arguments in support of its position. The Company filed a statement of defense in which it alleged, *inter alia*, that the claim or part of it should be stricken *in limine*, or it should be clarified and amended, and that in any case the claim should also be dismissed on its merits. At this stage, the Company is unable, based on the opinion of its legal advisers, to assess the chances and implications of the claim.

It is noted that concurrently with the above legal action, negotiations are in progress for settlement of the Real Estate dispute between the Company and the State and Israel Lands Administration. The main points of the agreement being formulated were approved by the relevant bodies in the State and by the Board of Directors of the Company and according to which a number of assets defined as "Renewable Lease Assets" from the Real Estate assets held by the Company will be returned to the State, while the rest of the assets will remain in the Company's possession on capitalized lease terms and the restrictions imposed on their use and utilization will be lifted. The final agreement will be subject to the approvals required by law.

- D. In April 2002, Pelephone Communications Ltd., a proportionally consolidated company, signed an agreement for the purchase and installation of a cellular communications system in CDMA 1X technology for \$147 million. The new system will significantly increase the capacity of the existing network, will add sites to improve coverage and communications

Notes to the Financial Statements as at December 31, 2002 (cont'd)

quality and will enable it to provide customers with advanced services, including value added services such as downloading games, transmitting pictures and animations and the like. Deployment of the network commenced during the third quarter of 2002 and commercial operation was planned for gradual introduction and commenced in October 2002. The terms of payment are according to delivery of the equipment, acceptance tests and commercial operation.

In addition, the company supplying the new system undertook to buy the old equipment for approximately \$32 million. As at December 31, 2002, Pelephone had paid the system supplier approximately \$60 million out of the above total (proportionally consolidated — approximately \$30 million).

- E. As at the balance sheet date, there are commitments to purchase fixed assets (mainly switching equipment) amounting to approximately NIS 766 million (consolidated) and NIS 447 million (Company).
- F. In 2001, a proportionally consolidated company depreciated assets which it will not use in providing its services. The net book value of the assets in the books of the proportionally consolidated company, was approximately NIS 217 million (proportionally consolidated — approximately NIS 109 million). The depreciation of the assets was included under the Other expenses, net item.

NOTE 10 — DEFERRED AND OTHER EXPENSES

Consolidated

| | Cost | Accumulated depreciation | Depreciable balance | |
|---|----------------|--------------------------|---------------------|------------------|
| | | | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Capitalized subscriber acquisition costs..... | 393,848 | 230,885 | 162,963 | 327,220 |
| Rights in channels | 5,583 | 2,290 | 3,293 | 3,969 |
| Representation rights in a communications corporation ... | 3,839 | 2,210 | 1,629 | 2,013 |
| Acquisition of operations ⁽¹⁾ | 26,082 | 3,532 | 22,550 | — |
| Frequencies ⁽²⁾ | 56,824 | — | 56,824 | — |
| | <u>486,176</u> | <u>238,917</u> | <u>247,259</u> | <u>333,202</u> |
| Expenses for issuance of debentures, raising loans and others | | | 15,414 | 18,086 |
| Goodwill not yet fully depreciated in consolidated companies ⁽³⁾ ... | | | 20,125 | — |
| Minority rights from a proportionally consolidated company | | | — | 11,224 |
| | | | <u>282,798</u> | <u>362,512</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Company

| | Depreciable balance | |
|---|---------------------|---------------------|
| | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands |
| Deferred expenses | | |
| Expenses for issuance of debentures and raising loans | 15,414 | 18,086 |

- (1) A consolidated company acquired an operation — the acquisition of resources, from Nortel Networks Israel (Sales and Marketing) Ltd. (see Note 19C(3)), to obtain independent capability for the provision of maintenance, support and installation services to customers of the consolidated company.
- (2) On the amortization of the investment in cellular frequency ranges in third generation technology of a proportionally consolidated company, see Note 8D(6).
- (3) On the amortization of goodwill, see Note 2F(6).

NOTE 11 — TAXES ON INCOME

A. General

The Income Tax Law (Adjustments for Inflation), 5745 — 1985, effective since the 1985 tax year, introduced a method of measuring operating results for tax purposes on a real basis. The various adjustments required by this law are intended to bring about taxation on the basis of real income. However, adjustment of the nominal profit in accordance with the tax laws is not always identical with the inflation adjustments prescribed for financial reporting purposes by opinions of the Institute of Certified Public Accountants in Israel. As a result, differences arise between the inflation-adjusted profit in the financial statements and adjusted taxable income.

The asset component demanded by the Company as an expense for tax purposes, is allocated directly to shareholders' equity.

On deferred taxes in respect of these differences — see Notes 20 above and 11D below.

B. Income tax (tax benefit) included in the statements of operations

Consolidated

| | For the year ended December 31 | | |
|--------------------------------------|--------------------------------|---------------|---------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Current taxes | 220,348 | 361,914 | 189,881 |
| Deferred taxes | 10,994 | (129,278) | (348,640) |
| Taxes for prior years, net | (20,023) | 12,935 | (6,825) |
| | 211,319 | 245,571 | (165,584) |

Company

| | For the year ended December 31 | | |
|--------------------------------------|--------------------------------|---------------|---------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Current taxes | 218,177 | 358,583 | 182,787 |
| Deferred taxes | 45,321 | (2,206) | (325,691) |
| Taxes for prior years, net | (29,442) | 12,906 | (6,987) |
| | 234,056 | 369,283 | (149,891) |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

C. Reconciliation between the theoretical tax computed in respect of the pre-tax inflation adjusted earnings and the actual tax expense in the books

Consolidated

| | For the year ended December 31 | | |
|--|--------------------------------|----------------|------------------|
| | 2002 | 2001* | 2000* |
| | NIS thousands | NIS thousands | NIS thousands |
| Tax computed at the regular tax rate | (134,999) | 216,642 | (199,186) |
| Increase (savings) in tax liability in respect of: | | | |
| Inflationary erosion of advance tax | | | |
| payments | 1,317 | 403 | (72) |
| Exempt income and capital gains | (39,144) | (37,340) | (46,052) |
| Non-deductible expenses | 6,962 | 32,380 | 14,048 |
| Timing differentials for which no tax benefit | | | |
| was created | 448,524 | 2,942 | — |
| Losses in respect of which a deferred tax | | | |
| asset was not created | (35,427) | 17,968 | 63,835 |
| Differences in the definition of equity and | | | |
| non-monetary assets for tax purposes . . . | (15,962) | 264 | 6,812 |
| Taxes in respect of prior years, net | (20,023) | 12,935 | (6,825) |
| Others | 71 | (623) | 1,856 |
| | <u>211,319</u> | <u>245,571</u> | <u>(165,584)</u> |

* Reclassified

Company

| | For the year ended December 31 | | |
|--|--------------------------------|----------------|------------------|
| | 2002 | 2001* | 2000* |
| | NIS thousands | NIS thousands | NIS thousands |
| Tax computed at the regular tax rate | (126,409) | 368,702 | (100,418) |
| Increase (decrease) in tax liability in | | | |
| respect of: | | | |
| Inflationary erosion of advance tax | | | |
| payments | 1,254 | 403 | (70) |
| Exempt income and capital gains | (39,144) | (36,460) | (46,031) |
| Non-deductible expenses | 3,330 | 29,689 | 10,356 |
| Timing differentials for which no tax benefit | | | |
| was created | 443,722 | — | — |
| Taxes in respect of prior years, net | (29,442) | 12,906 | (6,988) |
| Differences in the definition of equity and | | | |
| non-monetary assets for tax purposes . . . | (17,862) | (5,487) | (5,800) |
| Others | (1,393) | (470) | (940) |
| | <u>234,056</u> | <u>369,283</u> | <u>(149,891)</u> |

* Reclassified

Notes to the Financial Statements as at December 31, 2002 (cont'd)

D. Deferred Taxes

| | Consolidated | | Company | |
|--|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Activity — | | | | |
| Balance at beginning of year | 635,637 | 869,458 | 502,779 | 858,914 |
| Charged to statement of operations for the year | (10,994) | 129,278 | (45,321) | 2,207 |
| Charged to income tax refundable in respect of prior years | — | (358,342) | — | (358,342) |
| Charged to statement of operations in respect of prior years | <u>(19,735)</u> | <u>(4,757)</u> | <u>(19,735)</u> | <u>—</u> |
| Balance as at end of year | <u>604,908</u> | <u>635,637</u> | <u>437,723</u> | <u>502,779</u> |
| Composition of deferred taxes — | | | | |
| Difference between the adjusted value of fixed assets and their value for income tax purposes | (628,909) | (578,872) | (457,438) | (502,465) |
| Adjustment of materials and spare parts | (522) | (370) | (239) | (217) |
| Deferred tax due to losses | 308,524 | 281,833 | — | — |
| Differences in the recognition of expenses relating to employee rights, doubtful debts and other | <u>925,815</u> | <u>933,046</u> | <u>895,400</u> | <u>1,005,461</u> |
| Total | <u>604,908</u> | <u>635,637</u> | <u>437,723</u> | <u>502,779</u> |
| Stated as follows: | | | | |
| As part of current assets | 202,832 | 158,600* | 200,744 | 156,448 |
| As part of other assets | <u>402,076</u> | <u>477,037*</u> | <u>236,979</u> | <u>346,331</u> |
| Total | <u>604,908</u> | <u>635,637</u> | <u>437,723</u> | <u>502,779</u> |

* Reclassified

The deferred taxes are computed at the tax rate expected to be in effect at the time (36%). Realization of the tax benefit is contingent upon the existence of adequate taxable income at appropriate levels in the future. The tax benefit is included in the financial statements since, according to the Company's business plans, its realization is anticipated. The tax benefit in respect of a loss accumulated at Pelephone was recorded according to the assessment of Pelephone's management that there is a high degree of certainty that these losses will be realized in the foreseeable future.

Losses of consolidated companies for tax purposes of which are carried forward to the coming years amounted to approximately NIS 1,023,011,000 (2001 — NIS 1,072,540,000). The balance of the losses and deduction carry-forwards for which no deferred tax benefit was included because of the uncertainty of their realization, is approximately NIS 22,223,000 (2001 — NIS 315,643,000).

E. Final tax assessments

- (1) In June 2001 an agreement was signed between the Company and the Income Tax Authorities in respect of final assessments for the years 1994 — 1998 inclusive. Under the agreement, the Company's claim to increase the depreciation rate of switching and subscriber equipment was recognized and several other matters were also agreed upon, principally postponement of the dates for recognition of certain expenses. As a result of the above, the Company recorded tax expenses in the 2001 financial statements in respect of preceding

Notes to the Financial Statements as at December 31, 2002 (cont'd)

years, amounting to approximately NIS 12 million, as well as financing income of approximately NIS 79 million (tax exempt) deriving from the rebate payable to the Company.

- (2) Under an assessment agreement signed on January 30, 2003, between consolidated company Bezeq International Ltd. and the assessment officer, concerning final tax assessments issued to Bezeq International for the years 1996 — 1999, Bezeq International Ltd. undertook to pay approximately NIS 14 million, of which approximately NIS 3 million represented interest and linkage differentials.
- (3) A proportionally consolidated company has received final assessments up to and including 1994, and a final assessment was determined up to 1998 by prescription. BezeqCall Communications Ltd. has received final assessments up to and including 1998.
- (4) Pelephone Communications Ltd. ("Pelephone"), a proportionally consolidated company, received deduction assessments for the years 1998 — 2000., which are in dispute and concerning which Pelephone will be submitting objections. Pelephone included in its books a provision in an amount which, based on the opinion of its legal advisers, it believes to be adequate in the event that its position is not accepted.

F. Value added tax

- (1) The Company files a consolidated tax return with its subsidiaries for Value Added Tax purposes.
 - (2) The Company is in dispute with the Value Added Tax Authorities regarding the Company's right to reimbursement of Value Added Tax it paid which was not collected from customers in that it was a bad debt and its right to receive that reimbursement plus interest and linkage differentials from the date on which the debt was generated. An objection filed by the Company was dismissed by the VAT Authorities, and the Company intends to submit the matter for a decision in the appropriate proceedings.
- G.** On January 1, 2003, the tax reform took effect. Company Management estimates that the amendment is not expected to have a material effect on the business results of the Company.

NOTE 12 — BANK CREDIT

| | Interest rate | Consolidated | |
|---------------------------|---------------|----------------------|----------------------|
| | | December 31, 2002 | December 31, 2001 |
| | | % | NIS thousands |
| Unlinked loans..... | 9.4 — 10.15 | 368,123 | 413,264 |
| CPI-linked loans..... | 6.5 — 6.65 | 125,185 | — |
| Dollar-linked loans | 2.69 — 2.94 | 35,517 | 37,817 |
| | | 528,825 | 451,081 |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 13 — LONG-TERM LOANS

A. Composition

| | Consolidated | | Company | |
|---------------------------------|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Banking institutions..... | 2,583,794 | 3,180,009 | 1,832,629 | 2,420,677 |
| Pension fund | 72,054 | 90,391 | 72,054 | 90,391 |
| Others | 907 | 17,614 | — | — |
| Suppliers credit | 17,575 | 1,498 | — | — |
| | <u>2,674,330</u> | <u>3,289,512</u> | <u>1,904,683</u> | <u>2,511,068</u> |
| Less — | | | | |
| Current maturities from banks.. | 545,063 | 593,104 | 373,184 | 390,866 |
| Other current maturities | 25,902 | 19,182 | 21,065 | 18,465 |
| | <u>2,103,365</u> | <u>2,677,226</u> | <u>1,510,434</u> | <u>2,101,737</u> |

B. Linkage terms and interest

| | Interest rate % | Consolidated | | Company | |
|----------------------------------|--------------------|---------------------|---------------------|---------------------|---------------------|
| | | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Loans in foreign currency | | | | | |
| US dollar(*) | 2.2 — 3 | 1,580,702 | 1,921,120 | 1,563,818 | 1,921,120 |
| Euro | | — | 1,455 | — | 1,455 |
| | | <u>1,580,702</u> | <u>1,922,575</u> | <u>1,563,818</u> | <u>1,922,575</u> |
| Loans linked to the CPI | 3.6 — 8.2 6.1 | 781,574 72,054 | 864,896 90,391 | 268,811 72,054 | 498,102 90,391 |
| | | <u>853,628</u> | <u>955,287</u> | <u>340,865</u> | <u>588,493</u> |
| Unlinked loans | 6.85 — 8.2 | 240,000 | 411,650 | — | — |
| | | <u>2,674,330</u> | <u>3,289,512</u> | <u>1,904,683</u> | <u>2,511,068</u> |

(*) These loans bear interest at LIBOR plus a margin. The rate shown in the above table is a weighted average rate as at the balance sheet date.

C. Repayment schedule

| | Consolidated NIS thousands | Company NIS thousands |
|---------------------------|-------------------------------|--------------------------|
| December 31 | | |
| 2004..... | 585,895 | 380,694 |
| 2005..... | 747,270 | 547,432 |
| 2006..... | 681,273 | 546,780 |
| 2007..... | 64,887 | 35,528 |
| 2008 and thereafter | 24,040 | — |
| | <u>2,103,365</u> | <u>1,510,434</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

D. Security

- (1) Long-term loan agreements of the Company, aggregating NIS 1,673,608,000 include certain conditions upon the occurrence of which the lender may demand early repayment of the loans, including:

- The intervention of an authority in the administration of the Company's affairs.
- In respect of loans aggregating NIS 868,318,000, a decrease in the State's voting rights in the Company to 26% or less, of which in respect of a balance of approximately NIS 532,913,000 upon the occurrence of an event which also allows other loans of the Company to be made available for early repayment.
- In respect of the remaining loan balance of NIS 805,290,000, upon the occurrence of an event which allows early repayment of other loans of the Company and of material subsidiaries to be demanded, or failure to comply with the following financial covenants relating to the Group:
 - a. Net financial debt to Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) of not more than 3: 1.
 - b. Tangible shareholders' equity to be at least 35% of total tangible assets.

As at the balance sheet date, the Company is in compliance with these financial covenants.

- A change, made without the lenders' consent, in the nature of the Company's business which would have a materially adverse effect on its business, assets or financial condition.

Regarding the possibility of existence of the above conditions, including a decrease in the voting rights of the State and the possibility of the complete opening of the communications market to competition — see Note 1.

The Company created a negative pledge in favor of the lenders.

- (2) A proportionally consolidated company provided a negative pledge and undertook to meet certain financial conditions in respect of bank loans it received, the proportionally consolidated balance of which, as at the balance sheet date, is NIS 696,153,000. As at the balance sheet date, that company is complying with those financial conditions.
- (3) A subsidiary provided a negative pledge and undertook to meet certain financial conditions in respect of loans from banking institutions, the balance of which as at the balance sheet date is approximately NIS 55 million.

E. Loan-procurement expenses

Deferred expenses for raising loans as at December 31, 2002, and December 31, 2001, amounted to NIS 9,280,000 and NIS 11,161,000 respectively. The expenses are presented after deduction of accumulated amortization amounting to NIS 3,937,000 and NIS 4,064,000, respectively.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 14 — OTHER DEBENTURES

A. Composition and terms

| | Interest Rates | Consolidated and Company | |
|---|----------------|--------------------------|-------------------------|
| | | December 31 2002 | December 31 2001 |
| | % | NIS thousands | NIS thousands |
| CPI-linked debentures issued to the public: | | | |
| Debentures Series 1 ⁽¹⁾ | 4.5 | <u>141,957</u> | <u>212,555</u> |
| Debentures issued to the public: | | | |
| Linked to the euro ⁽²⁾ | 4.3 — 6.5 | <u>1,476,805</u> | <u>1,241,855</u> |
| Debentures issued: | | | |
| Unlinked ⁽³⁾ | 4.9 — 8.5 | <u>500,241</u> | <u>532,597</u> |
| Debentures issued to financial institutions and others: | | | |
| CPI-linked | 4.99 | <u>860,418</u> | <u>900,088</u> |
| | | <u>2,979,421</u> | <u>2,887,095</u> |
| Less — current maturities | | <u>210,294</u> | <u>198,851</u> |
| | | <u><u>2,769,127</u></u> | <u><u>2,688,244</u></u> |

(1) The outstanding balance of the debentures is NIS 39,900,581 par value (2001 — NIS 59,850,864 par value).

(2) The outstanding balance of the debentures is 300,000,000 euro par value.

(3) The outstanding balance of the debentures is NIS 500,656 par value.

B. Repayment schedule

| | NIS thousands |
|---------------------------|-------------------------|
| 2004 | 603,699 |
| 2005 | 214,281 |
| 2006 | 174,636 |
| 2007 | 78,724 |
| 2008 and thereafter | <u>1,697,787</u> |
| | <u><u>2,769,127</u></u> |

C. Security

The debentures are not secured, except for a nominal lien. However, the Company has undertaken that as long as the debentures are outstanding, it will refrain from encumbering its property with other liens.

Some of the lenders, the balance of whose loans as at December 31, 2002 amounts to approximately NIS 725,179,000, are entitled to demand the immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26% (see Note 1).

In addition, in respect of a balance of NIS 1,456,093,000 of debentures which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for immediate repayment of other loans of the Company and of material subsidiaries.

The Company has created a negative pledge in favor of the holders of the euro-linked debentures issued to the public.

D. Issuance expenses

Deferred expenses with respect to the issuance of the debentures amounted to NIS 34,494,000 (2001 — NIS 31,873,000) and are stated net of amortization of NIS 25,729,000 (2001 — NIS 22,405,000).

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 15 — TRADE PAYABLES

| | Consolidated | | Company | |
|--|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Suppliers of goods and services . . . | 1,148,526 | 1,084,141 | 676,213 | 607,589 |
| Current maturities of long-term supplier credit | <u>4,837</u> | <u>717</u> | <u>—</u> | <u>—</u> |
| | <u>1,153,363</u> | <u>1,084,858</u> | <u>676,213</u> | <u>607,589</u> |
| Including subsidiaries | <u>—</u> | <u>—</u> | <u>37,223</u> | <u>8,918</u> |
| Including a proportionally consolidated company | <u>50,711</u> | <u>37,586</u> | <u>101,422</u> | <u>75,172</u> |

NOTE 16 — LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Composition

| | Consolidated | | Company | |
|---|---------------------|---------------------|---------------------|---------------------|
| | December 31 2002 | December 31 2001 | December 31 2002 | December 31 2001 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Provision for early retirement, (see D below) | 1,268,711 | 1,544,370 | 1,268,711 | 1,544,370 |
| Compensation for unutilized sick leave (see E below) | <u>57,306</u> | <u>66,647</u> | <u>57,306</u> | <u>66,647</u> |
| | <u>1,326,017</u> | <u>1,611,017</u> | <u>1,326,017</u> | <u>1,611,017</u> |
| Provision for severance pay (see C below) | 72,239 | 66,477 | 15,426 | 16,269 |
| Less — reserve in compensation fund | <u>(45,805)</u> | <u>(38,671)</u> | <u>—</u> | <u>—</u> |
| | <u>26,434</u> | <u>27,806</u> | <u>15,426</u> | <u>16,269</u> |
| | <u>1,352,451</u> | <u>1,638,823</u> | <u>1,341,443</u> | <u>1,627,286</u> |
| Stated as follows: | | | | |
| In current liabilities | 212,631 | 280,028 | 212,631 | 280,028 |
| In long-term liabilities | <u>1,139,820</u> | <u>1,358,795</u> | <u>1,128,812</u> | <u>1,347,258</u> |
| | <u>1,352,451</u> | <u>1,638,823</u> | <u>1,341,443</u> | <u>1,627,286</u> |

B. Eligibility of employees upon reaching retirement age

- (1) The liability of the Company and its investee companies for severance benefits to employees is fully covered by current payments to pension funds and insurance companies and the above liabilities. The accumulated amounts are not under the management or control of the companies and, therefore, are not reflected in the balance sheet.
- (2) The pension rights of the Company's employees with respect to the period of their employment in government service, up to January 31, 1985, are covered by a pension fund ("Keren Makefet") which assumed the Government's liability in accordance with an agreement between the Government, the Company, the New General Federation of Labor (Histadrut) and the Fund.

C. Employee rights before retirement age

The Company's liability to pay severance pay to employees leaving their employment under conditions entitling them to such benefits is covered, in respect of the period from February 1, 1985, by current deposits in pension funds and with insurance companies, as stated in section B above. Severance pay in respect of the period of government service up

Notes to the Financial Statements as at December 31, 2002 (cont'd)

to January 31, 1985, is paid by the Company, and the amounts accumulated with Keren Makefet with respect to this period are held in the Fund for use in connection with the employees' rights. For a small number of employees (employed under special contracts), the Company has a commitment to pay severance pay exceeding the amount accumulated on the employee severance pay fund.

The Group's liability for pension and severance payments are mainly covered by current deposits in the employees' name in recognized pension and severance funds, and/or by acquisition of policies from insurance companies. The aforementioned deposited amounts are not included in the balance sheet since they are not under the control and management of the companies.

Employees who transferred to the Company from government service and who leave the Company before reaching retirement age, are entitled, under certain conditions, if they so choose, to receive early pension benefits in lieu of severance pay. The cost of the early pension benefits, except for cases of sickness or disability up to retirement age, are to be borne by the Company. The costs of retirement of such employees is included in the provision for early retirement plans, as described below.

D. Early retirement plans

- (1) Under a special collective agreement for retirement, signed on November 23, 1997 between the Company and the workers' representatives, approximately 2,050 employees retired from the Company up to December 31, 1999.
- (2) As part of the plan for organizational change in the Company, which was approved by the Board of Directors in March 2000, approximately 530 employees retired from the Company between December 31, 1999 and December 31, 2001.
- (3) a. The Company reached agreement with the workers' representatives in September 2000, to extend the collective early retirement agreement from 1997. Under the agreement, which applies from April 1, 2001 to December 31, 2006 (with an option to extend the final retirement date for certain employees to December 31, 2008), another 1,770 employees will take early retirement.

Furthermore, pursuant to the agreement, the Company's management will be able to dismiss employees under a compensation arrangement over and above the number stated in the agreement. The Company's management estimates that the possibility of additional employees retiring in the compensation track is remote, and accordingly, no provision was made for them in the financial statements. The number of employees who retired under this plan up to December 31, 2002, is approximately 355.

- b. The pension fund through which the early retirement plan is implemented ("the Fund") was directed by the Capital Markets Division of the Ministry of Finance to fulfill an undertaking it made in connection with changing the retirement tracks of approximately 600 Company retirees, provided that the Company pay the Fund NIS 50 million. After the Fund undertook that no extra cost would be imposed on the Company, the Company notified the Fund that it should continue to implement the agreement which enabled transfer from one retirement track to another at no additional cost to the Company. As a result, the Fund no longer allowed Company retirees to switch from one retirement track to another and even stopped implementation of the agreement, in whole or in part, in relation to retirement benefits paid in respect of April 2002. In the opinion of the Company's Management, based on consultations with its legal advisers, it is unlikely that the Company will be charged any costs in connection with implementation of the agreement and therefore it will insist on its implementation with no further payment to the Fund. Accordingly, no provision was made in the financial statements in respect of the above.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

E. Compensation for unutilized sick leave

The financial statements include a provision for compensation in respect of unutilized sick leave for all employees, in accordance with the conditions fixed in the employment agreement.

NOTE 17 — OTHER CURRENT LIABILITIES

| | <u>Consolidated</u> | | <u>Company</u> | |
|--|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | <u>December 31 2002</u> | <u>December 31 2001</u> | <u>December 31 2002</u> | <u>December 31 2001</u> |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| The Government of Israel in respect of royalties, interest and other fees | 198,588 | 209,705 | 158,447 | 158,502 |
| Wages and salaries ⁽¹⁾ | 308,041 | 257,953 | 242,881 | 210,745 |
| Provision for vacation pay | 91,492 | 101,730 | 86,420 | 97,685 |
| Income tax payable | — | 102,021 | — | 97,183 |
| Governmental institutions | 69,669 | 108,620 | 49,918 | 92,008 |
| Accumulated interest | 109,731 | 110,031 | 100,692 | 104,112 |
| Forward exchange contracts | 19,435 | 14,187 | 18,930 | 14,187 |
| Other accumulated expenses | 161,880 | 157,891 | 80,636 | 90,445 |
| Current maturities in respect of prepaid income | 40,651 | 46,420* | 26,701 | 32,361 |
| Provision for claims in respect of salary and pension components | <u>118,615</u> | <u>118,615</u> | <u>118,615</u> | <u>118,615</u> |
| | <u>1,118,102</u> | <u>1,227,173</u> | <u>883,240</u> | <u>1,015,843</u> |
| (1) Including current maturities of a long-term loan from a pension fund | <u>21,065</u> | <u>18,465</u> | <u>21,065</u> | <u>18,465</u> |

* Reclassified

NOTE 18 — PREPAID INCOME

Prepaid income consists mainly of receipts in respect of making infrastructures available for the use of external entities and from compensation in respect of a purchase agreement with a proportionally consolidated company.

NOTE 19 — CONTINGENT LIABILITIES

A. Claims

Following are details of the status of the contingent liabilities of the Company and investee companies as at December 31, 2002, in which the maximum possible exposure is significant.

- (1) In August 1996 a claim and an application by way of motion for approval of the claim as a class action were filed against the Company in the District Court. The plaintiff alleges that the Company is misleading the public in that the prices of direct-dial international calls are calculated and collected on the basis of meter pulses rather than call time units as promised in its advertisements. The damage claimed relates to overcharging deriving from rounding-up of fractions of meter pulses to a whole meter pulse. The value of the claim as a class action is approximately NIS 133 million, and it related to the seven years preceding the filing of the action. In February 1997 the court approved the action as a declaratory class action with regard to the deception only, and held that the extent of the damage of the members of the group should not be fixed, whether as a whole or as individuals. If the class action is allowed and a declaration made that the advertising was misleading, a subscriber who believes that

Notes to the Financial Statements as at December 31, 2002 (cont'd)

he sustained damages as a result of the deception will be able to file a personal claim against the Company, in which he will attempt to prove his losses. The plaintiff filed an appeal against that part of the court's decision that rejected the application to recognize the action as a monetary class action. The Company filed a cross-appeal of the decision to recognize the action a declaratory class action. In March 1998 the application of the plaintiff to conjoin Bezeq International Ltd. as an additional defendant in the class action was allowed. Bezeq International filed an appeal against this decision in May 1998 in the Supreme Court. On the same occasion, Bezeq International Ltd. requested that it be conjoined as an additional appellant in the Company's appeal. On July 2, 2001 the Supreme Court denied the appeal of the plaintiff and allowed the appeal of the Company and of Bezeq International. On July 17, 2001 the plaintiff filed an application for an additional hearing of the case against the Company only, and therefore Bezeq International Ltd. is no longer a party to this case. On September 29, 2002 the Supreme Court allowed the plaintiff's application for an additional hearing, and ruled that the additional hearing would be before a panel of seven justices. On October 17, 2002 the Supreme Court allowed the application of the Israeli Consumer Council to be added as a party to the additional hearing. If in the additional hearing, the ruling in the Company's appeal is reversed, the main hearing in the District Court will be resumed. In the Company's opinion, relying on the legal adviser who is handling the claim on its behalf, it is not possible, at this stage, to estimate the chances of the claim. Accordingly, no provision was included in the financial statements in respect of this claim.

- (2) In June 1997 a group of approximately 130 employees filed a claim, through the Histadrut, in the Regional Labor Court, for declaratory relief in respect of the pension rights of those employees of the group who were transferred from the Ministry of Communications, serving as departmental managers and employed under personal contracts. According to the plaintiffs, they are entitled to pension terms identical to those of all Company employees to whom a collective agreement applies. In September 1997 the Attorney General gave notice of his appearance in the proceeding. In May 1998 the Company filed an actuarial opinion in the Regional Labor Court, stating that the cost of the plaintiffs' demand would be approximately NIS 155 million. In November 1999 a decision was issued rejecting almost all the causes of the action. This decision has been appealed. The arguments stage in the case has been completed and now awaits the decision of the National Court on the appeal. Negotiations are in progress between the Company and the workers' representatives, with the aim of reaching an arrangement which will end the dispute. A provision was made in the financial statements based on an arrangement proposed by the Company's management. As at the date of approval of the financial statements, the arrangement had not been approved by the Wages and Employment Agreements Division at the Ministry of Finance, but the Company still has the possibility of appealing the Ministry's decision.
- (3) On September 16, 2001 a revised statement of claim and an application for recognition as a class action were filed against Bezeq International Ltd. and the State of Israel under Section 46A of the Anti Trust Law. The plaintiff alleges that the tariffs for international telecommunication services in the period from May 10, 1996 to July 8, 1997 were exorbitant and unreasonable, while exploiting the status of Bezeq International Ltd. as a monopoly, against a background of lowering prices as the international calls market was opening up to competition. On February 18, 2002 Bezeq International Ltd. filed its response to the court, in which it rejected the allegations of the Plaintiff and alleged that conditions did not exist for allowing the claim as a class action. The Court allowed the application of the Applicant to study the financial statements of Bezeq International Ltd. for the relevant period, and the minutes of the meetings of its board of directors from the same period. The legal advisers of Bezeq International Ltd. estimate that if the claim is allowed as a class action, the amount of the action is liable to reach hundreds of millions of shekels. The legal advisers of Bezeq International Ltd. are unable, at this stage, to estimate the chances of the claim, and therefore no provisions were made for this claim in the financial statements.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (4) In September 1997 a claim was filed against the Company and the State in the Regional Labor Court. The claim was filed on behalf of 128 senior employees who are employed under personal contracts. The nature of the claim is the plaintiffs' allegation that commencing October 1, 1996, they are entitled to a wage increment of 33%, corresponding to the increment which was given at that time to Members of the Knesset and to senior civil servants whose salaries are linked to those of Members of the Knesset. The total amount of the claim in respect of salary differences is approximately NIS 12 million. Withholding differences are also claimed in respect of these amounts. The Company alleged that it pays the salaries of the plaintiffs in accordance with the directives of the Government Companies Authority. In the Company's opinion, relying on the legal adviser who is handling the claim on its behalf, it is not possible, at this stage, to estimate the outcome of this claim. No provision was made in the financial statements in respect of this claim.

The State joined as a party to the proceeding and filed a final opinion of the Attorney General, which supports the position of the Companies Authority that there is no obligation to pay senior employees the wage increment demanded. In the hearing held on January 27, 1998, the State's representative announced that the Attorney General had made his decision, which was that the Companies Authority has no obligation to issue an instruction to raise the senior employees' salaries by 33%, and that the Companies Authority had exercised its discretion reasonably on this question in deciding not to accede to the claim.

- (5) In November 1997 a claim was filed in the District Court, together with an application to recognize a claim as a class action, against the Company, Bezeq International Ltd., the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Anti-Trust Commissioner determined that Bezeq International had unfairly exploited its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs when it refrained from clarifying to the public that only those who register as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 53 million. In December 1997, the Company was stricken from the claim. On June 19, 2001 the District Court decided to reject the application for approval as a class action. On September 20, 2001 the decision of the District Court was appealed in the Supreme Court. On October 28, 2001 Bezeq International filed an application to strike the appeal *in limine*. On January 7, 2002 the court rejected the application and ruled that the appeal would be heard on its merits. On October 30, 2002 the plaintiffs requested to lower the guarantee required as a condition to hearing the appeal and to extend the date of filing. On November 19, 2002 Bezeq International submitted its objection to this request and on December 3, 2002 the Supreme Court allowed the position of Bezeq International, and the parties filed their summations. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the appeal filed in the Supreme Court, and therefore no provision was included in the financial statements in respect of this claim.
- (6) In December 1998 the Anti-Trust Commissioner published notice that the Investigations Department of the Anti-Trust Authority ("the Authority") had completed an investigation which had been carried out over the past year, regarding *prima facie* suspicion of binding agreements between Koor Industries, Telrad, Tadiran, the Company and BezeqCall Communications Ltd., concerning the supply of large exchanges and Network End Point ("NEP") exchanges.

Below are the main points of the Commissioner's notice:

The investigation focused on two main areas: the public switching market, which includes the supply of digital exchange equipment and related services by Tadiran and Telrad to the Company; and the NEP exchange market.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

According to the Commissioner, the Authority investigators recommend that concerning some of the suspicions investigated, indictments be filed against some of those who were investigated. The Legal Department at the Anti-Trust Commission will now examine the investigation material and the recommendations of the investigators, in order to determine whether offenses against the Anti-Trust Law were indeed perpetrated, and whether there is sufficient evidentiary basis for trial.

This examination is expected to last several months.

The Commissioner added that the findings of the investigation paint a harsh picture of the manner in which the Company purchased exchanges from Koor, and of the manner in which the NEP market was operated until recently.

In the area of public switching, the Authority's investigation raises suspicions of collaboration between Telrad and Tadiran against the Company. Among other matters, there is *prima facie* suspicion that Telrad and Tadiran coordinated various aspects of the competition between them in relation to the Company, in some cases with the knowledge of the Company and in other cases without its knowledge. The Authority also investigated suspicion of coordination between Telrad and Tadiran relating to telecommunications tenders in 1998 and relating to framework agreements with the Company in 1994 and 1996.

The second area of suspicion which was investigated in connection with the large exchanges, concerns suspicion of binding agreements between the Company and Koor, Telrad and Tadiran, which includes a commitment by the Company not to purchase exchanges from a third vendor; division of purchases between Telrad and Tadiran according to a predetermined calculation, i.e. the ostensible pre-arrangement of the competition between the companies in relation to the Company and an undertaking by the Company not to purchase equipment through tenders from the two companies. It is suspected that these undertakings, or some of them, in the relevant circumstances, constitute violation of the provisions of the Anti-Trust Law. From the findings of the investigation, it appears, ostensibly, that in fact the Company purchased exchanges from one vendor (Koor Industries) — at prices which were seemingly much higher than those the Company would have paid had it not bound itself and had the entire market not been blocked by the aforementioned arrangement in relation to other equipment vendors.

The investigation of the Authority also revealed, ostensibly, that in some of these contracts the Company acted in clear contravention of legal advice it received. In the opinion of the Authority investigators, this element of willful blindness constitutes not only proof that the relevant parties knew they were involved in an offense, but also defines aggravated circumstances for this offense.

The findings of the Authority's investigation in this area appear to indicate a series of binding agreements and attempted offenses in the field of NEP, between Bezeq Call Communications, Telrad and Tadiran. Among other things, suspicions are raised of cartels or attempts at such arrangements — in providing maintenance service for private exchanges, in the prices of buying the service, in customer transfer arrangements and in price discrimination arrangements; in the field of providing maintenance services for private exchanges and NEP infrastructures that determine the type, composition and price of the service which will be offered to customers for the exchanges in their possession; in ongoing coordination between those entities or some of them; in tenders which were held by final customers for the purchase of NEP exchanges. It is suspected that these companies or some of them, in various instances, coordinated the prices of the proposals they would submit in the tenders of final customers. In addition, *prima facie* evidence was found of arrangement for dividing the market between the companies, as well as agreements concerning non-marketing of the product of an additional third vendor in the field of NEP exchanges.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

In November 2000 a shareholder approached the Company with a demand that the Company take legal action against the suppliers, stating that in his opinion the Company had suffered a loss of approximately NIS 400 million due to the binding agreement. In his demand, the shareholder reserves the right to file a derivative action pursuant to Section 194 of the Companies Law. The Company replied that it is monitoring developments in the matter and has requested the investigative material from the Anti-Trust Authority, and that it would formulate its stance in accordance with the decision of the Authority and its findings, if any. In November 2001 a similar approach was made by another shareholder, to which the Company replied that it was still awaiting the decision of the Anti-Trust Authority.

On March 3, 2002 the Company was summonsed to a hearing by the Anti-Trust Authority. The summons (which relates to the investigation of the public switching issue only, and not to the case of the NEP exchange market, which is still being examined by the Authority's legal department) states that the Authority is considering committing the Company for trial for offenses against the Anti-Trust law, 5748-1988 ("the Anti-Trust Law"), and has not yet decided whether or not to file an indictment in this matter. It was decided to allow the Company to voice its allegations in the hearing proceeding, and to read the relevant investigation material in respect of which no immunity would be granted. According to the summons, the findings of the investigation raise suspicions that the Company was a party to the cartel arrangements concerning the purchase of equipment and receipt of various services in the field of public switching and the dividing up of the market and the non-entry of a new competitor in the framework agreements for the years 1994-1997 and the years 1997-2000.

The Anti-Trust Law forbids contracting as a party to a binding agreement which was not duly approved or which was not granted exemption or a temporary permit. The perpetration of such an act is a criminal offense and a tort and is a possible basis for proceedings against a party to the arrangement and for a class action.

The Company, relying on its legal advisers, is unable at this stage to estimate the significance of the decision of the Anti-Trust Authority or what the final decisions of the Authority will be after the Company's hearing and their implications for the Company, including the ability of its shareholders or its customers or any other third party to sue it, or its own ability to sue others.

- (7) In March 1999 a claim was filed against the Company by a group of employees who were employed as temporary workers at the Ministry of Communications and who were transferred to the Company when it commenced operations. The plaintiffs are requesting that the Labor Court determine that they are entitled to all the benefits which were granted to permanent transferred employees, graduates of Bezeq College and Ministry of Communications pensioners. The Company filed an application for dismissal of the claim *in limine* due to its prescription. In the hearing of the Company's application to dismiss, the parties reached agreement regarding partial dismissal and a narrowing of the claim in respect of some of its components, following which, exposure decreased in respect of the claim. During 2002, the plaintiffs withdrew their consent to narrow the claim, and the Labor Court may now rule whether it will approve the withdrawal of consent.

The questions raised in this claim are liable to have a broad effect on the Company. However, in view of the above agreements, exposure has been significantly reduced as long as the court does not approve the plaintiffs' withdrawal of consent. The Company, relying on its legal advisers, is unable, at this stage, to estimate the chances of the action, and accordingly, no provision was made in the financial statements in respect of this claim.

- (8) On February 15, 2000 a claim was filed against the Company in the Jerusalem District Court in the amount of NIS 22 million. The plaintiff alleges in its claim that the Company violated its undertakings and representations to it to purchase large quantities of equipment from it. The plaintiff further alleges that the procedure adopted for

Notes to the Financial Statements as at December 31, 2002 (cont'd)

selecting the equipment which would be purchased by the Company was unlawfully managed, with infringement of the tenders laws and the rules of good administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. At this stage of the proceedings, the Company is unable, relying on the legal adviser who is handling the claim on its behalf, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

- (9) On February 23, 2000, two former employees of the Company filed a financial claim in the Jerusalem District Court against the State of Israel and against the Company. An application was attached to the claim, requesting approval as a class action in the names of additional employees and pensioners of the Company. The amount of the personal claim of the two representative plaintiffs is approximately NIS 6,500. The amount of the claim of all the plaintiffs for whom representation is requested, is not stated in the claim. The groups for whom approval of representation is applied for in the action comprise a total of 8,272 employees.

In their statement of claim, the plaintiffs allege, *inter alia*, that the defendants violated various undertakings toward them which were included in the prospectus of the Company published in 1991, including undertakings to allot Company shares, to pay dividends and to make preferential loans available to the plaintiffs. The plaintiffs allege that the allotment of shares to employees in accordance with the Company's prospectus which was published in 1998 constitutes only partial and inadequate fulfillment of those undertakings. (For example, they allege that the number of shares allotted was insufficient, that inadequate sums were paid in dividends, that no preferential loans were granted, etc.) The plaintiffs further allege that the 1998 prospectus contained misleading details and representations, and material documents which ought to have been attached were not attached.

On May 8, 2001 the District Court dismissed the claim, in part for prescription and in part due to absence of cause. The plaintiffs appealed this decision in the Supreme Court. On December 16, 2002 the Supreme Court dismissed the plaintiffs' appeal.

- (10) In October 1999, a class action was filed against Pelephone Communications Ltd. ("Pelephone") in the District Court, under the Consumer Protection Law, 5741-1981 and the Anti-Trust Law, 5748-1988. The statement of claim is based on the applicants' allegation that throughout the years when Pelephone was a monopoly in the cellular telephone market, it abused its status and collected exorbitant prices for all its services. The applicants were therefore seeking to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly amount to the amount of the claim (NIS 12.3 billion). On November 14, 2002 an application was filed to appeal the decision of the Tel Aviv District Court dated October 1, 2002, dismissing the applicants' request to approve their claim against Pelephone as a class action. On February 2, 2003 Pelephone responded to the application for leave to appeal. At this stage, Pelephone and its legal advisers are unable to estimate the chances of the appeal.
- (11) In July 2000 an action and application for its approval as a class action were filed against the Company. According to the plaintiffs, the Company collected money unlawfully from its subscribers for certain services which it provides. The claim is for approximately NIS 974 million. Following the court's decision to dismiss the application for approval as a class action, the plaintiffs filed an application for leave to appeal in the Supreme Court. On October 22, 2002 the Supreme Court decided to convert the application for leave to appeal into an appeal, since the plaintiffs were entitled to appeal the decision from the outset. In the opinion of the legal advisers of the Company, the Company has meritorious arguments against the application and against the claim. Nevertheless, they are unable to estimate the chances of the application for approval being allowed, and accordingly, no provisions were included in the financial statements in respect of this claim.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (12) In August 2000, an action and application for its approval as a class action were filed against the Company. The amount of the class action is approximately NIS 65 million including VAT. According to the plaintiff, the Company collected from its subscribers, unlawfully, payment differentials for the fixed monthly fee for using the telephone line. The requested reliefs are two — declaratory, whereby the Court is requested to declare that the Company collected the payment differentials unlawfully, and “operative — financial”, for reimbursement of said amounts. The Company rejects the plaintiff’s allegations and alleges that its method of charging meets the criteria of the law, reasonableness and justice. On November 20, 2001 the Company filed an application for dismissal *in limine* of the application for approval, since there is no legal authority for filing the class action. On December 17, 2001 it was determined that the hearing of the case would be delayed for the time being, until the decision of the Supreme Court (in another case, to which the Company is not a party) on the question of whether the regulation which was relied upon in filing the claim, constitutes a source of legal authority for filing class actions. In the Company’s opinion, relying on its legal advisers, the chances of the claim’s success cannot be estimated at this stage. Accordingly, no provision was made in the financial statements in respect of this claim.
- (13) In September 2000, a declaratory claim was filed against the Company in the Jerusalem Labor Court, by 2,423 pensioners of the Company, former employees who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are requesting from the Labor Court declaratory relief which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are normal pay for work which should be seen as part of their regular wage for calculating their pension and for the payments made to them upon retirement. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for the pension should be calculated according to the last salary which was paid to each of them for the last month of work, and not according to the average rank which each of them held. The Company filed a preliminary application for dismissal of the claim *in limine*, a response to that application was filed, and no defense has yet been filed. In the opinion of the Company, relying on the opinion of its legal adviser, the chances of the claim cannot be estimated at this stage. Accordingly, no provision has been made in the financial statements in respect of this claim.
- (14) In September 2000, a class action and an application for approval as a class action were filed against the Company, in the amount which is estimated at approximately NIS 111 million. According to the plaintiff, the Company unlawfully collected “collection expenses” from its subscribers for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiff. The reliefs requested by the plaintiff are mainly two — declaratory, in which the Court is requested to declare that the collection of “collection expenses” by the Company in the instances described in the claim was unlawful, and that the Company may not continue to collect such expenses in the future, and “operative — financial”, for reimbursement of said amounts. In January 2001 the Company filed its response to the application for approval of the class action, in which it alleges that the claim does not meet the criteria of the law and states that it rejects the plaintiff’s interpretation of the collection regulations, claiming to have acted lawfully. The plaintiff filed his reply to the Company’s response. On May 30, 2001 the Court approved an agreement reached between the parties regarding the continuation of the hearing. On February 20, 2003 the Court approved the action as a class action. The Company intends to file an application for leave to appeal that decision. In the opinion of the Company, relying on the legal adviser who is handling the case on its behalf, an application for leave to appeal and the appeal itself have a reasonable chance of success.

On October 18, 2001 another class action was filed on the same matter, in respect of unlawful charging of collection fees on Company bills which were not promptly paid, before it had started any collection actions. The plaintiff alleges that this action consti-

Notes to the Financial Statements as at December 31, 2002 (cont'd)

tutes exploitation of the distress of the consumer, in contravention of the Consumer Protection Law, as well as unjust enrichment. The plaintiff estimates amount of this class action at approximately NIS 21 million. On December 16, 2001 the Court approved a continuance until after a decision on the application for approval of the claim described at the beginning of this sub-section as a class action, due to the similarity in the causes of action in the two cases.

In view of the assessment given above, no provision was included in the financial statements in respect of these claims.

- (15) In September 2000 a class action and application for approval as a class action was filed against the Company in an amount estimated at more than NIS 810 million. According to the plaintiffs, the Company unlawfully collected from its subscribers a fixed payment for the lease of telephones which the Company made available to them, so they allege, since the telephones were supplied to subscribers without a specific lease agreement being made, without disclosure and proper publication of the fact that the telephones were given in a "lease" agreement unlimited in time, and also concerns the amount of the "lease fee" demanded and the continued collection of the "lease fee" even after the date on which the Company's subscribers had paid the "lease fees" in an amount equal to the full revalued amount of the telephones supplied. The plaintiffs further allege that the Company collected "lease fees" unlawfully in that it did not give its subscribers the choice of whether to "lease" or purchase the telephones and in that it did not inform them of the option to cease payment of the fixed lease fee in exchange for a lump-sum payment which of itself, according to the plaintiffs, is unlawful. The relief requested by the plaintiffs is mainly financial, for reimbursement of the aforesaid amounts.

In addition, on November 21, 2000 the Company received a class action with an application for approval as a class action. The amount of this claim is estimated at approximately NIS 259 million. It is noted that the action makes allegations which are similar or identical to those in the above action from September 2000.

The plaintiffs filed an application for consolidation of the hearings in the two claims, which was approved on April 25, 2001. On June 10, 2001 the plaintiffs filed an amended statement of claim and amended application for approval as a class action. Additional allegations were made in the amended statement of claim, *inter alia*, concerning unlawful charging of "maintenance fees". The amount of the two claims together is now estimated at more than one billion shekels. The Company filed an application for dismissal *in limine* of the amended application for approval as a class action. No decision has yet been made.

The Company, relying on its legal advisers, is unable, at this stage, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

- (16) On May 10, 2001 a claim was served to an affiliate in which the plaintiff alleges that the affiliate is misleading consumers in its advertisements in connection with the possibility for the consumer to purchase certain channels only, and with regard to the number of channels offered. It is also alleged that the affiliate required its subscribers to consume a maximum channel package even if they did not choose that package. The plaintiff filed the claim as the representative of the subscribers of the affiliate, and together with the claim also filed an application for recognition of the claim as a class action under the Consumer Protection Law. The personal losses of the plaintiff, as alleged by the plaintiff, are negligible, and the sum stated as accumulated loss for all members of the class is approximately NIS 177 million.

On March 18, 2002 the parties signed a settlement agreement whereby an application will be filed in court to dismiss the claim and the application for its approval as a class action. In exchange, the affiliate will compensate the plaintiff in an amount which is not material.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (17) In September 2000 a class action and application for approval as a class action were filed in the Tel Aviv District Court against the Company, Bezeq International Ltd. and the other international communications operators. The total amount of the claim, according to the action, cannot be calculated accurately, and is estimated by the plaintiffs at "millions of shekels per year".

According to the plaintiffs, commencing October 20, 1998, the Company unlawfully collected 17% VAT for some of the collect calls originating outside Israel and received by its subscribers in Israel, in contravention of the VAT law and its regulations and in violation of a legislated duty, in a way that breaches existing agreements, while acting in bad faith in the fulfillment of such contracts and with negligent conduct. The plaintiffs make further allege against the international operators concerning the collection of VAT in respect of calls made from abroad to Israel using phone cards. The plaintiffs estimate the total loss incurred by the group due to the unlawful collection of VAT for all the calls made from abroad to Israel in the relevant period (since October 20, 1998) at millions of shekels per year.

The reliefs requested by the plaintiffs are mainly two — declaratory, in which each of the defendants violated its obligations under the contractual agreement between it and the member of the group with which it contracted, and financial, for restitution of said amounts, compensation for the damage caused to the members of the group in the aforesaid amounts. On June 21, 2001 the Attorney General gave notice that he would appear in this proceeding. On January 6, 2002 the Court decided to conjoin the Director General of the VAT authority as an additional defendant in the action and the application for its approval as a class action, and denied the application of Bezeq International for dismissal *in limine*. At the hearing on February 28, 2002, the plaintiffs' legal representative clarified that the plaintiffs are not demanding independent relief from the communications companies, but rather, reimbursement of the VAT which the Director General of the VAT authority will pay them if the claim is successful. The plaintiffs' attorney also proposed that the communications companies be considered formal defendants. A date was set for filing summations on the matter of approval of the claim as a class action, while excusing the communications companies from filing them. The legal advisers of the Company and of the consolidated company are unable, at this stage, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

- (18) In December 2000 a claim was filed by the State of Israel in the District Court against Pelephone Communications Ltd. ("Pelephone"), for royalties allegedly payable for the period from January 1994 to February 1996. The amount claimed is approximately NIS 260 million, consisting of principal, linkage differentials and interest.

In the opinion of the management of Pelephone, based on the opinions of its outside legal advisers, Pelephone has a genuine defense against the claim, the amount of which is also deemed to be highly exaggerated.

On March 11, 2001 Pelephone filed a defense and a counter-claim relating to the State's claim for payment of royalties for the period from January 1, 1994 until February 7, 1996. In the counter-claim, Pelephone claims reimbursement of NIS 66 million (including interest and linkage differentials) in respect of an advance payment it made to the State as a goodwill gesture for reaching a settlement in 1996, a payment which was contingent upon the State not suing Pelephone for royalties. Before the case was heard in court, the parties agreed to transfer the matter for clarification through mediation.

It should be noted that the claim includes sums in respect of the period January — October 1994, for which the Company also received a demand to pay royalties, even though in the Company's opinion the royalties for that period were already paid by the Company as part of a compromise arrangement with the State in November 1995.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (19) In February 2001 a class action and application for its approval as a class action were filed against the Company, as well as an application for an interlocutory injunction. The amount of the claim is not stated, but according to the action, the accumulated loss for the entire group in whose name the plaintiff has filed suit, is estimated at "millions of shekels".

According to the plaintiff, the "Light Net" track, which is one of the tracks in the alternative basket of payments introduced on May 1, 2000, is actually a "default" from the aspect of the customer, since it is an offer which contains nothing but acquisition of the customer.

The plaintiff alleges that since from May 1, 2000, when the new tariffs took effect, until the end of June, the Company charged the calls to the network of subscribers who did not select one of the tracks, at the Light Net tariff as if it were the "regular" tariff for connecting to the network, then from July 1, 2000 also the Company should have continued to apply the Light Net tariff to all subscribers who did not choose another track. The plaintiff alleges that the charge in the months May — June 2000 constitutes deception, as does the representation of the Company, on the basis of which the subscriber's situation changed for the worse, and therefore, according to the plaintiff, the Company is precluded from renouncing that representation. In so doing, according to the plaintiff, the Company violated the provisions of Section 2(a) of the Consumer Protection Law, 5741-1981. On October 24, 2001 the District Court denied the plaintiff's application for recognition of the claim as a class action pursuant to the Consumer Protection Law. The plaintiff appealed the decision in the Supreme Court. On December 17, 2002 the Supreme Court heard the appeal and the appellant agreed to withdraw it.

- (20) In March 2001 a petition was filed in the Supreme Court against the Minister of Communications, the Company and three cellular operators, in which the petitioner requests, *inter alia*, that the court direct the Minister of Communications and the Company to provide a blocking service for every Company subscriber against outgoing calls to cellular phone area codes, as a positive default. The court forwarded the petition to the defendants for their response. The Company gave notice that it does not oppose providing such a service, but emphasized that it would require the approval of the Ministry of Communications. Pelephone Communications Ltd. objected to the provision of the blocking service. The Company filed an application to expedite the hearing of the petition. On November 6, 2002, following the recommendation of the Supreme Court, the petitioners withdrew their petition and it was stricken.
- (21) In September 2001, an application was filed for approval of a class action against the Company. The plaintiffs allege that in view of the amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Bezeq subscriber who calls a Pelephone subscriber was lower than the amount actually collected. The applicants estimate the amount of the claim at approximately NIS 45 million. The Company filed a response to the application for approval. On May 12, 2002 the Company's request to conjoin Pelephone as a party to the proceeding was allowed. Based on the opinion of the legal adviser who is handling the case on its behalf, the Company is unable, at this early stage of the proceeding, to estimate the chances of the plaintiff in the above proceedings. Accordingly, no provision was made in the financial statements in respect of this claim.
- (22) In July 2001 a claim was filed in the District Court against Pelephone Communications Ltd. ("Pelephone"). The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of their patent. Among the reliefs claimed are that Pelephone be directed to refrain from infringing the patent, ordered to submit a report on the number of cards, the revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in damages. The claim is pending in the District Court and is in proceedings before the Registrar of Patents. At this stage, Pelephone is unable to estimate the chances and the implications of the claim.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (23) In August 2001 an application for approval of a class action was filed against Pelephone in the Tel Aviv District Court. The applicant, through his attorney, alleges that Pelephone collected from its customers surplus amounts in respect of interconnect fees, in contravention of the regulations applicable thereto and/or of its license. The amount of the claim, if recognized as class action, would have exceeded NIS 32.6 million. The parties arrived at a settlement agreement that took effect on May 2, 2002, in which the District Court gave partial approval for the claim as a class action and simultaneously validated the settlement agreement as a decision. The amount of the settlement derived from that agreement is approximately NIS 6.6 million. The financial statements include a provision that the management of Pelephone deems appropriate.
- (24) In September 2001 a claim was filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd., against Pelephone Communications Ltd. ("Pelephone") and another company. The plaintiff alleges that its license grants it, inter alia, the right to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and mobile, for the supply of fixed and cellular communications services for an extended period, during part of which it was granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its approaches to the defendants, they are continuing to provide cellular communications services to the inhabitants of the West Bank and the Gaza Strip, without restraint and without a license from the Palestinian communications authority, thereby violating various provisions of the law and prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority, and a financial action for NIS 676 million from Pelephone alone.

As at the date of signing these financial statements, service of process of this claim was halted by the Attorney general, and alternative service by registered mail was returned by the Ministry of Justice, and therefore the case is not included in the pending claims against Pelephone.

- (25) In October 2001 the Company received a letter of demand in the name of the Moshav Porath Committee in the Sharon region, which contains allegations in connection with direct and indirect damages which were and are being sustained, according to the moshav members, as a result of the erection of the Hillel station near the moshav, and the station's broadcasts. The Company replied to the letter, refuting the allegations and the demand. In the Company's opinion, relying on its legal advisers, the chances of the Company's defense cannot be estimated if a claim is actually filed against it in this matter. Accordingly, no provision was made in respect of this matter in the financial statements.
- (26) A number of private claims of current and former employees are pending against the Company, mainly concerning the recognition of various wage components as pension components, which could have a wide-ranging effect. It is noted that a precedent ruled in another case (to which the Company is not a party) changed the Company's position for the worse as regards a particular wage component. However, the Company's management believes, relying on the opinion of the legal advisers who are handling the claims on its behalf, that the amount of money involved cannot be estimated, nor the chances of the claims and the implications for the Company. Accordingly, no provision was made in respect of these claims in the financial statements.
- (27) In 1995 the Company, together with others through a joint company, submitted bids in tenders of the Government of India for the development of a basic communications system in India. Letters of intent and draft franchise agreements for development of the basic telephone system in the four regions for which the joint company won the tender, were submitted to the joint company. However, the joint company did not sign

Notes to the Financial Statements as at December 31, 2002 (cont'd)

the letters and drafts because, *inter alia*, in its opinion the drafts do not correspond to the terms of the tender. At the time of the tender, the joint company gave the Indian Ministry of Communications bank guarantees, in which the Company's part was 273 million rupees (approximately NIS 27 million). The Indian Ministry of Communications demanded foreclosure on the guarantees at the end of June 1996. On September 19, 1997 the court gave a permanent injunction, preventing the Indian Ministry of Communications from foreclosing on the guarantees. At the end of October 1997 the Indian Ministry of Communications appealed that decision. The Company's management and legal advisers are unable to estimate the chances of the appeal in those proceedings. Accordingly, no provision was made in the financial statements in respect of this matter.

- (28) In January 2002 the Company received a claim for payment of financial compensation of approximately NIS 56 million and for writs of mandamus, which was filed in the Tel Aviv District Court by an international communications operator against the Company and a subsidiary, Bezeq International Ltd. The claim makes allegations concerning the customer allocation process to the international communications operators. According to the plaintiff, it is entitled to compensation from the Company and from Bezeq International in respect of postponement of implementation of the customer allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the main file and removing them from the customer allocation process, and in respect of losses it suffered due to the method of the voice announcement of the possibility of dialing from card-operated public telephones. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company under an interconnect agreement which was allegedly forced upon it unlawfully. The plaintiff also requests that the court give orders directing investigations and accounts be made in relation to certain actions in the allocation process and for changing the order of the voice announcement in public telephones so as to ensure, in its opinion, equality among the international operators. The Company, Bezeq International and their legal advisers are unable, at this stage, to estimate the chances and the implications of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.
- (29) In October 2000, Bezeq International Ltd., a consolidated company, received a report from the Ministry of Communications expressing doubt as to the credibility of one of the main files which was forwarded to the Ministry of Communications in the customer allocation process. Bezeq International submitted its objections to the report to the Ministry of Communications. Following the report, one of the competing operators approached the Ministry of Communications, demanding that it direct that the dial code "00" be blocked to all telephone lines which were in the aforementioned file. On April 23, 2001, an agreement was signed between Bezeq International and the competing international operators, with the approval of the Ministry of Communications, whereby the allocation process will be redone for the group of customers called "new customers" in the main file, and Bezeq International would pay financial compensation in respect of the period which had elapsed from the date of allocation of the main file to the date of the renewed allocation for that group, where the compensation formula is two thirds of the contribution generated to Bezeq International in respect of the traffic of those customers in that period. On May 21, 2001 the competing operators sent a letter to the Ministry of Communications giving notice of cancellation of the agreement. On June 7, 2001 the Ministry of Communications gave notice of transfer of the file to the operators for performance of the agreement. Despite this, the competing operators reneged on the matters which had been agreed and accordingly, Bezeq International notified them, on July 15, 2001, that if within seven days they do not give their explicit consent to performance of the agreement, Bezeq International will deem the agreement to have been breached. On July 16 and 18, 2001, the competing operators notified the Ministry of Communications that they do not intend to rescind their decision, and subsequently Bezeq International gave notice, on July 29, 2001, that it considers the agreement to have been breached.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

On October 28, 2001 the Minister of Communications notified the Company and the international operators that a supplementary referendum would be held for all the subscribers included in the "main file", except for those allocated to an international operator in an allocation form, and he requested their response to this proceeding by November 6, 2001. On that date, Bezeq International submitted to the Ministry of Communications its objections to the supplementary referendum proceeding. Following the objections of the Company, Bezeq International and the competing operators, the Ministry of Communications proposed another format for the, supplementary referendum on December 11, 2001, and after receiving yet more objections from the Company Bezeq International and the competing international operators, on February 14, 2002 the Ministry proposed a final text and details for carrying out the supplementary referendum, which would start on February 21, 2002 and end during July 2002. On March 12, 2002 Bezeq International petitioned the Supreme Court, sitting as the High Court of Justice, to direct the Ministry of Communications to refrain from passing its customer file to the competing international operators before the removal of the particulars of those customers who had requested allocation to Bezeq International on the form, and that a supplementary referendum be carried out also for the customers of the competing operators who have no allocation form. Bezeq International also requested an interlocutory injunction concerning transfer of the customer file to the competing companies. On March 14, 2002 the Supreme Court decided to grant an interlocutory injunction for non-transfer of the customer file to the competing companies. In the hearing on June 26, 2002, Bezeq International withdrew the petition as recommended by the court. The customer allocation process and the supplementary referendum commenced on July 1, 2002, and after postponements, ended in February 2003. The management of Bezeq International is unable, at this stage, to assess the results of the above process and its implications for its financial condition and the results of its operations.

- (30) In January 2002 the Company received a letter of demand from a supplier, in which it was alleged that an order issued by the Company to the supplier for a total sum of approximately NIS 32 million, is valid. According to the Company, the order was contingent upon suspending conditions which were not fulfilled, and therefore the order is not valid. In the opinion of the Company, relying on the legal adviser who is handling the demand on its behalf, the chances of the Company's defense cannot be estimated if a claim is filed against it in this matter. Accordingly, no provisions were made in the financial statements in respect of this matter.
- (31) In February 2002 a claim and application for recognition as a class action were filed against the Company in the District Court, concerning reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard. The amount of the class action is estimated by the plaintiff at approximately NIS 15 million as at the date of filing the claim. A pre-trial hearing was scheduled for May 13, 2002. No response and/or defense has yet been filed. In the opinion of the Company, relying on the legal adviser who is handling the claim on its behalf, the chances of the claim cannot be estimated at this stage. Accordingly, no provisions were made in the financial statements in respect of this claim.
- (32) On February 24, 2002 the Company received a "Notice of a party to a collective dispute" ("the Notice"), which was filed in the Regional Labor Court in Jerusalem on February 21, 2002 by the New General Federation of Workers ("the Applicant") in the name of Company employees. The Applicant alleges that payments for grossing up of tax, the on call duty benefits component and clothing allowances which were and are paid to Company employees, are normal wages constituting part of the employee's regular pay, and that various payments and provisions should be made in respect thereof, including for pension purposes. The Notice states that the requested reliefs are for all Company employees, including those whom were transferred from govern-

Notes to the Financial Statements as at December 31, 2002 (cont'd)

ment service to the Company who are currently Company employees and also for former employees.

On October 20, 2002 the Attorney General gave notice that he would be joining the claim, and he later submitted his position, stating that the application and all its parts should be dismissed. A judgment given by the National Labor Court in another case (to which the Company is not a party), could change the Company's position on this matter for the worse. To the best of the Company's knowledge, an appeal will be filed in a higher court against the court which gave that decision. In the opinion of the Company, relying on its legal advisers, the claim is material, regarding at least part of which there are considerable risks. However, it is not possible, at this stage, to assess the risks in the claim, and therefore, no additional provision was made in the financial statements beyond that made on the basis of the assessments of the management prior to the date of the aforementioned judgment.

- (33) On January 3, 2002 the Company received a class action together with an application for its recognition as a class action, which were filed in the Tel Aviv District Court against the Company and against two cellular companies.

The amount of the class action against the two cellular companies is estimated at approximately NIS 94 million. No mention was made in the claim of the amount claimed (if any) from the Company, although the plaintiff alleges that the Company must repay customers the costs of disconnected calls which were collected through it to the coffers of the defendants. The plaintiff, who claims to be a subscriber of the Company and of the two cellular companies, alleges that the defendants collect payments in respect of calls in the cellular network which were disconnected due to a malfunction in the cellular network rather than on the initiative of the caller or the call recipient. The plaintiff alleges that such collection for a product which was not supplied is unlawful, constitutes a violation of the provisions of the Consumer Protection Law and the Contracts Law, and even constitutes unjust enrichment. On December 31, 2002 the Company was stricken from the action.

- (34) On May 21, 2002 a statement of claim together with an application for its recognition as a class action were received at the Company's offices. The claim and application were filed in the Tel Aviv District Court against all the cellular companies in Israel, among them Pelephone (a proportionally consolidated company) and against the Company as a formal defendant. The plaintiffs, who contend that they are subscribers of the Company and of one of the defendant cellular companies, allege in their claim that the defendant cellular companies collected and collect, unlawfully, payments for what are ostensibly cellular calls but which in fact are fixed-line calls in every respect. The reference is to calls initiated by Company subscribers to commercial entities that provide entertainment and information services and which contracted with the cellular companies. Even though these calls do not "consume airtime", the cellular companies collected payment for them, in contravention of their licenses and of the law.

The amount of the class action against the cellular companies is estimated at approximately NIS 613 million. The Company has filed its response to the application for recognition of the claim as a class action. It is noted that the Company approached the Ministry of Communications on this matter, requesting its intervention. The Company, relying on its legal advisers, is unable at this stage to estimate the chances and implications of the claim, and accordingly, no provision was made in the financial statements in respect of this claim.

- (35) On July 28, 2002, a claim and an application for recognition as a class action, filed in the Tel Aviv District Court against the Company, was received at the Company offices. The plaintiffs, who contend that they are Company subscribers or use its services, allege that the Company unlawfully collects interest in arrears, as defined in a directive from the Accountant General concerning interest rates in respect of arrears in payment for services provided by other communications service providers, which are included in the invoice which the Company issues to its subscribers. The plaintiffs

Notes to the Financial Statements as at December 31, 2002 (cont'd)

allege that the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself. They further allege that the Company does not transfer the full amount of interest in arrears it collects to the other communications providers. The plaintiffs are requesting restitution of the interest in arrears that the Company is alleged to have collected unlawfully. If approved as a class action, the total amount of the claim is estimated by the plaintiffs to be in the tens of millions of shekels. The Company, based on consultations with its legal advisers, is unable, at this stage, to estimate the chances of the action, and therefore no provision was included in the financial statements in respect thereof.

- (36) In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"). The plaintiff alleges that Pelephone collected excess payment from users who make calls at peak hours from cellular telephones to Bezeq subscribers, and that it does so unlawfully and in contravention of the Telecommunications Regulations (Payments for interconnect), 5760-2000. This collection allegedly commenced at the beginning of 2001 and is coordinated with the other cellular companies. According to the plaintiff, even though the collection is ostensibly for Bezeq, Pelephone does not transfer the full payment to Bezeq and retains part of it for itself. Pelephone has not yet filed its response to the petition, but its management estimates, based on the opinion of its legal advisers and on an outside legal opinion, that the claim has little chance of succeeding, as *res judicata* exists on this matter as a result of a settlement agreement which was validated as a judgment, in which the claim was approved as a class action and restitution was made to the plaintiff and to Pelephone customers in respect of excess payment, *inter alia* for the same charges in respect of which the present claim was filed. Pelephone's lawyers contacted the plaintiff and referred him to that *res judicata*. The plaintiff admitted that he had been unaware of the settlement agreement, but has not yet given notice of what he intends to do with regard to the claim he filed.
- (37) In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"), in a total amount of NIS 20 million. The applicant, through his lawyers, alleges that Pelephone compels its customers to subscribe to the "GoNext" service and connects them without their prior consent and without giving them a clear explanation of the nature of the service. Pelephone has filed an application to strike the application *in limine* due to the absence of the legally-required affidavit. In the hearing held on February 23, 2003, the claim and the application were stricken with no order for costs.
- (38) On November 11, 2002 a petition was filed in the High Court of Justice by Ganei Tikva Local Council, against the Minister of Communications, the Company and Golden Channels Co. The petition is for the relocation of the cable network in the Council's jurisdiction, which the Company maintains for Golden Channels, to an underground infrastructure (instead of above-ground). The petitioners are requesting that the High Court of Justice direct the Minister of Communications to instruct the Company and Golden Channels to relocate the network immediately and at their own expense, since the network, in its condition today, constitutes a safety hazard. The Company and the cable companies are embroiled in a long-standing dispute on the question of who should bear the costs of relocating the infrastructure, which derives from conflicting interpretations of the contract between the parties. In the Company's opinion, based on consultations with its legal advisers, the chances and the implications of the petition cannot be estimated at this stage. Accordingly, no provision was made in the financial statements in respect of this action.
- (39) On December 22, 2002 a claim and application for recognition as a class action were filed in the Tel Aviv District Court against the Company. The plaintiffs, who contend that they are subscribers of cellular communications providers, allege that the Company is misleading the public, regarding calls to 1-800 or 177 numbers, into thinking that such numbers are free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies. In so doing,

Notes to the Financial Statements as at December 31, 2002 (cont'd)

the Company is perpetrating a tort according to the Consumer Protection Law, and all the members of the group represented in the action have consequently sustained losses. The estimated amount of the claim is approximately NIS 700 million, which includes compensation for financial loss, non-financial damages and punitive damages. The court is also requested to give interlocutory and permanent injunctions against the Company, to cease misleading consumers and to refrain in the future from advertising or making any other representation liable to mislead consumers regarding the price of such calls. The Company is studying the claim and consulting with its legal advisers. At this stage, the Company is unable to estimate the chances and the implications of the claim, and therefore no provisions were made in the financial statements in respect thereof.

- (40) In December 2002 a claim was filed in the District Court against Pelephone and against another cellular company, together with an application for recognition as a class action in the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion against Pelephone.

The applicants, through their legal representatives, base their claim on the following allegations:

- a. Every cellular operator is a monopoly in the incoming call service to its network. Pelephone and the additional cellular company abused their monopoly status in that they set high and unfair prices for the incoming call service to their networks. The correct and fair tariff for this service is 25 agorot per minute, and not as collected in the past by Pelephone and the other company nor as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.
- b. Pelephone and the other company violated legislated obligations under the Telecommunications Law, their licenses and the duty of faith to demand a reasonable price for a telecommunications service for which no price was set.

Pelephone and its legal advisers are studying the claim, and are unable, at this stage, to estimate its chances.

- (41) On December 3, 2002 an application was filed for recognition of a claim as a class action against an affiliate, the Council for Cable and Satellite Broadcasts and the Ministry of Communications, in connection with the broadcasts of the Channel 5+ sports channel. According to the applicants, the broadcasts of Channel 5+ contravene the terms laid down with the approval of the Council for its broadcasting, while emptying Channel 5 of its content in contravention of the aforementioned approval. The applicants, who wish to sue the affiliate for deception, violation of fiduciary duty and good faith in a contracted agreement, fundamental breach of the contract between the affiliate and its customers and unjust enrichment, estimate the amount of the claim at approximately NIS 126 million up to the date of its filing, plus NIS 10.5 million for each month from the date of filing the claim to the date on which the decision will be given. The affiliate has filed a response to the application, requesting that it be stricken *in limine*, or alternatively — its dismissal on its merits or strengths. In the opinion of the legal advisers of the affiliate, it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be, and therefore no provisions were made in the financial statements in respect thereof.
- (42) On March 3, 2003 a consolidated company received a claim filed against it for approximately NIS 18.5 million. The plaintiff alleges that the consolidated company unlawfully canceled an agreement to supply and install a customer care and billing system, and is suing for enforcement of the agreement on the consolidated company, and compensation for the losses deriving from the delay in the project, and alternatively — if the claim for enforcement is not allowed — compensation in respect of all the losses

Notes to the Financial Statements as at December 31, 2002 (cont'd)

it sustained as a result of breach of the contract. The management of the consolidated company and its legal advisers are unable to estimate the chances of the claim.

- (43) In the matter of the notice of the Accountant General at the Ministry of Finance on the subject of the end of the period of two-year renewable rental of assets, see Note 9C.
- (44) For the income tax and value added tax assessments, see note 11.
- (45) For possible demand for early repayment of bank loans, see Notes 13D(1) and 14C.
- (46) Miscellaneous claims — Various claims are pending against the Company in the normal course of business. It is the opinion of the Company's management that the risk inherent in each of these claims will not cause the Company significant financial losses beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without interest) in terms of shekels of December 31, 2002.

B. Forward Exchange Contracts

Consolidated

1. Hedging Transactions

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Amounts receivable</u> | <u>Amounts payable</u> |
|---|-------------------------------|-----------------------------|-------------------------------------|-------------------------------|----------------------------|
| | NIS millions | | | | |
| Contracts at predetermined interest rates | | | | | |
| | Dollar | Linked NIS | April 2004 | 889 | 916 |
| | Euro | Linked NIS | February 2005 | 1,177 | 1,030 |
| Forward exchange contracts at predetermined currency rates (excluding premium/discounts) | | | | | |
| | Dollar | NIS | December 2003 | 286 | 296 |
| | Euro | NIS | December 2003 | 323 | 296 |
| | Linked NIS | NIS | June 2003 | 27 | 26 |
| | NIS | Dollars | January 2003 | 86 | 85 |
| Call options purchased . . . | Dollar | NIS | March 2003 | 39 | 41 |

2. Non-Hedging Transactions

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Fair value</u> | <u>Scope of contract</u> |
|---|-------------------------------|-----------------------------|-------------------------------------|-------------------|------------------------------|
| | NIS millions | | | | |
| Call options purchased | Dollar | NIS | December 2003 | 1 | 24 |
| Call options written | Linked NIS | NIS | August 2003 | — | 20 |
| Forward exchange contracts at predetermined currency rates | Dollar | NIS | December 2003 | (2) | 71 |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Company

1. Hedging Transactions

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Amounts receivable</u> | <u>Amounts payable</u> |
|---|-------------------------------|-----------------------------|-------------------------------------|-------------------------------|----------------------------|
| | NIS millions | | | | |
| Contracts at predetermined interest rates | | | | | |
| | Dollar | Linked NIS | April 2004 | 889 | 916 |
| | Euro | Linked NIS | February 2005 | 1,177 | 1,030 |
| Forward exchange contracts at predetermined currency rates (excluding premium/discounts) | | | | | |
| | Dollar | NIS | December 2003 | 175 | 184 |
| | Euro | NIS | December 2003 | 323 | 296 |
| | Linked NIS | NIS | June 2003 | 27 | 26 |
| | NIS | Dollar | January 2003 | 86 | 85 |

2. Non-Hedging Transactions

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Fair value</u> | <u>Scope of contract</u> |
|---------------------------------------|-------------------------------|-----------------------------|-------------------------------------|-------------------|------------------------------|
| | NIS millions | | | | |
| Call options written | Linked NIS | NIS | August 2003 | — | 20 |

C. COMMITMENTS

(1) Lease Contract Commitments

| <u>For the year ended December 31</u> | <u>Consolidated</u> | <u>Company</u> |
|---------------------------------------|---------------------|----------------|
| | NIS thousands | NIS thousands |
| 2003 | 162,818 | 70,243 |
| 2004 | 175,473 | 60,224 |
| 2005 | 153,282 | 52,665 |
| 2006 | 136,948 | 51,965 |
| 2007 | 129,502 | 51,827 |
| 2008 and thereafter | 413,477 | 304,771 |
| | <u>1,171,500</u> | <u>591,695</u> |

An affiliated company is committed to two main operating lease contracts in respect of buildings it uses. One agreement will expire in 2003 with an option for extension for an additional three years with the other expiring in 2009 with an option for extension for an additional 10 years. The rent is linked to the U.S. dollar ("dollar"). In addition, the same company is bound by several other operating lease agreements for various periods.

The annual rent in the next five years, calculated according to the rent in effect as at December 31, 2002, amounts to approximately NIS 10 million as adjusted.

- (2) A consolidated company has commitments to provide maintenance services in the network end point field amounting to approximately NIS 63 million.
- (3) On June 27, 2002, a consolidated company and Nortel Networks Israel (Sales and Marketing) Ltd. ("Nortel") signed three agreements intended to provide the consolidated company with the ability to operate independently with respect to sales, maintenance, support and

Notes to the Financial Statements as at December 31, 2002 (cont'd)

installation services for its customers who have Nortel exchanges on their premises, as follows:

- a. An agreement whereby the consolidated company was granted, on a non-exclusive basis, resources, manpower, abilities and licenses for maintaining an independent ability to provide maintenance, support and installation services in voice enterprise products of the Meridian family. The consideration in the purchase agreement for the resources was set at approximately \$6 million, as follows —
 - \$2 million to Nortel on the closing date of the transaction (July 31,2002)
 - \$4 million spread over 16 quarterly installments.
 - b. A non-exclusive distribution agreement for three years, whereby the consolidated company will serve as a distributor of Nortel voice enterprise products. The consolidated company has made a commitment to purchase not less than \$4 million of these products per year from Nortel.
 - c. A services agreement whereby Nortel undertook to supply the consolidated company with various services over a period of four years, mainly high-level support services (software level), repair or replacement services for hardware products and training services and future know-how transfer.
- (4) In August 2002 the Company signed an agreement for hiring consultation services in various Company projects, in consideration of approximately \$2.8 million. The consultation services are provided in respect of the Company's main future technological projects.
 - (5) An affiliated company entered into an agreement as at December 31, 2002, to purchase broadcasting rights, for an inclusive amount of approximately NIS 216 million.
 - (6) An affiliated company entered into an agreement to lease space segments on the Amos 1 satellite. The agreement is for 8.5 years, commencing on April 14, 2000, with an option to extend for additional periods of six months each. In addition, the same affiliated company entered into an agreement on May 16, 2001, to lease space segments of the Amos 2 satellite, which has not yet been launched into space. The lease period will end after ten years from the date of the satellite's launch or at the end of the satellite's life, whichever is earlier. The launch is expected during 2003.
 - (7) An affiliated company is committed to several operating lease agreements for a period of four years in respect of motor vehicles in its service. The annual forecasted lease fees, calculated according to the fees in effect at December 31, 2002, amount to approximately NIS 12 million.
 - (8) A proportionally consolidated company has commitments to purchase stocks of subscriber equipment in the amount of approximately NIS 354 million and to purchase services in the amount of approximately NIS 19 million.

D. SECURITIES AND LIENS

For securities, liens and stipulations in connection with loan covenants given by the Company and investee companies, see Notes 13D and 14C.

E. GUARANTEES

- (1) The Company has provided guarantees to third parties in the amount of approximately NIS 540,000.
- (2) A proportionally consolidated company has given a guarantee to third parties amounting to approximately NIS 123 million of which approximately NIS 95 million is in connection with the tender for third generation frequencies in respect of cellular telephones.
- (3) Subsidiaries have provided guarantees to third parties for approximately NIS 11 million.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

- (4) In February 2002, in accordance with a requirement of the Ministry of Communications, a subsidiary, Bezeq International Ltd., gave a bank guarantee of \$2 million in respect of fulfillment of the terms of its license for the provision of international telecommunications services.
- (5) An affiliated company provided guarantees to third parties for approximately NIS 67 million.

Regarding guarantees to related parties, see Note 27C.

NOTE 20 — SHARE CAPITAL

- A. The share capital consists of ordinary shares of a par value of NIS 1 each. The registered capital is 2,565,000,000 shares (which will be reduced by 130,000,000 shares — see paragraph B below). The issued and paid up capital is 2,411,657,538 shares (2001 — 2,411,657,538 shares — subsequent to an issue of bonus shares). All the shares are listed on the Tel Aviv Stock Exchange.

The General Meeting which convened on November 23, 2000, passed a resolution to approve the recommendation of the Board of Directors of the Company to increase the registered capital of the Company by 1.6 billion ordinary shares and to distribute bonus shares in the amount of 1.6 billion shares, so that in respect of each share of par value of NIS 1, two bonus shares of a par value of NIS 1 each will be distributed. In January 2001 the Ministerial Committee for Privatization approved the increase of the registered capital for the purpose of allotment of the bonus shares. The increase and the allotment were implemented during February 2001.

- B. On January 13, 2002, a framework agreement was signed between the State and the Company, whereby capital would be raised by way of a private placement. The proceeds from raising the capital was designated for financing the costs involved in the retirement of Company employees.

The price at which the State will sell the shares will be not less than NIS 6 net per share. Pursuant to the resolution of the General Meeting of the Shareholders of the Company, the registered share capital which is not allotted in the capital raising by February 28, 2003, or by another date on which the State will hold 51.02% of the Company's share capital (at full dilution), whichever is the earlier, will be cancelled. Since no capital was raised by February 28, 2003, registered capital of 130,000,000 shares was cancelled.

- C. On January 27, 2003, the Special General Meeting of the Company approved the recommendation of the Board of Directors from January 2, 2003, for the distribution of a cash dividend to holders of Company shares which are recorded in the Register of Shareholders at the end of the business day on February 5, 2003. The X-date was February 6, 2003, and the date of payment was February 20, 2003. The cash dividend, amounting to approximately NIS 190,000 thousand, represents 7.8784 agorot per share and 7.8784% of the issued and paid up capital of the Company as at the date of distribution.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 21 — REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

| | For the year ended December 31 | | |
|--|--------------------------------|------------------|------------------|
| | 2002 | 2001 | 2000* |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from communications services — | | | |
| Domestic fixed-line communications | 2,306,801 | 2,556,153 | 2,727,680 |
| Fixed fees | 2,147,448 | 2,208,685 | 2,147,684 |
| Cellular telephone ⁽¹⁾ | 2,134,548 | 2,206,421 | 2,317,118 |
| International communications and internet services .. | 675,508 | 835,377 | 914,055 |
| Installation and sale of equipment to subscribers | 536,717 | 453,180 | 535,954 |
| Other | 111,378 | 126,904 | 151,616 |
| | <u>7,912,400</u> | <u>8,386,720</u> | <u>8,794,107</u> |
| Other revenues | 322,143 | 294,677 | 280,059 |
| | <u>8,234,543</u> | <u>8,681,397</u> | <u>9,074,166</u> |

Company

| | For the year ended December 31 | | |
|--|--------------------------------|------------------|------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from communications services — | | | |
| Domestic fixed-line communications | 2,329,567 | 2,585,298 | 2,750,270 |
| Fixed fees | 2,016,760 | 2,090,029 | 2,032,896 |
| International communications and internet services .. | 138,404 | 348,852 | 419,533 |
| Cellular telephone ⁽¹⁾ | 556,629 | 711,624 | 909,866 |
| Installation and sale of equipment to subscribers | 155,138 | 148,867 | 228,180 |
| Other | 117,053 | 134,217 | 155,646 |
| | <u>5,313,551</u> | <u>6,018,887</u> | <u>6,496,391</u> |
| Other revenues | 254,303 | 258,685 | 255,867 |
| | <u>5,567,854</u> | <u>6,277,572</u> | <u>6,752,258</u> |

(1) See Note 1E(1).

NOTE 22 — OPERATING AND GENERAL EXPENSES

Consolidated

| | For the year ended December 31 | | |
|--|--------------------------------|------------------|------------------|
| | 2002 | 2001 | 2000* |
| | NIS thousands | NIS thousands | NIS thousands |
| Salaries and related expenses | 2,019,868 | 2,042,429 | 1,810,226 |
| General expenses | 746,336 | 872,772* | 1,061,780* |
| Materials and spare parts | 606,743 | 541,498 | 451,537 |
| Cellular telephone expenses ⁽¹⁾ | 482,237 | 373,021* | 223,436* |
| Building maintenance | 358,444 | 406,436 | 419,741 |
| Services and maintenance by sub-contractors | 272,177 | 344,411 | 429,941 |
| International communications expenses | 155,110 | 212,875 | 271,142 |
| Vehicle maintenance expenses | 98,471 | 88,709 | 78,405 |
| Collection fees | 35,488 | 39,025 | 42,127 |
| | <u>4,774,874</u> | <u>4,921,176</u> | <u>4,788,335</u> |
| Less — salaries charged to investment in fixed assets | 150,384 | 163,415 | 161,922 |
| | <u>4,624,490</u> | <u>4,757,761</u> | <u>4,626,413</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Company

| | For the year ended December 31 | | |
|---|--------------------------------|------------------|------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Salaries and related expenses | 1,553,908 | 1,616,353 | 1,417,633 |
| General expenses | 310,527 | 394,985* | 579,390* |
| Materials and spare parts | 66,987 | 67,098 | 52,074* |
| Building maintenance | 330,260 | 355,761 | 371,392 |
| Services and maintenance by sub-contractors | 225,755 | 287,286 | 358,029* |
| International communications expenses | 5,038 | 10,323 | 13,116 |
| Vehicle maintenance expenses | 84,435 | 73,809 | 67,402 |
| Collection fees | 35,403 | 38,670 | 41,884 |
| | <u>2,612,313</u> | <u>2,844,285</u> | <u>2,900,920</u> |
| Less — salaries charged to investment in fixed assets | 150,384 | 163,415 | 161,922 |
| | <u>2,461,929</u> | <u>2,680,870</u> | <u>2,738,998</u> |

* Reclassified

(1) See Note 1E(1)

NOTE 23 — FINANCING EXPENSES, NET

Consolidated

| | For the year ended December 31 | | |
|---|--------------------------------|----------------|----------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Financing expenses in respect of a debenture issued to the State of Israel | — | — | 5,272 |
| Expenses in respect of long-term liabilities* | | | |
| Debentures | 403,265 | 198,330 | 128,264 |
| Loans | 124,766 | 322,372 | 186,204 |
| | <u>528,031</u> | <u>520,702</u> | <u>319,740</u> |
| Income in respect of deposits and investments | (22,012) | (198,200) | (71,278) |
| Expenses (income) in respect of forward currency transactions | (337,873) | (123,977) | 110,398 |
| Short-term bank credit | 7,659 | 35,837 | 38,629 |
| Interest income from income tax | (5,979) | (83,635) | (7,187) |
| Other expenses (income), net | (1,332) | 2,708 | (19,622) |
| | <u>168,494</u> | <u>153,435</u> | <u>370,680</u> |
| (*) Including appreciation (net of erosion) in respect of liabilities in foreign currency | 256,779 | 168,499 | (54,005) |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Company

| | For the year ended December 31 | | |
|--|--------------------------------|----------------|-----------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Financing expenses in respect of a debenture issued to the State of Israel | — | — | 5,272 |
| Expenses in respect of long-term liabilities* | | | |
| Debentures | 403,265 | 198,330 | 128,264 |
| Loans | 93,885 | 283,416 | 165,821 |
| | <u>497,150</u> | <u>481,746</u> | <u>299,357</u> |
| Income in respect of deposits and investments | (23,446) | (196,589) | (71,278) |
| Expenses (income) in respect of forward currency transactions | (331,773) | (117,699) | 110,398 |
| Interest income from income tax | (8,979) | (83,635) | (7,187) |
| Other expenses, net..... | <u>(13,566)</u> | <u>(6,342)</u> | <u>(13,413)</u> |
| | <u>119,386</u> | <u>77,481</u> | <u>317,877</u> |
| (*) Including appreciation (net of erosion) of liabilities in foreign currency | <u>256,779</u> | <u>168,499</u> | <u>(50,765)</u> |

NOTE 24 — OTHER EXPENSES, NET

Consolidated

| | For the year ended December 31 | | |
|--|--------------------------------|----------------|------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Provision for employee severance benefits upon early retirement (Note 16D)..... | — | — | 1,562,136 |
| Provision for erosion of investment in convertible debentures ⁽¹⁾ | 1,232,560 | — | — |
| Compensation in respect of the billing system..... | — | — | (107,058) |
| Provision for claims in respect of salary and pension components | — | — | 53,999 |
| Provision and decrease in value of fixed assets..... | — | 108,654 | 11,893 |
| Direct expenses for the customer allocation process | — | 1,574 | 29,904 |
| Capital gains, net | (12,984) | (9,270) | (1,448) |
| Capital gain from sale of an affiliated company ⁽²⁾ | — | — | (149,831) |
| Cancellation of provision for a guarantee for an affiliated company | — | — | (25,169) |
| Loss in respect of decrease in holding in an affiliated company | — | 3,706 | — |
| Provision for a decrease in value of investments in other companies | 23,792 | 8,173* | — |
| Others | (125) | 2,420 | 4 |
| | <u>1,243,243</u> | <u>115,257</u> | <u>1,374,430</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Company

| | For the year ended December 31 | | |
|--|--------------------------------|---------------|------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Provision for employee severance benefits upon early retirement (Note 16D)..... | — | — | 1,562,136 |
| Provision for erosion of investment in convertible debentures ⁽¹⁾ | 1,232,560 | — | — |
| Compensation for the billing system | — | — | (107,058) |
| Provision for claims in respect of salary and pension components | — | — | 53,999 |
| Capital gains (losses), net | (12,490) | 2,665 | (2,869) |
| Capital gain from sale of an affiliated company ⁽²⁾ | — | — | (149,831) |
| Cancellation of provision for a guarantee for an affiliated company | — | — | (25,169) |
| Provision for a decrease in value of investments in other companies | 10,452 | — | — |
| Others | (133) | — | 241 |
| | <u>1,230,389</u> | <u>2,665</u> | <u>1,331,449</u> |

* Reclassified

(1) See Note 8D(2)

(2) In 2000, the Company signed an agreement for the sale and transfer of the Company's holdings in an affiliated company. By December 31, 2001, the Company had received the full consideration for the sale of its holdings.

NOTE 25 — EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

| | For the year ended December 31 | | |
|--|--------------------------------|------------------|------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Primary and diluted earnings (loss) | <u>(930,322)</u> | <u>129,182</u> | <u>(587,857)</u> |
| Weighted number of shares in primary earnings and diluted earnings | <u>2,411,658</u> | <u>2,411,658</u> | <u>2,411,658</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 26 — BUSINESS SEGMENTS

The Company and the investee companies operate in various segments of the telecommunications sector. The data concerning operations by segment are presented according to the operating segments of those companies.

Consolidated

| | For the year ended December 31, 2002 | | | | | |
|---|--|-----------------------|---|----------------|------------------|-------------------|
| | Fixed-line domestic communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues | | | | | | |
| Revenues from external sources | 5,358,071 | 1,996,234 | 683,338 | 196,900 | — | 8,234,543 |
| Inter-segment revenues .. | 209,782 | 7,789 | 8,431 | 30,010 | (256,012) | — |
| Total revenues | <u>5,567,853</u> | <u>2,004,023</u> | <u>691,769</u> | <u>226,910</u> | <u>(256,012)</u> | <u>8,234,543</u> |
| Segment results | <u>998,643</u> | <u>(63,877)</u> | <u>110,100</u> | <u>(8,781)</u> | <u>656</u> | 1,036,741 |
| Financing expenses | | | | | | 168,494 |
| Earnings after financing expenses | | | | | | 868,247 |
| Other expenses, net | | | | | | 1,243,243 |
| Losses before income tax | | | | | | (374,996) |
| Income tax | | | | | | 211,319 |
| Losses after income tax | | | | | | (586,315) |
| Equity in losses of affiliated companies ... | 2,559 | | | 344,513 | | 347,072 |
| Minority equity in losses of a consolidated company | (3,065) | | | | | (3,065) |
| Net loss | | | | | | <u>(930,322)</u> |
| Identified assets | 10,255,007 | 2,302,111 | 698,315 | 186,651 | (123,160) | 13,318,924 |
| Investment by equity method | 14,983 | | | 375,091 | | 390,074 |
| General assets | | | | | | 2,833,573 |
| Total consolidated assets | | | | | | <u>16,542,571</u> |
| Segment liabilities | 1,549,268 | 875,211 | 333,814 | 97,272 | (119,016) | 2,736,549 |
| General liabilities | | | | | | 7,089,255 |
| Total consolidated liabilities | | | | | | <u>9,825,804</u> |
| Capital investments | <u>870,939</u> | <u>480,669</u> | <u>139,011</u> | <u>6,269</u> | | |
| Depreciation and amortization | <u>1,925,472</u> | <u>515,257</u> | <u>84,842</u> | <u>4,992</u> | | |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Consolidated

For the year ended December 31, 2001

| | <u>Fixed-line domestic communications</u> | <u>Cellular telephone</u> | <u>International communications and internet services</u> | <u>Others</u> | <u>Adjustments</u> | <u>Consolidated</u> |
|---|---|-------------------------------|---|----------------|--------------------|---------------------|
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues | | | | | | |
| Revenues from external sources | 5,917,943 | 1,894,147 | 700,410 | 168,897 | — | 8,681,397 |
| Inter-segment revenues .. | 359,630 | 6,444 | 11,870 | 23,067 | (401,011) | — |
| Total revenues | <u>6,277,573</u> | <u>1,900,591</u> | <u>712,280</u> | <u>191,964</u> | <u>(401,011)</u> | <u>8,681,397</u> |
| Segment results | <u>1,104,319</u> | <u>(193,092)</u> | <u>(42,738)</u> | <u>1,329</u> | <u>657</u> | 870,475 |
| Financing expenses | | | | | | <u>153,435</u> |
| Earnings after financing expenses | | | | | | 717,040 |
| Other expenses, net | | | | | | <u>*115,257</u> |
| Earnings before income tax | | | | | | 601,783 |
| Income tax | | | | | | <u>245,571</u> |
| Earnings after income tax | | | | | | 356,212 |
| Equity in losses of affiliated companies ... | (30,307) | | | 264,154* | | 233,847 |
| Minority equity in losses of a consolidated company | (6,624) | | | | | <u>(6,624)</u> |
| Net earnings | | | | | | <u>128,989</u> |
| Identified assets | 11,868,258 | 2,217,920 | 618,705 | 128,370* | (60,898) | 14,772,355 |
| Investment by equity method | 135,033 | | | 355,985 | | 491,018 |
| General assets | | | | | | <u>3,004,880</u> |
| Total consolidated assets | | | | | | <u>18,268,253</u> |
| Segment liabilities | 1,551,950 | 791,066 | 311,031 | 53,988* | (60,145) | 2,647,890 |
| General liabilities | | | | | | <u>7,973,274</u> |
| Total consolidated liabilities | | | | | | <u>10,621,164</u> |
| Capital investments | <u>849,579</u> | <u>517,164</u> | <u>125,961</u> | <u>8,766</u> | | |
| Depreciation and amortization | <u>2,290,770</u> | <u>753,147</u> | <u>80,760</u> | <u>5,431</u> | | |

* Reclassified

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Consolidated

| | For the year ended December 31, 2000 | | | | | |
|---|--|-----------------------|---|----------------|------------------|-------------------|
| | Fixed-line domestic communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues | | | | | | |
| Revenues from external sources | 6,384,724 | 1,801,198 | 720,614 | 167,630 | — | 9,074,166 |
| Inter-segment revenues .. | 367,534 | 57,504 | 4,789 | 33,303 | (463,130) | — |
| Total revenues | <u>6,752,258</u> | <u>1,858,702</u> | <u>725,403</u> | <u>200,933</u> | <u>(463,130)</u> | <u>9,074,166</u> |
| Segment results | <u>1,370,386</u> | <u>(31,224)</u> | <u>(160,792)</u> | <u>13,268</u> | <u>177</u> | 1,191,815 |
| Financing expenses | | | | | | <u>370,680</u> |
| Earnings after financing expenses | | | | | | 821,135 |
| Other expenses, net | | | | | | <u>1,374,430</u> |
| Loss before income tax .. | | | | | | (553,295) |
| Tax benefit | | | | | | <u>(165,584)</u> |
| Loss after income tax | | | | | | (387,711) |
| Equity in losses of affiliated companies ... | 13,062 | | | 197,704 | | 210,766 |
| Minority equity in losses of a consolidated company | (5,284) | | | | | <u>(5,284)</u> |
| Net loss | | | | | | <u>(593,193)</u> |
| Identified assets | 13,282,694 | 2,477,532 | 579,310* | 96,297 | (59,871) | 16,375,962 |
| Investment by equity method | 108,501 | | | 77,984 | | 186,485 |
| General assets | | | | | | <u>1,658,604</u> |
| Total consolidated assets | | | | | | <u>18,221,051</u> |
| Segment liabilities | 2,647,989 | 998,677 | 434,665* | 53,339 | (57,884) | 4,076,786 |
| General liabilities | | | | | | <u>6,626,188</u> |
| Total consolidated liabilities | | | | | | <u>10,702,974</u> |
| Capital investments | <u>1,091,526</u> | <u>881,632</u> | <u>140,241</u> | <u>8,809</u> | | |
| Depreciation and amortization | <u>2,372,688</u> | <u>572,348</u> | <u>80,358</u> | <u>4,801</u> | | |

* Reclassified

NOTE 27 — TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

- A.** The Company is a government company which transacts a significant volume of business in the regular course of its operations with government ministries, agencies and government companies. The business transacted is primarily the provision of telecommunications services and the execution of development work, as well as the receipt of various types of services. It is not practicable to determine the identity of the interested parties involved in such transactions, nor to make a distinction in the recording thereof. The Securities Authority, pursuant to its authority under the Securities Regulations (Preparation of annual financial statements), 5753 — 1993, (exemption for the year 2002 is dated February 24, 2003), exempted the Company from detailing its transactions with interested parties, other than extraordinary transactions.
- B.** The Company provides services to the Israeli Defense and Security Forces in accordance with terms agreed upon in prior years and which provided, *inter alia*, that the Ministry of Defense will fund the Company's infrastructure investments in consideration for discounts which the Company will grant in respect of current services.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

Due to controversies which arose between the Company and the Ministry of Defense in connection with the terms of the services which the Company provides to the Israeli Defense Forces, a professional committee was established to examine the differences of opinion. In May 1996, the committee submitted recommendations for the resolution of the differences of opinion.

Since the recommendations were not adopted by the Ministers of Defense and Communications, the arrangements which were hitherto in effect between the Company and the Israeli Defense Forces, and which were the subject of the committee's discussions, continued to govern. In July 2002 the Company and the Ministry of Defense (in the name of the State of Israel) reached an agreement for the provision of telecommunications services by the Company.

The main points of the agreement are as follows:

1. The Company will provide telecommunications services to the IDF at a special discount of approximately 28% for services which the Company provided to the IDF prior to signing the agreement and at 14% for services which did not exist or which the Company did not provide for the IDF prior to signing the agreement. Based on the volume of the services which the Company provided to the IDF prior to the date on which the agreement takes effect, the discount in respect of the services under the agreement is not materially different from the discount which was granted pursuant to the memorandum by which the parties acted prior to signing the agreement.
2. The Ministry of Defense undertakes to purchase Company services for which the consideration will be not less than approximately NIS 81.2 million (excluding VAT) for each year of the commitment, and additionally to order from the Company cabling and communications infrastructure development works inside IDF bases which are used to provide the Company's services, for which the consideration will not be less than 80% of the total financial volume of Ministry of Defense orders for such infrastructures for the IDF in each year of the commitment.
3. The agreement ends and exhausts all the disputes between the parties up to April 1, 2001, including the disputes which were brought before the special professional committee ("the Gabai Committee"), but excludes the matter of an 18% discount which the Ministry of Defense deducted from payments which the Company collected for other communications providers.
4. Ownership of the infrastructures inside IDF bases will remain at the end of the term of the agreement with the Ministry of Defense and ownership of infrastructures outside the IDF base will remain with the Company.
5. The term of the contract is from the date of signing the agreement — July 21, 2002, until March 31, 2005 (under the terms of the agreement, retroactive accounting was carried out starting from April 1, 2001, subsequent to which the Company received a refund in a non-material amount).

C. Guarantees

The Company has provided guarantees to banks in connection with credit granted to subsidiary companies of up to NIS 70 million.

Regarding guarantees given by the Company in respect of its investments in India, see Note 19A (27).

The Company gave a guarantee for an affiliated company in the amount of approximately NIS 10 million in respect of a bank guarantee of approximately NIS 33 million which the affiliate made available in favor of the State of Israel. The guarantee is valid until December 31, 2010.

In connection with an additional guarantee in respect of the Company's investments in the affiliated company, see Note 8E.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

D. Transactions with investee companies (Company)

| | For the year ended December 31 | | |
|--|--------------------------------|---------------|---------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues — | | | |
| Interconnect and access fees | 173,799 | 292,588 | 321,519 |
| Services, royalties and commissions | 142,896 | 338,939 | 217,044 |
| Rent, and fixed fees for use of buildings and equipment | 24,955 | 43,464 | 10,564 |
| Interest | — | 6,955 | — |
| Expenses — | | | |
| Purchase of services | 41,125 | 36,470 | 154,290 |
| Interest | 6 | — | — |
| Total losses from fixed asset transactions | — | — | (479) |
| Total transaction turnover | — | — | 613 |

Transactions with a proportionally consolidated company were presented in full (100%).

For balances with subsidiaries and a proportionally consolidated company, see relevant notes.

E. Benefits for directors and CEO

| | For the year ended December 31 | | |
|---|--------------------------------|---------------|---------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Total cost of compensation of the CEO and the Chairman of the Board* | 1,680 | 1,537 | 1,266 |
| Number of employees | 2 | 2 | 2 |
| Compensation of members of the Board of Directors who are not Company employees** | 1,584 | 1,431 | 1,492 |
| Number of directors receiving compensation | 19 | 19 | 17 |

* The total cost includes payment of severance pay to the Chairman of the Board in the amount of approximately NIS 100,000.

** Compensation for directors in a proportionally consolidated company is presented at the proportional share of the Company (50%).

The Company holds an insurance policy for the directors and officers of the Company. The maximum insurance is \$ 150 million per event and per period (of 12 months) and up to an additional \$ 30 million for legal expenses in Israel. In addition, the Company will indemnify directors and officers in an amount not exceeding \$ 50 million per director and officer for a financial obligation imposed upon them in any matter connected with the Company's prospectus from February 27, 1998, and which is not covered by the insurance policy.

NOTE 28 — FINANCIAL INSTRUMENTS

A. Financial derivatives

The Group has an excess of liabilities over assets in or linked to foreign currency in the amount of approximately NIS 3,014 million of which the excess of current liabilities over current assets was approximately NIS 320 million. The excess of current liabilities is partially covered by forward exchange contracts, as described in Note 19B. The Group has revenues in foreign currency from international communications.

As at December 31, 2002, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 965 million of which the excess of current liabilities over current assets was approximately NIS 164 million. As stated in Note 1B, most

Notes to the Financial Statements as at December 31, 2002 (cont'd)

of the Company's tariffs are subject to government regulation and are revised from time to time in accordance with the increase in the CPI, net of an efficiency factor.

The Company has limited commitments in financial derivatives which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2002 — see Note 19B.

B. Credit risks

At December 31, 2002, most of the cash and cash equivalents, as well as bank deposits are deposited in large Israeli banks. Short-term investments primarily represent investments in government debentures and bank deposits, while a small part is invested in debentures of companies trading on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

The Group's revenues derive from a large number of customers. Management reviews customer balances on a current basis and the financial statements include provisions which, in Management's opinion, are adequate for doubtful debts. The exposure to credit risk in connection with customers is limited considering the large number of customers of the Company.

C. Fair value of financial instruments

The book value of the cash and cash equivalents, short-term investments, trade receivables, other receivables, other current assets, most of the long-term liabilities, trade payables and accrued expenses are equal or are close to their fair values. The fair value of loans from banks is also close to their book value since they bear interest at roughly the market rate.

Regarding several items, there is a difference between the amount recorded in the books and their estimated fair value, as detailed below.

| | December 31, 2002 | |
|------------------------------|-------------------|---------------|
| | Book value | Fair value |
| | NIS thousands | NIS thousands |
| Debentures: | | |
| Issued to the public | | |
| CPI-linked | 141,957 | 193,536 |
| Euro-linked | 1,476,805 | 1,422,289 |
| Unlinked | 500,241 | 490,560 |
| Issued to others | 860,418 | 761,368 |
| CPI-linked loans | 781,574 | 716,179 |
| Unlinked loans | 240,000 | 207,462 |
| Foreign currency loans | 1,568,252 | 1,154,363 |

The fair value of debentures issued to the public is based on their market price. The fair value of the other liabilities presented above is based on the present value of the cash flows related thereto.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 29 — LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2002

Consolidated

| | In or linked to foreign currency | | | CPI-linked | Unlinked | Total |
|---|----------------------------------|------------------|--------------|------------------|------------------|------------------|
| | Dollar-linked | Euro-linked | Other | | | |
| | NIS Thousands | | | NIS Thousands | | |
| Assets | | | | | | |
| Cash and cash equivalents | 26,919 | 1,614 | — | — | 963,921 | 992,454 |
| Short-term investments | 165,752 | — | — | 739,068 | 275,261* | 1,180,081 |
| Trade receivables | 19,619 | — | — | 6,683 | 1,725,686 | 1,751,988 |
| Other receivables and debit balances | 7,552 | 149,075 | — | 92,537 | 23,379 | 272,543 |
| Long-term investments, deposits and debit balances | 99,477 | 31,902 | — | 237,827 | 315,522 | 684,728 |
| | <u>319,319</u> | <u>182,591</u> | <u>—</u> | <u>1,076,115</u> | <u>3,303,769</u> | <u>4,881,794</u> |
| Liabilities | | | | | | |
| Short-term bank credit | 35,517 | — | — | 125,185 | 368,123 | 528,825 |
| Current maturities of long-term liabilities | 227,376 | — | — | 468,190 | 59,791 | 755,357 |
| Trade payables | 358,135 | 1,334 | 1,662 | 500 | 791,732 | 1,153,363 |
| Other current liabilities | 27,039 | 39,102 | — | 80,488 | 944,771 | 1,091,400 |
| Long-term loans | 1,348,489 | — | — | 574,668 | 180,208 | 2,103,365 |
| Other long-term debentures | — | 1,476,805 | — | 792,080 | 500,242 | 2,769,127 |
| Employee severance benefits | — | — | — | — | 1,352,451 | 1,352,451 |
| | <u>1,996,556</u> | <u>1,517,241</u> | <u>1,662</u> | <u>2,041,111</u> | <u>4,197,318</u> | <u>9,753,888</u> |

Company

| | In or linked to foreign currency | | | CPI-linked | Unlinked | Total |
|---|----------------------------------|------------------|--------------|------------------|------------------|------------------|
| | Dollar-linked | Euro-linked | Other | | | |
| | NIS thousands | | | NIS thousands | | |
| Assets | | | | | | |
| Cash and cash equivalents | 2,478 | 1,614 | — | — | 913,273 | 917,365 |
| Short-term investments | 165,752 | — | — | 739,068 | 275,169* | 1,179,989 |
| Trade receivables | 5,510 | — | — | — | 1,120,848 | 1,126,358 |
| Other receivables and debit balances | 5,720 | 149,075 | — | 85,816 | 10,583 | 251,194 |
| Long-term investments, deposits and debit balances | 99,477 | 31,902 | — | 224,284 | 235,938 | 591,601 |
| | <u>278,937</u> | <u>182,591</u> | <u>—</u> | <u>1,049,168</u> | <u>2,555,811</u> | <u>4,066,507</u> |
| Liabilities | | | | | | |
| Current maturities of long-term liabilities | 227,376 | — | — | 356,102 | — | 583,478 |
| Trade payables | 5,478 | 1,334 | 1,662 | — | 667,739 | 676,213 |
| Other current liabilities | 26,409 | 39,102 | — | 46,714 | 744,314 | 856,539 |
| Long-term loans | 1,336,442 | — | — | 173,992 | — | 1,510,434 |
| Other long-term debentures | — | 1,476,805 | — | 792,080 | 500,242 | 2,769,127 |
| Employee severance benefits | — | — | — | — | 1,341,443 | 1,341,443 |
| | <u>1,595,705</u> | <u>1,517,241</u> | <u>1,662</u> | <u>1,368,888</u> | <u>3,253,738</u> | <u>7,737,234</u> |

* Including mutual fund participation certificates of approximately NIS 111 million consolidated and for the Company.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 19B.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 29 — LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2001

Consolidated

| | In or linked to foreign currency | | | CPI-linked | Unlinked | Total |
|---|----------------------------------|------------------|--------------|------------------|------------------|-------------------|
| | Dollar-linked | Euro-linked | Other | | | |
| | NIS Thousands | | | NIS Thousands | | |
| Assets | | | | | | |
| Cash and cash equivalents | 43,219 | 1,086 | — | 109 | 1,343,230 | 1,387,644 |
| Short-term investments | 18,086 | — | — | 161,352 | 289,841** | 469,279 |
| Trade receivables | 32,291 | — | — | 4,634* | 1,758,889 | 1,795,814 |
| Other receivables and debit balances | 61,651 | 24,005 | — | 5,736 | 19,852 | 111,244 |
| Long-term investments, deposits and debit balances . . | <u>1,178,774</u> | <u>8,392</u> | <u>—</u> | <u>227,489*</u> | <u>287,980</u> | <u>1,702,635</u> |
| | <u>1,334,021</u> | <u>33,483</u> | <u>—</u> | <u>399,320</u> | <u>3,699,792</u> | <u>5,466,616</u> |
| Liabilities | | | | | | |
| Short-term bank credit | 37,817 | — | — | — | 413,264 | 451,081 |
| Current maturities of long-term liabilities | 211,629 | — | — | 441,881 | 138,445 | 791,955 |
| Trade payables | 298,117 | 448 | 6,784 | — | 779,509 | 1,084,858 |
| Other current liabilities | 18,775 | 38,166 | — | 193,937 | 929,875 | 1,180,753 |
| Long-term loans | 1,709,492 | 1,455 | — | 692,861 | 273,418 | 2,677,226 |
| Other long-term debentures | — | 1,241,855 | — | 913,792 | 532,597 | 2,688,244 |
| Employee severance benefits . . . | — | — | — | — | 1,638,823 | 1,638,823 |
| | <u>2,275,830</u> | <u>1,281,924</u> | <u>6,784</u> | <u>2,242,471</u> | <u>4,705,931</u> | <u>10,512,940</u> |

Company

| | In or linked to foreign currency | | | CPI-linked | Unlinked | Total |
|---|----------------------------------|------------------|--------------|------------------|------------------|------------------|
| | Dollar-linked | Euro-linked | Other | | | |
| | NIS Thousands | | | NIS Thousands | | |
| Assets | | | | | | |
| Cash and cash equivalents | 19,217 | 1,086 | — | — | 1,332,587 | 1,352,890 |
| Short-term investments | 16,312 | — | — | 157,779 | 278,115** | 452,206 |
| Trade receivables | 5,765 | — | — | — | 1,214,194 | 1,219,959 |
| Other receivables and debit balances | 58,511 | 24,005 | — | 1,544 | 6,049 | 90,109 |
| Long-term investments, deposits and debit balances . . | <u>1,178,774</u> | <u>8,392</u> | <u>—</u> | <u>214,507</u> | <u>237,948</u> | <u>1,639,621</u> |
| | <u>1,278,579</u> | <u>33,483</u> | <u>—</u> | <u>373,830</u> | <u>3,068,893</u> | <u>4,754,785</u> |
| Liabilities | | | | | | |
| Current maturities of long-term liabilities | 211,629 | — | — | 378,088 | — | 589,717 |
| Trade payables | 19,753 | 448 | 6,784 | — | 580,604 | 607,589 |
| Other current liabilities | 18,776 | 38,166 | — | 146,479 | 780,061 | 983,482 |
| Long-term loans | 1,709,492 | 1,455 | — | 390,790 | — | 2,101,737 |
| Other long-term debentures | — | 1,241,855 | — | 913,792 | 532,597 | 2,688,244 |
| Employee severance benefits . . . | — | — | — | — | 1,627,286 | 1,627,286 |
| | <u>1,959,650</u> | <u>1,281,924</u> | <u>6,784</u> | <u>1,829,149</u> | <u>3,520,548</u> | <u>8,598,055</u> |

* Reclassified

** Including mutual fund participation certificates of approximately NIS 181 million, consolidated and approximately NIS 178 million, Company.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 19B.

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 30 — CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES

A. Balance sheets

| | December 31 2002 | December 31 2001 |
|--|---------------------|---------------------|
| | NIS thousands | NIS thousands |
| Assets | | |
| Current assets | 3,700,531 | 3,093,366 |
| Materials and spare parts | 121,427 | 151,239 |
| Long-term investments, deposits and debit balances | 670,610 | 1,619,378 |
| Investments in investee companies | 1,460,901 | 1,481,849 |
| Fixed assets | 5,866,740 | 6,374,488 |
| Other assets | <u>867,487</u> | <u>992,328*</u> |
| | <u>12,687,696</u> | <u>13,712,648</u> |
| Liabilities | | |
| Current | | |
| Long-term | 2,355,562 | 2,341,098 |
| | <u>5,458,668</u> | <u>5,833,124</u> |
| | <u>7,814,230</u> | <u>8,174,222</u> |
| Shareholders' equity | <u>4,873,466</u> | <u>5,538,426*</u> |
| | <u>12,687,696</u> | <u>13,712,648</u> |

* Restated

B. Statements of operations

| | For the year ended December 31 | | |
|---|--------------------------------|-------------------|-------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from telecommunications services | <u>5,538,991</u> | <u>5,875,892</u> | <u>6,237,202</u> |
| Costs and expenses | | | |
| Operating and general expenses | 2,456,935 | 2,503,376 | 2,531,190 |
| Depreciation | 1,362,889 | 1,466,867 | 1,482,947 |
| Royalties to the Government of Israel | 187,596 | 188,853 | 204,058 |
| | <u>4,007,420</u> | <u>4,159,096</u> | <u>4,218,195</u> |
| Operating income | 1,531,571 | 1,716,796 | 2,019,007 |
| Financing expenses, net | <u>173,769</u> | <u>117,455</u> | <u>289,522</u> |
| Earnings after financing expenses | 1,357,802 | 1,599,341 | 1,729,485 |
| Other expenses, net | <u>1,317,364</u> | <u>18,193</u> | <u>1,227,500</u> |
| Earnings before income tax | 40,438 | 1,581,148 | 501,985 |
| Income tax | <u>(236,439)</u> | <u>(494,736)*</u> | <u>(118,751)*</u> |
| Earnings (loss) after income tax | (196,001) | 1,086,412 | 383,234 |
| Equity in losses of investee companies | <u>468,959</u> | <u>447,964</u> | <u>364,188</u> |
| Net earnings (loss) | <u>(664,960)</u> | <u>638,448</u> | <u>19,046</u> |

* Restated

Notes to the Financial Statements as at December 31, 2002 (cont'd)

C. Statement of changes in shareholders' equity

| | <u>Share capital</u> | <u>Capital reserves</u> | <u>Dividend proposed after the balance sheet date</u> | <u>Retained earnings (loss)</u> | <u>Total</u> |
|--|--------------------------|-----------------------------|---|---|------------------|
| | NIS thousands | | | | |
| Balance as at January 1, 2000 | 783,391 | 3,200,518 | — | 644,052 | 4,627,961 |
| Net earnings | — | — | — | 19,046* | 19,046 |
| Tax benefit in respect of shares to employees | — | 21,841 | — | — | 21,841 |
| Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares | — | 1,600,000 | — | (1,600,000) | — |
| Conversion of convertible debentures | 14,590 | 148,757 | — | — | 163,347 |
| Balance as at December 31, 2000 | 797,981 | 4,971,116 | — | (936,902) | 4,832,195 |
| Net earnings | — | — | — | 638,448* | 638,448 |
| Conversion of convertible debentures | 5,905 | 61,878 | — | — | 67,783 |
| Distribution of bonus shares | 1,607,772 | (1,600,000) | — | (7,772) | — |
| Balance as at December 31, 2001 | 2,411,658 | 3,432,994 | — | (306,226) | 5,538,426 |
| Net loss | — | — | — | (664,960) | (664,960) |
| Dividend proposed subsequent to the balance sheet date | — | — | 190,000 | (190,000) | — |
| Balance as at December 31, 2002 | <u>2,411,658</u> | <u>3,432,994</u> | <u>190,000</u> | <u>(1,161,186)</u> | <u>4,873,466</u> |

* Restated

D. Restatement

The Company has restated its nominal financial statements in order to retroactively reflect the recording of deferred taxes in respect of fixed assets.

(1) Effect on net earnings:

| | <u>For the year ended December 31</u> | |
|---|---------------------------------------|---------------|
| | <u>2001</u> | <u>2000</u> |
| | NIS thousands | NIS thousands |
| Net earnings as previously reported | 555,753 | 60,379 |
| Effect of restatement: | | |
| Increase in income tax | 82,695 | (41,333) |
| | <u>638,448</u> | <u>19,046</u> |

Notes to the Financial Statements as at December 31, 2002 (cont'd)

NOTE 31 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND
PELEPHONE COMMUNICATIONS LTD. AND ITS SUBSIDIARY

1. *Bezeq International Ltd.*

A. Balance sheets

| | December 31 2002 | December 31 2001 |
|--------------------------------------|---------------------|---------------------|
| | NIS thousands | NIS thousands |
| Current assets | 197,319 | 174,368 |
| Investments..... | 10,899 | 9,113 |
| Fixed assets | 493,484 | 432,063 |
| Other assets | 8,592 | 16,549 |
| | <u>710,294</u> | <u>632,093</u> |
| Current liabilities | 378,818 | 345,107 |
| Long-term liabilities | 174,037 | 205,902 |
| Quasi-capital receipt..... | — | 171,150 |
| Shareholders' equity (deficit) | 157,439 | (90,066) |
| | <u>710,294</u> | <u>632,093</u> |

B. Statements of operations

| | For the year ended December 31 | | |
|---|--------------------------------|-----------------|------------------|
| | 2002 | 2001 | 2000 |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from international communications services | 691,769 | 712,271 | 725,414 |
| Operating expenses | 387,407 | 526,391* | 601,650* |
| Gross profit | 304,362 | 185,880 | 123,764 |
| Marketing expenses..... | 133,909 | 129,764 | 178,617 |
| General and administrative expenses: | | | |
| In respect of the reporting period..... | 67,894 | 98,854 | 105,942* |
| In respect of cost differences in telecommunication services in previous periods..... | (7,541) | — | — |
| | <u>194,262</u> | <u>228,618</u> | <u>284,559</u> |
| Operating income (loss) | 110,100 | (42,738) | (160,795) |
| Financing income (expenses), net..... | 1,613 | (11,554) | (3,432) |
| Earnings (loss) after financing | 111,713 | (54,292) | (164,227) |
| Other income (expenses), net..... | 35 | 4,243 | (42,893) |
| Earnings (loss) before income tax..... | 111,748 | (50,049) | (207,120) |
| Income tax | (10,741) | (3,214) | (1,750) |
| Earnings (loss) after income tax | 101,007 | (53,263) | (208,870) |
| Company's equity in losses of investee company | (24,652) | (28,401) | (11,295) |
| Net earnings (loss) | <u>76,355</u> | <u>(81,664)</u> | <u>(220,165)</u> |

* Reclassified

Notes to the Financial Statements as at December 31, 2002 (cont'd)

2. Pelephone Communications Ltd. and its Subsidiary

A. Balance sheets

| | <u>Consolidated</u> <u>December 31</u> <u>2002</u> | <u>Consolidated</u> <u>December 31</u> <u>2001</u> |
|--|--|--|
| | NIS thousands | NIS thousands |
| Current assets | 1,339,340 | 1,101,575* |
| Long-term trade receivables | 159,168 | 100,064 |
| Deferred taxes | 335,863 | 260,402* |
| Fixed assets | 2,793,852 | 2,686,839 |
| Other assets, net | 459,667 | 633,304 |
| | <u>5,087,890</u> | <u>4,782,184</u> |
| Current liabilities | 2,080,516 | 1,961,988 |
| Provision for losses of investee company | 4,499 | 3,967 |
| Long-term liabilities | 1,125,245 | 1,075,276 |
| Shareholders' equity | 1,877,630 | 1,740,953 |
| | <u>5,087,890</u> | <u>4,782,184</u> |

B. Statements of Operations for the year ended December 31

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|------------------|-------------------|------------------|
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from Pelephone services, sales and services | 4,008,045 | 3,801,182 | 3,717,403 |
| Cost of Pelephone services, sales and services | <u>3,521,563</u> | <u>3,497,027*</u> | <u>3,106,350</u> |
| Gross profit | 486,482 | 304,155 | 611,053 |
| Sales and marketing expenses | 475,012 | 491,280* | 484,242 |
| General and administrative expenses | 156,814 | 172,143* | 216,130 |
| | <u>631,826</u> | <u>663,423</u> | <u>700,372</u> |
| Operating loss | (145,344) | (359,268) | (89,319) |
| Financing expenses, net | (94,680) | (131,196) | (105,838) |
| Other income (expenses), net | 1,496 | (216,943) | 1,852 |
| Loss before income tax | (238,528) | (707,407) | (193,305) |
| Tax benefit | 75,461 | 242,848 | 55,555 |
| Loss after income tax | (163,067) | (464,559) | (137,750) |
| Minority equity in losses of a consolidated company | 5,814 | 13,248 | 10,573 |
| Company equity in losses of investee companies | (667) | (8,155) | (11,797) |
| Net loss | <u>(157,920)</u> | <u>(459,466)</u> | <u>(138,974)</u> |

* Reclassified

APPENDIX A — LIST OF GROUP COMPANIES

| | Percent of control and ownership as at | |
|--|---|---------------------|
| | December 31 2002 | December 31 2001 |
| | % | % |
| Subsidiaries | | |
| Bezeq International Ltd. | 100 | 100 |
| BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.) ⁽¹⁾ .. | 100 | 100 |
| BezeqCall Ltd. ⁽¹⁾ | 100 | 100 |
| Bezeq Globe Ltd. ⁽²⁾ | 100 | 100 |
| Bezeq On Line Ltd. ⁽³⁾ | 100 | 100 |
| Goldnet Communication Services — registered partnership ⁽⁴⁾ | 54 | 49 |
| Proportionally Consolidated Companies | | |
| Telephone Communications Ltd. | 50 | 50 |
| GoNext Ltd. ⁽⁵⁾ | 50 | 26 |
| Affiliated Companies | | |
| Stage One Venture Capital Fund (Israel) L.P. (An Israeli Limited Partnership) (hereinafter — the Fund) ⁽⁶⁾ | 100 | 100 |
| Stage One Capital Investments L.P. (An Israeli Limited Partnership) (hereinafter — SOCI) ⁽⁶⁾ | 27 | 27 |
| The International Company for Underwater Cables Ltd. ⁽⁷⁾ | 50 | 50 |
| Aphrodite B.V. Amsterdam ⁽⁸⁾ | 67 | 67 |
| D.B.S. Satellite Services (1998) Ltd. ⁽⁹⁾ | 44.9 | 30 |
| Infogate Online Ltd. ⁽¹⁰⁾ | 26.2 | 29 |
| Eden Telecom Ltd. ⁽¹¹⁾ | 23 | 23 |
| Walla! Communications Ltd. ⁽¹²⁾ | 36.74 | 25 |
| Adanet Business Group Ltd. ⁽¹³⁾ | 50 | 50 |
| Companies that are not investee companies | | |
| Comfynet Ltd. | 17 | 17 |
| Xpert Integrated Systems Ltd. ⁽¹⁴⁾ | 16 | 16 |
| Personeta Inc. | 4 | 4 |
| Exent Ltd. | 6 | 6 |
| Atrica Inc. | 1 | 1 |
| Venture Capital Funds that are not affiliates | | |
| Eurofund 2000 L.P. | 14 | 14 |
| B.R.M. Capital Fund L.P. | 3 | 3 |

(1) Commencing July 1, 1997, the operations of both companies were merged and BezeqCall Ltd. ceased operations.

(2) The company ceased to operate on July 1, 1998. In 2000 the company decided on voluntary liquidation. The liquidation was approved by the Ministerial Committee for Privatization and the company appointed a liquidator.

(3) The company was founded in December 2000 and commenced operations in 2001.

(4) See Note 8H.

(5) See Note 8D (4).

(6) The Fund is a venture capital fund managed by SOCI. The Company undertook to invest the sum of \$ 20 million in the fund, of which approximately NIS 27 million was invested by the end of 2002.

(7) The Company maintained an underwater cable which it laid. The Company's share of the cost and maintenance of the equipment is charged to fixed assets and maintenance expenses. In February 1997 use of the cable ceased. In January 1999 the Board of Directors resolved upon voluntary liquidation as of March 31, 1999.

(8) Following the sale of Aphrodite's investment in Emitel and the transfer of the earnings as a dividend to the Company, Emitel ceased operations.

(9) See Note 8E.

(10) The Company is developing and supplying data communication services under the ASP concept, in which computers are linked in a broadband network to a central server from which various services are received.

(11) See Note 8D(5).

(12) See Note 8F.

(13) See Note 8G.

(14) In 2001, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration of 16.26% (at full dilution) of the capital of that company, as well as options which will enable it to increase its holdings to 20.33% (15.98% at full dilution). Xpert is an Israeli company involved mainly in the construction and integration of IP networks.

DBS SATELLITE SERVICES (1998) LTD.

2002 ANNUAL REPORT

TABLE OF CONTENTS

| | <u>Page</u> |
|--|-------------|
| AUDITORS' REPORT | 157 |
| FINANCIAL STATEMENTS — IN ADJUSTED NEW ISRAELI SHEKELS (NIS): | |
| Balance sheets | 158 |
| Statements of operations | 159 |
| Statements of changes in capital deficiency | 160 |
| Statements of cash flows | 161 |
| Notes to financial statements | 163 |

AUDITORS' REPORT

To the shareholders of

DBS SATELLITE SERVICES (1998) LTD.

We have audited the balance sheets of DBS Satellite Services (1998) Ltd. (hereafter — the Company) as of December 31, 2002 and 2001 and the related statements of operations, changes in capital deficiency and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's board of directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Israel, including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. Those standards require that we plan and perform the audit to obtain reasonable assurances about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's board of directors and management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2002 and 2001 and the results of its operations, the changes in its capital deficiency and its cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in Israel. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Israeli Securities (Preparation of Annual Financial Statements) Regulations, 1993.

As explained in note 1b, the financial statements referred to above are presented in values adjusted for the changes in the general purchasing power of Israeli currency, in accordance with pronouncements of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to note 1a(2) regarding the financial position of the Company and the financing agreements with banks and with the Company's shareholders. As explained in the abovementioned note, the Company's activity depends on the continued execution of the financing agreements, including the formulation of an addendum to the agreements, as described in the said note, and on the receipt of additional loans from shareholders.

Tel Aviv
March 3, 2003

Balance Sheets
In adjusted NIS

| | Note | December 31 | |
|---|-----------|--------------|-------------|
| | | 2002 | 2001 |
| | | In thousands | |
| Assets | | | |
| Current assets: | 10 9 | | |
| Cash and cash equivalents | | 4,522 | 22 |
| Accounts receivable: | 11a | | |
| Trade | | 106,266 | 60,667 |
| Other | | 4,845 | 31,769 |
| Total current assets | | 115,633 | 92,458 |
| Broadcasting rights: | 1d | | |
| Cost | 11e | 251,891 | 305,186 |
| Less — utilized rights | | 112,342 | 68,476 |
| | | 139,549 | 236,710 |
| Fixed assets: | 1e;2 | | |
| Cost | | 1,950,841 | 1,591,097 |
| Less — accumulated depreciation | | 613,158 | 273,328 |
| | | 1,337,683 | 1,317,769 |
| License fees — advance on account of royalties | 3 | 6,484 | 27,893 |
| | | 1,599,349 | 1,674,830 |
| Liabilities, net of capital deficiency | | | |
| Current liabilities: | 10 9 | | |
| Accounts payable and accruals: | 11c | | |
| Trade | | 538,252 | 553,294 |
| Other | | 78,865 | 31,924 |
| | | 617,117 | 585,218 |
| Bank credit | 1a(2);11b | 1,125,584 | 939,826 |
| Total current liabilities | | 1,742,701 | 1,525,044 |
| Long-term liabilities: | 9 | | |
| Liability for employee rights upon retirement — net | 5 | 2,840 | 1,226 |
| Customer deposits — net | 1g | 42,060 | 20,491 |
| Other liability, net of current maturity | 11d | 14,336 | 28,870 |
| Total long-term liabilities | | 59,236 | 50,587 |
| Shareholders' loans | 4 | 2,091,371 | 1,670,418 |
| Commitments and contingent liabilities | 6 | | |
| Total liabilities | | 3,893,308 | 3,246,049 |
| Capital deficiency | 7 | (2,293,959) | (1,571,219) |
| | | 1,599,349 | 1,674,830 |

Date of approval of the financial statements: March 3, 2003.

Avi Gabay
Member of the
Board of Directors

Shlomo Liran
Chief Executive Officer

David Brodet
Chairman of the
Board of Directors

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

Statements of Operations
In adjusted NIS

| | <u>Note</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|-------------|-----------------------|-----------------------|-----------------------|
| | | In thousands | | |
| Revenues | | 672,577 | 325,572 | 28,382 |
| Operating expenses..... | 11f | <u>1,089,741</u> | <u>767,162*</u> | <u>280,022</u> |
| Gross loss | | 417,164 | 441,590 | 251,640 |
| Selling and marketing expenses | 11g | 119,357 | 203,244* | 177,048 |
| General and administrative expenses | 11h | <u>117,031</u> | <u>148,266*</u> | <u>133,804</u> |
| Loss from ordinary operations | | 653,552 | 793,100 | 562,492 |
| Financial expenses, net | 11i | 48,084 | 101,054 | 24,789 |
| Other expenses | 2c | <u>21,113</u> | <u> </u> | <u> </u> |
| Loss for the year | | <u><u>722,749</u></u> | <u><u>894,154</u></u> | <u><u>587,281</u></u> |

* Reclassified.

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

Statements of Changes in Capital Deficiency
In adjusted NIS

| | Share capital | Receipts on account of shares | Accumulated deficit | Total |
|---|------------------|-------------------------------------|------------------------|--------------------|
| | In thousands | | | |
| Balance at January 1, 2000 | * | 1 | (89,795) | (89,794) |
| Changes during 2000: | | | | |
| Issue of share capital | 11 | (1) | | 10 |
| Loss | — | — | (587,281) | (587,281) |
| Balance at December 31, 2000 | 11 | — | (677,076) | (677,065) |
| Changes during 2001 — loss | — | — | (894,154) | (894,154) |
| Balance at December 31, 2001 | 11 | — | (1,571,230) | (1,571,219) |
| Changes during 2002: | | | | |
| Issue of share capital | 9 | — | | 9 |
| Loss | — | — | (722,749) | (722,749) |
| Balance at December 31, 2002 | <u>20</u> | <u>—</u> | <u>(2,293,979)</u> | <u>(2,293,959)</u> |

* Represents an amount of less than adjusted NIS 1,000.

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

Statements of Cash Flows
In adjusted NIS

| | 2002 | 2001 | 2000 |
|---|--------------|-----------|-----------|
| | In thousands | | |
| Cash flows from operating activities: | | | |
| Loss for the year | (722,749) | (894,154) | (587,281) |
| Adjustments required to reflect the cash flows from operating activities (a) | 652,549 | 284,371* | 293,556 |
| Net cash used in operating activities | (70,200) | (609,783) | (293,725) |
| Cash flows from investing activities, see (b) below: | | | |
| Payments on account of purchase of fixed assets, see (b) below | (481,865) | (543,680) | (710,476) |
| Payments on account of purchase of broadcasting Rights | (49,783) | (99,441)* | (134,722) |
| Proceeds on sale of fixed assets | 10,850 | | |
| Net cash used in investing activities | (520,798) | (643,121) | (845,198) |
| Cash flows from financing activities: | | | |
| Receipt of long-term loans from shareholders | 409,740 | 844,590 | 678,522 |
| Credit from banks — net | 185,758 | 407,880 | 412,416 |
| Net cash provided by financing activities | 595,498 | 1,252,470 | 1,090,938 |
| Increase (decrease) in cash and cash equivalents | 4,500 | (434) | (47,985) |
| Balance of cash and cash equivalents at beginning of year | 22 | 456 | 48,441 |
| Balance of cash and cash equivalents at end of year | 4,522 | 22 | 456 |

* Reclassified.

Statements of Cash Flows
In adjusted NIS

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|-----------------|-----------------|----------------|
| | In thousands | | |
| (a) Adjustments required to reflect the cash flows from operating activities: | | | |
| Expenses not involving cash flows: | | | |
| Depreciation and amortization | 348,441 | 217,410 | 58,355 |
| Broadcasting rights utilized | 149,386 | 79,746 | 35,004 |
| Impairment provision in respect installation equipment | 21,048 | | |
| Liability for employee rights upon retirement — net | 1,614 | 1,226 | |
| Linkage differences on other long-term liability | 1,533 | | |
| Linkage differences and interest on principal of shareholders' loans | 11,213 | 1,096 | 1,239 |
| Other | 990 | | |
| | <u>534,225</u> | <u>299,478</u> | <u>94,598</u> |
| Changes in operating asset and liability items: | | | |
| Decrease (increase) in accounts receivable: | | | |
| Trade | (35,836) | (56,390) | (4,277) |
| Other | 26,933 | 14,508 | 37,687 |
| Increase (decrease) in accounts payables and accruals: | | | |
| Trade, see (b) below | 59,567 | 13,551* | 214,153 |
| Customer deposits — net | 29,873 | 27,042 | 227 |
| Other | 37,787 | (13,818) | 26,542 |
| | <u>118,324</u> | <u>(15,107)</u> | <u>198,958</u> |
| | <u>652,549</u> | <u>284,371</u> | <u>293,556</u> |
| (b) Supplementary information on investing activities not involving cash flows: | | | |
| (1) Increase (decrease) in suppliers' credit for purchase of fixed assets | <u>(93,118)</u> | <u>32,945</u> | <u>145,479</u> |
| Increase in suppliers' credit for purchase of broadcasting rights | <u>2,442</u> | <u>19,029*</u> | <u>32,302</u> |
| (2) In the second half of 2002, the Company sold to its customers digital satellite decoders in installments, as part of a one-time marketing campaign. The payments received until December 31, 2002 were included under investing activities for 2002. The remaining balance, approximately adjusted NIS 10 million, will be included in 2003. | | | |

* Reclassified.

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

Notes to Financial Statements

NOTE 1 — Significant Accounting Policies

The significant accounting policies, applied on a consistent basis, are as follows:

a. General:

1) Activities

DBS Satellite Services (1998) Ltd. (hereafter — the Company) was incorporated in Israel on December 2, 1998. In January 1999, the Company received a license from the Ministry of Communications to broadcast, in Israel, television broadcasts by means of satellite (hereafter — the License). The License is for a period of ten years from the day of its receipt and can be extended for an additional period of six years on certain conditions. In June 2002, the License was extended by five years.

The Company paid an advance on account of license fees (royalties) in the amount of approximately adjusted NIS 33 million, and presented a bank guarantee in the same amount in favor of the State of Israel. The Company is subject to the Telecommunications Law, 1982 (hereafter — the Telecommunications Law), the regulations and rules promulgated thereunder and the terms of the License.

In July 2000, the Company completed the development stage and began to provide its customers with multi-channel television broadcasts in accordance with the License granted it under the Telecommunications Law.

2) The Company's financial position

a) Since the commencement of its activities, the Company has incurred significant losses and negative cash flows. The loss for 2002 amounts to approximately adjusted NIS 723 million and the negative cash flow from ordinary operations aggregated approximately adjusted NIS 70 million. As a result of these losses, the Company's capital deficiency and working capital deficiency as of December 31, 2002 amounted to approximately adjusted NIS 2,294 million and adjusted NIS 1,627 million, respectively. The working capital deficiency includes approximately adjusted NIS 1,126 million in credit from banks (see also (b) below).

b) On May 23, 2001, the Company signed a financing agreement (hereafter — the financing agreement) with certain banks (hereafter — the Banks). The financing agreement includes, *inter alia*, undertakings by the Company to meet certain suspending conditions as well as specified cumulative milestones and financial stipulations (hereafter — the terms).

A financial review performed by the Banks at the beginning of 2002 determined that the additional amount of finance required for the Company's activities is significantly higher than the financing requirements defined in the agreement.

On December 30, 2002, the Company, its shareholders and the Banks signed an agreement regarding the expansion of the credit facility provided by the Banks (hereafter — the interim facility), which is to be carried out in parallel with additional investments by the shareholders, in an amount not less than 150% of the amount infused by the Banks. Receipt of the finance under the interim facility is, *inter alia*, conditional upon the Company's meeting certain financial and operating conditions, as stipulated in the said agreement.

To date of approval of these financial statements, the shareholders and the Banks have transferred the Company approximately U.S. \$30 million and U.S. \$20 million, respectively, on account of the interim facility.

To date of approval of these financial statements, not all the terms stipulated in the financing agreement and the interim facility have been fulfilled. Accordingly, the credit from the Banks was included under current liabilities.

In addition, discussions have been held between the parties regarding the expansion of the interim facility (hereafter — the addendum to the financing agreement). The principal shareholders of the Company have notified the Banks of their intention to invest, in parallel with the Banks, their proportionate share in the addendum to the financing agreement. To date of approval of these financial statements, the Banks have not yet passed a decision regarding the addendum to the financing agreement. The interim facility stipulates that, in the event that by March 31, 2003: (1) The Banks receive no proof that the overall financing requirements of the Company do not exceed the amount of the interim facility, with the addition of the addendum to the financing agreement (including the proportionate share of the shareholders) and (2) An addendum to the financing agreement is not signed by the Company, its shareholders and the Banks; the Banks would be entitled to take, at their sole discretion, the action necessary in order to collect all of the amounts due to them and to act on their rights under the financing agreement in the event of a breach, as stipulated in this agreement.

- c) The receipt of additional loans from a principal shareholder is conditional, inter alia, upon the approval of the Ministerial Committee for Privatization (hereafter — the Committee). The Committee has allowed the shareholder to increase his investment up to the sum of the multiplication of the percentage of his shareholding of the Company's share capital by U.S. dollar 480 million. In January 14, 2003, the Committee has given its approval for the shareholder to invest, beyond the abovementioned amount, an additional \$60 million in the Company. In the opinion of the Company's management, the total amount of investment approved by the Committee covers the principal shareholder's proportionate share in the interim facility as well as his proportionate share under the addendum to the financing agreement.
- d) The Company's activity depends on the continued execution of the financing agreement and the interim facility, on the signing of the addendum to the financing agreement, as described in (b) above, and on the receipt of additional loans from shareholders.

In the opinion of the Company's management, there are good chances that the discussions between the Company, the shareholders and the Banks will result in the signing of the addendum to the financing agreement and an arrangement for the financing resources required for the coming year.

3) **Definitions**

Interested parties — as defined in the Israeli Securities (Preparation of Annual Financial Statements) Regulations, 1993.

4) **Use of estimates in the preparation of financial statements**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of expenses during the reporting period. Actual results could differ from those estimates.

b. Adjusted financial statements:

- 1) The financial statements have been prepared on the basis of historical cost adjusted for the changes in the general purchasing power of Israeli currency, in accordance with pronouncements of the Institute of Certified Public Accountants in Israel (hereafter — the Israeli Institute). All figures in the financial statements are presented in adjusted new Israeli shekels (NIS) which have a uniform purchasing power (December 2002 adjusted NIS) — based upon the changes in the consumer price index (hereafter — the CPI); see also note 9b).

The adjustment of the financial statements is based on the accounts of the Company, maintained in nominal NIS. Condensed nominal Israeli currency data of the Company, on the basis of which its adjusted financial statements were prepared, are presented in note 14.

The components of the statements of operations were, for the most part, adjusted as follows: the components relating to transactions carried out during the year (revenues, purchases, labor costs, etc.) were adjusted on the basis of the index for the month in which the transaction was carried out, while those relating to non-monetary balance sheet items (mainly depreciation and amortization) were adjusted on the same basis as the related balance sheet item. The financing component represents financial income and expenses in real terms and the erosion of balances of monetary items during the year.

- 2) The adjusted amounts of non-monetary assets do not necessarily represent realization value or current economic value, but only the original historical values, adjusted for the changes in the general purchasing power of Israeli currency. In these financial statements, the term "cost" signifies cost in adjusted Israeli currency.

c. Cash equivalents

The Company considers all highly liquid investments, which include short-term bank deposits (up to three months from the date of deposit) that are not restricted as to withdrawal or use, to be cash equivalents.

d. Broadcasting rights

The rights are presented at cost.

The cost of acquired rights for the screening of movies and television programs includes commitments to the suppliers of the rights, with the addition of direct costs incurred in adapting such movies and programs for screening in Israel. The broadcasting rights are partially depreciated on the basis of actual screenings (the remaining balance to the end of the agreement is fully depreciated at the end of the agreement period) and partially according to the term of the rights agreement.

Costs relating to programs produced by the Company which, in the opinion of the Company, can be sold or broadcasted numerous times, are carried to broadcasting rights and depreciated on the basis of their estimated useful life.

e. Fixed assets

- 1) Fixed assets are stated at cost.
- 2) The assets are depreciated by the straight-line method, based on their estimated useful life.

Annual rates of depreciation are as follows:

| | % |
|--|------|
| Broadcasting and receiving equipment | 15 |
| Capitalized installation costs, see also (3) below | 10 |
| Digital satellite decoders | 25 |
| Office furniture and equipment | 7-15 |
| Computers | 33 |

Leasehold improvements are amortized by the straight-line method over the lease period or the estimated life of the improvements, whichever is shorter.

- 3) The Company capitalizes costs of installation of broadcasting and receiving equipment to fixed assets. The costs of installation in apartments are amortized based on the average term of engagement with customers. The costs of installation on buildings are amortized based on the estimated useful life of the installation costs.

In the first quarter of 2003, the Company completed a reassessment of the average term of engagement with subscribers. Based on this reassessment, market conditions and experience, commencing 2003, costs relating to installation in apartments will be amortized at the rate of 17%.

In addition, in the first quarter of 2003 the Company has completed an engineering review of the estimated useful life of costs relating to installation on buildings. Based on this review, commencing 2003, costs of installation as above will be amortized at the rate of 6.7%.

The abovementioned changes will increase, as from 2003, the annual depreciation expense by approximately adjusted NIS 34 million.

f. License fees — advance on account of royalties

The license fees, which reflect royalty amounts in advance as stipulated in the terms of the License (see note 1a(1)), are depreciated from the beginning the commercial utilization of the License, in accordance with the Company's royalty commitments, see note 3, over a period not exceeding ten years.

g. Revenue recognition:

- 1) Revenues from supply of content services are recognized as services are performed.
- 2) The Company leases digital satellite decoders to its customers, on an operational lease basis. Revenues from the lease fees are recognized ratably over the lease period.
- 3) The Company receives deposits from its subscribers for the digital satellite decoders, in an amount that does not exceed the cost of the decoders. Revenues from the depreciation of the deposits are carried to income over 5 or 10 years, based on the terms of the contract with the subscriber.

h. Allowance for doubtful accounts

The allowance is determined at progressively increasing percentages of the debt according to the amount of time the debt has been outstanding.

i. Recently issued pronouncements:

- 1) In February 2003, Accounting Standard No. 15 of the Israeli Accounting Standards Board (hereafter — the IASB) — "Impairment of Assets", became effective. This standard — based on International Accounting standard No. 36 — requires a periodic review, at each balance sheet date, to evaluate the need for a provision for the impairment of the Company's non-monetary assets — mainly fixed assets and identifiable intangibles, including goodwill, as well as investments in associated companies. The Standard is applicable to financial statements for periods commencing January 1, 2003 and thereafter. According to the Standard, if any events have occurred or changes in circumstances have taken place, which might indicate that there has been an impairment of one or more of the above assets, the Company must evaluate whether the carrying value of the investment in the asset is recoverable from the cash flows anticipated from that asset, and, if necessary, record an impairment provision up to the amount needed to adjust the carrying amount to the recoverable amount. The impairment loss is carried directly to income.

In the opinion of the company, the new Standard will not have a material effect on its operating results, financial position and cash flows.

- 2) In October 2001, the IASB issued Israel Accounting Standard No. 12 — "Discontinuation of Adjusting Financial Statements for inflation", which provided for the discontinuance of adjusting financial statements for the effects of inflation, as of January 1, 2003. In December 2002, Accounting Standard No. 17 was issued that postponed the date from which Accounting Standard No. 12 is to be applied until January 1, 2004. The inflation-adjusted amounts as of December 31, 2003 will be the base for the nominal-historical financial reporting in the following periods.

The implementation of Standard No. 12 will mainly affect the financing expenses item.

NOTE 2 — Fixed Assets:

a. Composition of assets and accumulated depreciation, grouped by major classifications and changes therein in 2002 are as follows:

| | Cost | | | Accumulated depreciation | | | | Depreciated balance | | |
|--|------------------------------|---------------------------|-----------------------------|--------------------------|------------------------------|---------------------------|-----------------------------|------------------------|---------------------------|------------------|
| | Balance at beginning of year | Additions during the year | Retirements during the year | Balance at end of year | Balance at beginning of year | Additions during the year | Retirements during the year | Balance at end of year | December 31 | |
| | Adjusted NIS in thousands | | | | | | | | Adjusted NIS in thousands | |
| Broadcasting and receiving equipment | 151,619 | 1,729 | | 153,348 | 34,472 | 23,874 | | 58,346 | 95,002 | 117,147 |
| Capitalized installation costs See c. below | 729,211 | 157,215 | 911 | 885,515 | 73,869 | 90,953 | 11 | 164,811 | 720,704 | 655,342 |
| Digital satellite decoders See d. below | 566,514 | 210,260 | 27,737 | 749,037 | 116,546 | 183,213 | 8,061 | 291,698 | 457,339 | 449,968 |
| Office furniture and equipment (including computers) | 116,099 | 18,291 | 355 | 134,035 | 44,324 | 41,139 | 178 | 85,285 | 48,750 | 71,775 |
| Leasehold improvements | 27,654 | 1,252 | | 28,906 | 4,117 | 8,901 | | 13,018 | 15,888 | 23,537 |
| | <u>1,591,097</u> | <u>388,747</u> | <u>29,003</u> | <u>1,950,841</u> | <u>273,328</u> | <u>348,080</u> | <u>8,250</u> | <u>613,158</u> | <u>1,337,683</u> | <u>1,317,769</u> |

b. As to liens on the assets — see note 10.

c. In 2002, the Company wrote down approximately adjusted NIS 21 million in respect of installation equipment that it does not expect to use.

d. The retirement of digital satellite decoders in 2002 represents the sale of decoders to customers as part of a one-time marketing campaign.

NOTE 3 — License Fees — Advance on Account of Royalties

In accordance with the terms of the License, the Company has undertaken to pay royalties to the Government of Israel, which are calculated on the basis of revenues from the supply of broadcasting services, as defined in the License. The rate of the royalties was set at 1.5% of the Company's revenues for the first five years, commencing January 1, 2000, or until the accumulation of 250,000 subscribers, whichever is the earlier. As of December 31, 2001, the Company has accumulated 250,000 subscribers.

Thereafter, royalties will be computed at the following rates:

| Year | Percentage of the Company's revenues |
|---------------------|--------------------------------------|
| 2003 | 4% |
| 2004 and thereafter | 3.5% |

The payments on account of license fees are considered as a non-refundable advance on account of said royalties. These payments are linked to the index known on balance sheet date (see note 1a(1)).

NOTE 4 — Shareholders' Loans:

a. At the general meeting of the shareholders of the Company on December 24, 2000, it was decided that the various loans which had been extended by the shareholders to the Company would be linked to the CPI and bear interest at the annual rate of 7%, from the date of their grant to the date of their repayment, or the repayment of any part thereof, as the case may be, or other interest and linkage differences if so decided by a meeting of the shareholders of the Company. These terms will also apply to loans extended to the Company by

the shareholders in the future, as long as no decision to the contrary is made by the shareholders' meeting. In addition, it was resolved that the above mentioned decision would take effect on January 24, 2001, unless by that date objections are submitted by a particular shareholder. In the event of such objections by the particular shareholder, the decision would take effect on the date the particular shareholder ceases to be a member of the enterprise.

To date of approval of these financial statements, the shareholder has submitted his objections as aforesaid, and the decision, therefore, had not taken effect. Accordingly, no interest has been charged on the shareholders' loans. The loans, as included in the financial statements, bear interest at the rate of the increase in the known CPI.

- b. In accordance with the agreement, dated December 30, 2002, between the shareholders and the Company, the loans that the shareholders extended to the Company since July 10, 2002 (hereafter — the new shareholders' loans) will have preference over loans extended by the shareholders prior to said date (hereafter — the previous shareholders' loans). The agreement stipulates that the new shareholders' loans are to be fully repaid by the Company prior to any distribution of dividend by the Company and/or the repayment of the previous shareholders' loans, this subject to the Company's cash flows and commitments according to the documents of the Banks. The new shareholders' loans are linked to the known CPI and bear interest at the annual rate of 5.5%.

As of December 31, 2002, the shareholders' loans are composed as follows:

| | <u>Adjusted NIS in thousands</u> |
|------------------------------------|--------------------------------------|
| Previous shareholders' loans | 1,947,457 |
| New shareholders' loans | <u>*143,914</u> |
| | <u>2,091,371</u> |

* Including interest of approximately adjusted NIS 1,840,000.

NOTE 5 — Employee Rights Upon Retirement — Net:

- a. Labor laws and agreements require the Company to pay severance pay to employees dismissed or retiring from its employ in certain circumstances. The Company's severance pay liability to its employees (which is based on the number of years worked and the latest monthly salary) is covered mainly by purchase of insurance policies. The amounts funded as above are not reflected in the balance sheets since they are not under the control and management of the Company.
- b. The amount of liability for severance pay presented in the balance sheets reflects that part of the liability not covered as above, in accordance with labor agreements in force.

NOTE 6 — Commitments and Contingent Liabilities:

a. Commitments:

- 1) As of December 31, 2002, the Company has entered into agreements for the purchase of broadcasting rights in the aggregate amount of approximately adjusted NIS 216 million (December 31, 2001 — approximately adjusted NIS 395 million).
- 2) The Company has entered into two main operating lease agreements for buildings it uses. One agreement expires in 2003 with an option to renew for three additional years, and the second agreement expires in 2009 with an option to renew for an additional 10 years. The lease fees are linked to the U.S. dollar (hereafter — the dollar). The Company has also entered into several additional operating lease agreements for various periods. The projected annual lease fees for the next five years, at rates in effect on December 31, 2002, are approximately adjusted NIS 10 million.
- 3) As to the Company's undertaking to pay royalties to the Government of Israel, see note 3.

- 4) The Company has entered into an agreement for the lease of space segments on the Amos 1 satellite. The agreement is for a period of 8.5 years commencing April 14, 2000, with options to renew for additional six month periods at a time.

In addition, on May 16, 2001, the Company has entered into an agreement for the lease of space segments on the Amos 2 satellite, which has not yet been launched into space. The agreement expires after 10 years from the launch of the satellite or at the end of the useful life of the satellite, whichever is earlier. The launch of the satellite is due during the year 2003.

The projected annual lease fees for the next 5 years under said agreements are as follows:

| | <u>Adjusted NIS in thousands</u> |
|---------------------------|--------------------------------------|
| 2003 | 137,468 |
| 2004 | 147,036 |
| 2005 | 147,036 |
| 2006 | 154,616 |
| 2007 and thereafter | 158,405 |

- 5) The Company has entered into several operating lease agreements in respect of vehicles that it uses for a period of 4 years. The projected annual lease payments, at rates in effect on December 31, 2002, are approximately adjusted NIS 12 million.

b. Contingent liabilities:

- 1) To secure its liabilities, the Company has provided documentary credit and guarantees in the amount of approximately NIS 67 million.

2) Claims:

- a) On November 27, 2001, Reuveni Pridan Advertisers (hereafter — Pridan) filed a claim for NIS 3 million against the Company. Pridan alleges that the Company has unlawfully cancelled the advertising services agreement between them, thereby, inter alia, preventing Pridan from receiving additional commissions under the agreement and damaging Pridan's reputation.

The dispute between the parties has been referred to an arbitrator.

In the opinion of the Company's legal counsel, the outcome of the claim cannot be estimated at this stage. Therefore, no provision was included in respect of this claim.

- b) The Company has a dispute with ICP Israel Cable Programming Co. Ltd (hereafter — ICP) regarding a debt. The dispute was referred to arbitration.

In December 2002, ICP has submitted the arbitrator a claim for NIS 11,065,000, with the addition of linkage differences and interest until payment date.

In the opinion of the Company's legal counsel, the outcome of the claim cannot be estimated at this stage. Therefore, no provision was included in respect of this claim, except the amount included in ICP's supplier account due to this claim.

- c) Since September 3, 2001, the general manager of the Consumer Council, the Cable and Satellite Broadcast Council (hereafter — the council) and the Head of the Supervising and Control Department in the Ministry of Communications have sent the Company several notices regarding the charging of delivery fees (NIS 2.9 per month) from customers for the delivery of the Yes magazine without prior consent of the customers.

These parties demand that the Company reimburse all the subscribers whose expressed consent had not been received and, that in the future, the Company would avoid charging any amounts without receiving the expressed consent of

consumers. Furthermore, the parties point out that the charging of the delivery fees is contrary to the terms of the License and of the subscriber agreements.

In addition, the chairwoman of the Cable and Satellite Broadcast Council notified the Company that she intends to exercise her authority and require the Company to pay a penalty in respect of this matter.

In her letter from June 16, 2002, the chairwoman of the council notified the Company that if the subscription form is amended by the end of the month, no penalty would be imposed. In October 2002, the Company decided to amend the form as required under the abovementioned letter.

In the opinion of the Company's legal counsel, whether a claim would be filed, what measures may be required under such claim or the chances thereof cannot be estimated at this stage.

- d) On September 10, 2002, the Company received a third party notice from Barel Management and Apartment Buildings Maintenance Ltd (hereafter — Barel), which requires the Company to indemnify Barel in respect of any amount ruled under a claim that was filed against Barel and other parties by an apartment building in Givatayim for damage caused to the elevators.

The Company rejects the parts of the statement of claim relating to it and the third party notice. In addition, the Company has submitted a fourth party notice to the subcontractor that performed the installation in said building.

In the opinion of the Company's legal counsel, the chances of the claim cannot be estimated at this stage. Therefore, no provision was made in respect of this claim.

- e) A dispute arose between the Company and one of its distributors in the Arab sector (hereafter — the distributor) with respect to the termination of the agreement between the parties.

On March 22, 2001, the Company received a liquidation notice from the distributor, in which he requires a payment of approximately NIS 4.8 million in respect of commissions that he alleges are due to him from the Company.

The Company rejects the claims of the distributor and claims that the distributor owes the Company approximately NIS 100,000, before taking into account damages caused to the Company by his breach of the agreement, that have not yet been fully estimated by the Company.

The Company and the distributor are currently negotiating the type of proceedings by which their disputes are to be deliberated.

In the opinion of the Company's legal counsel, it cannot be determined at this stage whether a claim would be filed, what measures may be required under such claim or what the chances of such claim may be.

- f) On December 3, 2002, an application for the approval of a class action against the Company, the Cable and Satellite Broadcast Council and the Ministry of Communications was filed in connection with the broadcasts of Sports Channel 5+. The applicants allege that the broadcasts of Channel 5+ contravene the terms stipulated in the Council's approval for its broadcasts, by draining Channel 5 of content in contravention of the aforementioned approval.

The applicants accuse the Company of alleged deceit, breach of contractual obligations of trust and good faith, fundamental breach of the contract between the Company and its customers, and unjust enrichment. In respect of the above, the applicants estimate that the action amounts to NIS 126 million as of the date of submitting the claim, with a further NIS 10.5 million being added for every month between the date of submitting the claim until judgment.

The Company has submitted its response to the application, requesting to reject the application in limine or, alternatively, reject the underlying claim or the application for its approval as a class action.

In the opinion of the company's legal counsel, at this stage it is difficult to estimate the chances of the claim being approved as a class action, and — if it is so approved — what the chances are of its success. Therefore, no provision was made in respect of this application.

- g) On January 30, 2003, a letter was received from the Ministry of Communications, claiming that the arrangement under which the Company receives deposits from its subscribers in an amount less than the value of the decoder lent, from which it deducts up to 10% of the value of the decoder every year (hereafter — the arrangement) is unlawful and in contradiction of the terms of the License and the subscriber agreements.

In addition, the Company is required to cease the abovementioned arrangement and reimburse monies to all its subscribers from the deposits of which it had deducted amounts in accordance with the arrangement. According to a preliminary assessment made by the Company, the amounts deducted as above mentioned from costumers who had terminated their contract with the Company aggregates approximately adjusted NIS 2 million. In a response letter sent by the Company and its legal counsel, the Company argues that the arrangement is lawful and substantially economic for its customers.

In the opinion of the Company's legal counsel, it is difficult to estimate at this stage what measures, if any, the Ministry of Communications will take to enforce its demands as above. Therefore, no provision was included in respect of this claim.

NOTE 7 — Share Capital:

- a. The share capital is composed of ordinary shares of NIS 1 par value, as follows:

| | <u>December 31</u> | |
|-----------------------|--------------------|---------------|
| | <u>2002</u> | <u>2001</u> |
| | Number of shares | |
| Authorized | <u>36,000</u> | <u>36,000</u> |
| Issued and paid | <u>19,888</u> | <u>10,000</u> |

- b. **Stock options to employees**

The employment agreements with certain employees entitle them to participate in an employee stock option plan, should the Company choose to adopt one, under which options would be granted for the purchase of Company shares. The exact number of options to be granted to each employee under such plan will be determined at the sole discretion of the Company's management.

In accordance with the Company's employment agreements with some of its senior employees, each of these employees is to be granted options for the purchase of Company shares, by way of allotment of ordinary shares of NIS 1 par value, at par, so that after the options are exercised, the number of shares held by each of said employees would range between 0.2% and 0.8% of the Company's issued share capital as on the date of the signing of each agreement.

Each employee would be entitled to exercise the options in purchase of the number of shares stipulated in the agreement with such employee. To date of approval of these financial statements, the Company has not adopted an employee stock option plan.

See also note 13a(3).

NOTE 8 — Taxes on Income:**a. Measurement of results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985 (hereafter — the inflationary adjustments law)**

Under the inflationary adjustments law, results for tax purposes are measured in real terms, having regard to the changes in the CPI. The Company is taxed under this law.

b. Tax rates applicable to the Company

The income of the Company will be taxed at the regular rate of 36%.

c. Losses for tax purposes carried forward to future years

Carryforward losses as of December 31, 2002, amount to adjusted NIS 2,259 million. Under the inflationary adjustments law, carryforward losses are linked to the CPI and can be utilized indefinitely.

Due to the uncertainty of their utilization in the foreseeable future, the Company has not created deferred taxes in its accounts in respect of these losses.

d. Tax assessments

The Company has not been assessed for tax purposes since incorporation.

NOTE 9 — Linkage Terms of Monetary Balances:**a. As follows:**

| | December 31, 2002 | | |
|---|------------------------------------|------------------|------------------|
| | In dollars or linked thereto | CPI linked | Unlinked |
| | Adjusted NIS in thousands | | |
| Assets — current: | | | |
| Cash and cash equivalents | 4,519 | | 3 |
| Accounts receivable: | | | |
| Trade | | | 106,266 |
| Other | | | 4,845 |
| | <u>4,519</u> | | <u>111,114</u> |
| Liabilities: | | | |
| Current liabilities: | | | |
| Accounts payable and accruals: | | | |
| Trade | 196,569 | | 327,357 |
| Other | | 21,138 | 46,417 |
| Bank credit | | 105,030 | 1,020,554 |
| Long-term liabilities: | | | |
| Customer deposits — net | | 42,060 | |
| Other liability, (including current maturity) | | 28,662 | |
| Shareholders' loans | | 2,091,371 | |
| | <u>196,569</u> | <u>2,288,261</u> | <u>1,394,328</u> |

b. Data regarding the exchange rate and the CPI:

| | Exchange rate of one U.S. dollar | CPI* |
|--------------------------------------|--|--------------|
| At end of year: | | |
| 2002..... | NIS 4.737 | 182.0 points |
| 2001..... | NIS 4.416 | 170.9 points |
| 2000..... | NIS 4.041 | 168.5 points |
| 1999..... | NIS 4.153 | 168.5 points |
| Increase (decrease) during the year: | | |
| 2002..... | 7.3% | 6.5% |
| 2001..... | 9.3% | 1.4% |
| 2000..... | (2.7)% | 0.0% |

* Based on the index for the month ending on each balance sheet date, on the basis of 1993 average = 100.

NOTE 10 — Liabilities Secured by Liens and Restrictions Imposed in Connection with Liabilities:

a. Following is the balance of secured liabilities and guarantees of the Company:

| | December 31 | |
|--------------------------------|---------------------------|---------|
| | 2002 | 2001 |
| | Adjusted NIS in thousands | |
| Liabilities — bank credit..... | 1,125,584 | 939,826 |
| Guarantees..... | 66,765 | 55,713 |

b. To secure the abovementioned liabilities and guarantees, the Company registered a lien on all its assets, including share capital and goodwill.

c. As to the financing agreements that the Company signed with banks which, inter alia, stipulates prerequisite conditions for the utilization of credit lines within the facility, including undertakings by the Company to meet certain suspending conditions as well as specified cumulative milestones and financial stipulations — see note 1a(2)(b).

NOTE 11 — Supplementary Financial Statement Information:

Balance sheets:

a. Accounts receivable:

1) Trade:

This item net of an allowance for doubtful accounts of adjusted NIS 10,924,000 (December 31, 2001 — approximately adjusted NIS 5,679,000).

2) Other:

| | December 31 | |
|--|------------------------------|---------------|
| | 2002 | 2001 |
| | Adjusted NIS in thousands | |
| Institutions (December 31, 2001 — mainly VAT)..... | 128 | 19,936 |
| Advances to suppliers of purchased channels..... | | 8,729 |
| Other..... | 4,717 | 3,104 |
| | <u>4,845</u> | <u>31,769</u> |

b. Bank credit:

- 1) Classified by currency, linkage basis and interest rates, the credit is as follows:

| | December 31 | | |
|------------------|----------------|------------------------------|----------------|
| | 2002 | 2002 | 2001 |
| | Interest rates | Amount | |
| | % | Adjusted NIS in thousands | |
| CPI linked | 5 | 105,030 | |
| Unlinked | 11.2 | <u>1,020,554</u> | <u>939,826</u> |
| | | <u>1,125,584</u> | <u>939,826</u> |

- 2) As to securities and restrictions imposed in connection with credit — see note 10.

c. Accounts payable and accruals:

| | December 31 | |
|---|------------------------------|----------------|
| | 2002 | 2001 |
| | Adjusted NIS in thousands | |
| 1) Trade: | | |
| Open accounts* | 407,660 | 516,125 |
| Checks and notes payable | <u>130,592</u> | <u>37,169</u> |
| | <u>538,252</u> | <u>553,294</u> |
| * Including content suppliers | <u>48,780</u> | <u>93,944</u> |
| 2) Other: | | |
| Employees and employee institutions | 14,804 | 16,441 |
| Provision for vacation and recreation pay | 12,224 | 8,273 |
| Customer deposits | 15,932 | 6,778 |
| Institutions | 18,445 | |
| Income received in advance | 11,310 | |
| Sundries | <u>6,150</u> | <u>432</u> |
| | <u>78,865</u> | <u>31,924</u> |

d. Other liability:

On January 3, 2002, the Company filed a claim against Baran Raviv Telecom Ltd. (hereafter — Baran Raviv). The Company claims, inter alia, that Baran Raviv has failed to fulfill its duties according to the agreement between the two, in which Baran Raviv undertakes to establish, manage and operate an array for the installation of user end equipment for the reception of the Company's broadcasts, as an independent contractor, on behalf of the Company.

The balance of the Company's liabilities to Baran Raviv, according to the settlement reached on February 2002, was NIS 55.5 million, linked to the known CPI. The balance is payable in quarterly installments until the end of 2004. The basic CPI was determined according to the index for January 2002.

The balance of the Company's liabilities to Baran Raviv under the settlement are presented in the financial statements as follows:

| | December 31 | |
|---------------------------------|------------------------------|---------------|
| | 2002 | 2001 |
| | Adjusted NIS in thousands | |
| Among current liabilities | 14,326 | 30,234 |
| As a long-term liability | <u>14,336</u> | <u>28,870</u> |
| | <u>28,662</u> | <u>59,104</u> |

e. Cost of broadcasting rights

The cost as of December 31, 2002 is presented net of fully utilized rights in the amount of Adjusted NIS 151,794,000 (December 31, 2001 — adjusted NIS 46,274,000).

Statements of operations:

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|---------------------------|----------------|----------------|
| | Adjusted NIS in thousands | | |
| f. Operating expenses**: | | | |
| Salaries and employee related expenses..... | 107,464 | 82,144 | 14,933 |
| Content costs | 266,033 | *236,977 | 114,283 |
| Amortization of broadcasting rights utilized | 149,386 | 79,746 | 35,004 |
| Consumption of space segments | 106,857 | 71,230 | 37,614 |
| Depreciation and amortization | 322,243 | 194,475 | 53,995 |
| Other | 137,758 | 102,590 | 24,193 |
| | <u>1,089,741</u> | <u>767,162</u> | <u>280,022</u> |
| g. Selling and marketing expenses: | | | |
| Salaries and employee related expenses..... | 51,605 | 85,660 | 62,407 |
| Advertising | 45,432 | 69,070 | 82,034 |
| Marketing consultation | 5,384 | 8,290 | 17,097 |
| Other | 16,936 | *40,224 | 15,510 |
| | <u>119,357</u> | <u>203,244</u> | <u>177,048</u> |
| h. General and Administrative expenses: | | | |
| Salaries and employee related expenses..... | 41,472 | 61,233 | 40,336 |
| Consultation and professional fees | 8,023 | 14,310 | 44,850 |
| Rent and maintenance | 14,787 | 14,910 | 9,267 |
| Depreciation | 27,033 | 22,038 | 12,255 |
| Allowance for doubtful accounts | 5,667 | 5,461 | 245 |
| Other | 20,049 | *30,314 | 26,851 |
| | <u>117,031</u> | <u>148,266</u> | <u>133,804</u> |
| i. Financial expenses — net: | | | |
| In respect of bank credit | 41,555 | 76,645 | 25,534 |
| Credit agreement fees | 1,420 | 21,518 | |
| Other — net..... | 5,109 | 2,891 | (745) |
| | <u>48,084</u> | <u>101,054</u> | <u>24,789</u> |

* Reclassified.

**the operating expenses for 2000 relate to the period from July 1, 2000 to December 31, 2000 (see note 1a(1)).

NOTE 12 — Financial Instruments and Risk Management:

a. Concentration of credit risks

The cash and cash equivalents as of December 31, 2002 and 2001 are deposited with Israeli banks. The Company is of the opinion that the credit risk in respect of these balances is remote.

The Company's revenues are received in Israel from a large number of customers. Consequently, the balance of the Company's trade receivables does not represent a significant concentration of credit risk as of December 31, 2002.

b. Fair value of financial instruments

The Company's financial instruments as of December 31, 2002 and 2001 are composed mainly of non-derivative assets and liabilities (which include working capital and long-term liabilities). In view of their nature, the fair value of the financial instruments included in

working capital is usually close or identical to their carrying value. As to shareholders' loans, see note 4.

NOTE 13 — Transactions and Balances with Interested Parties:

a. Transactions with interested parties:

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---|----------------------------------|----------------|---------------|
| | <u>Adjusted NIS in thousands</u> | | |
| 1) Operating expenses | <u>156,921</u> | <u>100,646</u> | <u>50,727</u> |
| Selling and marketing, administrative and general expenses | <u>6,804</u> | <u>21,499</u> | <u>13,093</u> |
| 2) Benefits to interested parties — salary to an interested party employed by the Company and a director's fees | <u>2,644</u> | <u>3,342</u> | <u>2,963</u> |

3) Under the employment agreement with the CEO of the Company, the Company is to allot him options exercisable in purchase of ordinary shares of NIS 1 par value of the Company, subject to the adoption of a stock option plan by the Company's board of directors. The options will be granted at no consideration and will be exercisable in purchase of a number of shares representing 0.8% of the Company's issued and paid share capital as of the date of the agreement.

To date of approval of these financial statements, the Company has not adopted an employee stock option plan.

4) Under the employment agreement with a former CEO of the Company, he will be entitled to require the Company to purchase from him the shares underlying exercise of the options to which he is entitled on the date he ended his office — 0.25% of the Company's share capital — at a price which will be set according to an estimated Company valuation which will be made within 60 days of the date on which the CEO gave written notice to the Company of his wish to require the Company to purchase the aforesaid shares from him. The CEO's right to require the Company to purchase the shares from him will be valid for a period of two years from the date of his severance, and so long as the Company's shares have not been listed on the stock exchange.

To date of approval of these financial statements, the former CEO has not notified the Company of his intention to require the Company to purchase the shares from him.

b. Balances with interested parties:

| | <u>December 31</u> | |
|---|----------------------------------|------------------|
| | <u>2002</u> | <u>2001</u> |
| | <u>Adjusted NIS in thousands</u> | |
| 1) Shareholders' loans (see note 4) | <u>2,091,371</u> | <u>1,670,418</u> |
| 2) Current liabilities — presented in the balance sheets under "accounts payable and accruals" | <u>175,837</u> | <u>71,440</u> |

c. The Company has entered into an agreement with an interested party for the import of digital satellite decoders. In the year ended December 31, 2002, the Company purchased decoders for the total amount of approximately adjusted NIS 210 million (2001 — approximately adjusted NIS 252 million).

d. The Company has entered into an agreement with an interested party for the lease of space segments, see note 6.

NOTE 14 — Nominal Data of the Company:

a. Balance sheet data

| | <u>Nominal NIS in thousands</u> | |
|--|---------------------------------|------------------|
| | <u>December 31</u> | |
| | <u>2002</u> | <u>2001</u> |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | 4,522 | 21 |
| Accounts receivable: | | |
| Trade | 106,266 | 56,967 |
| Other | 4,845 | 29,831 |
| | <u>115,633</u> | <u>86,819</u> |
| Broadcasting rights: | | |
| Cost | 241,278 | 286,574 |
| Less — utilized rights | 106,711 | 64,300 |
| | <u>134,567</u> | <u>222,274</u> |
| Fixed assets: | | |
| Cost | 1,842,404 | 1,484,682 |
| Less — accumulated depreciation | 574,567 | 254,135 |
| | <u>1,267,837</u> | <u>1,230,547</u> |
| License fees — advance on account of royalties | 4,583 | 26,192 |
| | <u>1,522,620</u> | <u>1,565,832</u> |
| Liabilities, net of capital deficiency | | |
| Current liabilities: | | |
| Accounts payable and accruals: | | |
| Trade | 538,252 | 519,551 |
| Other | 78,865 | 29,977 |
| | <u>617,117</u> | <u>549,528</u> |
| Bank credit | 1,125,584 | 882,510 |
| Total current liabilities | <u>1,742,701</u> | <u>1,432,038</u> |
| Long-term liabilities: | | |
| Liability for employee rights upon retirement, net | 2,840 | 1,151 |
| Customer deposits | 42,060 | 19,241 |
| Other liability, net of current maturity | 14,336 | 27,110 |
| Total long-term liabilities | <u>59,236</u> | <u>47,502</u> |
| Shareholders' loans | <u>2,091,371</u> | <u>1,568,546</u> |
| Total liabilities | 3,893,308 | 3,048,086 |
| Capital deficiency, see c. below | (2,370,688) | (1,482,254) |
| | <u>1,522,620</u> | <u>1,565,832</u> |

b. Operating results data

| | Nominal NIS in thousands | | |
|---|--------------------------|----------------|----------------|
| | 2002 | 2001 | 2000 |
| Revenues | 665,865 | 305,011 | 26,281 |
| Operating expenses | 1,056,700 | *716,126 | 245,786 |
| Gross loss | 390,835 | 411,115 | 219,505 |
| Selling and marketing expenses..... | 117,755 | *189,906 | 183,729 |
| General and Administrative expenses | 113,966 | *138,352 | 117,553 |
| Loss from ordinary operations | 622,556 | 739,373 | 520,787 |
| Financial expenses, net | 245,845 | 115,348 | 23,151 |
| Other expenses | 20,042 | | |
| Loss for the year — nominal | <u>888,443</u> | <u>854,721</u> | <u>543,938</u> |

* Reclassified.

c. Changes in capital deficiency:

| | Nominal NIS in thousands | | | |
|-----------------------------------|--------------------------|-------------------------------|---------------------|--------------------|
| | Share capital | Receipts on account of shares | Accumulated deficit | Total |
| Balance at January 1, 2000..... | * | 1 | (83,605) | (83,604) |
| Changes during 2000: | | | | |
| Issuance of share capital | 10 | (1) | | 9 |
| Loss | — | — | (543,938) | (543,938) |
| Balance at December 31, 2000..... | 10 | — | (627,543) | (627,533) |
| Changes during 2001 — loss | — | — | (854,721) | (854,721) |
| Balance at December 31, 2001..... | 10 | — | (1,482,264) | (1,482,254) |
| Changes during 2002: | | | | |
| Issuance of share capital | 9 | — | | 9 |
| Loss | — | — | (888,443) | (888,443) |
| Balance at December 31, 2002..... | <u>19</u> | <u>—</u> | <u>(2,370,707)</u> | <u>(2,370,688)</u> |

* Represents an amount of less than NIS 1,000.

“BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2003

Contents

| | <u>Page</u> |
|--|-------------|
| Auditors’ Review Report | 180 |
| Interim Consolidated Financial Statements (unaudited) | |
| Interim Consolidated Balance Sheet | 181 |
| Interim Consolidated Statement of Operations | 183 |
| Interim Statement of Changes in Shareholders’ Equity | 184 |
| Interim Consolidated Statement of Cash Flows | 185 |
| Notes to the Interim Consolidated Financial Statements | 187 |
| Appendix B — Financial Statements of D.B.S. Satellite Services (1998) Ltd..... | 209 |

**The Board of Directors of
"Bezeq" — The Israel Telecommunications Corp. Limited**

Dear Sirs,

**Re: Review of the Unaudited Interim Consolidated Financial Statements
for the Nine Month and Three Month Periods Ended September 30, 2003**

At your request we have reviewed the interim consolidated balance sheet of "Bezeq" — The Israel Telecommunication Corp. Limited and its subsidiaries as at September 30, 2003, as well as the interim consolidated statement of operations, the interim statement of changes in shareholders' equity and the interim consolidated statement of cash flows for the nine month and the three 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 interim financial statements of subsidiaries, whose assets as at September 30, 2003, constitute approximately 21.8% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 36.4% and approximately 37.5% of the total revenues included in the interim consolidated statement of operations for the nine months and the three months then ended. Furthermore, the data contained in the interim consolidated financial statements, which relate to the net asset value of the Company's investments in affiliated companies and to its equity in their operating results, is based on interim financial statements which were reviewed by other auditors.

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.

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

1. The anticipated 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 of early retirement, as described in Note 6.
3. Claims made against the Company and against investee companies, as described in Note 7A.
4. The financial position of an affiliated company. As described in Note 4A, the continuation of the activities of the affiliated company is dependent upon the execution of the Amendment to the Financing Agreement which was signed with the banking institutions and the receipt of additional loans from shareholders.

Somekh Chaikin
Certified Public Accountants (Isr.)
A member firm of KPMG International

November 11, 2003

Interim Consolidated Balance Sheet
In adjusted shekels of September 2003

| | September 30 2003 | September 30 2002 | December 31 2002 |
|--|------------------------------|------------------------------|----------------------------|
| | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Audited) NIS thousands |
| Current assets | | | |
| Cash and cash equivalents | 890,766 | 1,083,602 | 977,653 |
| Short-term investments | 1,376,068 | 815,430 | 1,162,482 |
| Trade receivables | 1,719,444 | 1,750,833* | 1,725,860 |
| Other receivables and debit balances | 463,097 | 408,664 | 507,079 |
| Inventory | 102,058 | 177,805 | 164,885 |
| | <u>4,551,433</u> | <u>4,236,334</u> | <u>4,537,959</u> |
| Materials and spare parts | <u>148,534</u> | <u>158,151</u> | <u>120,366</u> |
| Investments and long-term receivables | | | |
| Investments, deposits and debit balances | 640,998 | 1,533,194* | 757,346 |
| Investments in investee companies | 288,209 | 426,220 | 384,257 |
| | <u>929,207</u> | <u>1,959,414</u> | <u>1,141,603</u> |
| Fixed assets | | | |
| Cost | 30,401,375 | 30,393,799 | 29,509,683 |
| Less — accumulated depreciation | 21,222,821 | 20,441,402 | 19,688,402 |
| | <u>9,178,554</u> | <u>9,952,397</u> | <u>9,821,281</u> |
| Other assets | | | |
| Deferred charges and other assets | 232,342 | 280,643 | 278,581 |
| Deferred taxes | 456,781 | 446,520 | 396,080 |
| | <u>689,123</u> | <u>727,163</u> | <u>674,661</u> |
| | <u>15,496,851</u> | <u>17,033,459</u> | <u>16,295,870</u> |

* Reclassified

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

| | September 30 2003 | September 30 2002 | December 31 2002 |
|--|------------------------------|------------------------------|----------------------------|
| | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Audited) NIS thousands |
| Current liabilities | | | |
| Bank credit | 189,249 | 397,727 | 520,939 |
| Current maturities of: | | | |
| Long-term bank loans | 649,889 | 588,944 | 536,934 |
| Debentures | 599,272 | 200,319 | 207,158 |
| Trade payables | 998,645 | 911,546 | 1,136,163 |
| Employee severance benefits | 138,723 | 234,155 | 209,460 |
| Other current liabilities | <u>1,433,372</u> | <u>1,084,314*</u> | <u>1,101,428</u> |
| | <u>4,009,150</u> | <u>3,417,005</u> | <u>3,712,082</u> |
| Long-term liabilities | | | |
| Long-term loans | 1,889,208 | 2,322,397 | 2,071,997 |
| Debentures | 2,253,061 | 2,691,760 | 2,727,831 |
| Employee severance benefits | 780,141 | 1,163,315 | 1,122,822 |
| Deferred revenues | <u>31,678</u> | <u>48,203</u> | <u>43,973</u> |
| | <u>4,954,088</u> | <u>6,225,675</u> | <u>5,966,623</u> |
| Minority rights | <u>37</u> | <u>—</u> | <u>566</u> |
| Contingent liabilities (Note 7) | | | |
| Shareholders' equity | <u>6,533,576</u> | <u>7,390,779</u> | <u>6,616,599</u> |
| | <u>15,496,851</u> | <u>17,033,459</u> | <u>16,295,870</u> |

* Reclassified

Adv. Miriam (Miki) Mazar
Chairperson of the Board

Amnon Dick
Chief Executive Officer

Ron Eilon
Chief Financial Officer

Date of approval of the financial statements: November 11, 2003

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

Interim Consolidated Statement of Operations

In adjusted shekels of September 2003

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|--|---|------------------------------|--|------------------------------|-----------------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Audited) NIS thousands |
| Revenues from telecommunications services (Note 9) | 6,037,917 | 6,102,668* | 2,087,501 | 2,055,575* | 8,095,909* |
| Costs and expenses | | | | | |
| Operating and general expenses (Note 10) | 3,372,462 | 3,390,127* | 1,163,053 | 1,154,368* | 4,544,146* |
| Depreciation | 1,624,829 | 1,715,804 | 537,975 | 573,831 | 2,279,330* |
| Royalties to the Government of Israel | 184,023 | 186,958 | 62,278 | 56,094 | 251,153 |
| | <u>5,181,314</u> | <u>5,292,889</u> | <u>1,763,306</u> | <u>1,784,293</u> | <u>7,074,629</u> |
| Operating income | 856,603 | 809,779 | 324,195 | 271,282 | 1,021,280 |
| Financing expenses, net | <u>130,592</u> | <u>151,896</u> | <u>46,332</u> | <u>80,926</u> | <u>165,981</u> |
| Earnings after financing expenses ... | 726,011 | 657,883 | 277,863 | 190,356 | 855,299 |
| Other expenses, net (Note 11) | <u>321,443</u> | <u>385,321</u> | <u>282,154</u> | <u>390,851</u> | <u>1,224,702</u> |
| Earnings (loss) before income tax | 404,568 | 272,562 | (4,291) | (200,495) | (369,403) |
| Income tax | <u>175,327</u> | <u>178,231</u> | <u>9,656</u> | <u>24,336</u> | <u>208,168</u> |
| Earnings (loss) after income tax | 229,241 | 94,331 | (13,947) | (224,831) | (577,571) |
| Equity in losses of affiliates | 228,018 | 238,867 | 71,521 | 114,027 | 341,896 |
| Minority share in losses of a consolidated company | <u>(585)</u> | <u>(2,268)</u> | <u>(351)</u> | <u>(739)</u> | <u>(3,019)</u> |
| Net earnings (loss) | <u><u>1,808</u></u> | <u><u>(142,268)</u></u> | <u><u>(85,117)</u></u> | <u><u>(338,119)</u></u> | <u><u>(916,448)</u></u> |
| Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS) | <u><u>0.001</u></u> | <u><u>(0.059)</u></u> | <u><u>(0.035)</u></u> | <u><u>(0.140)</u></u> | <u><u>(0.380)</u></u> |

* Reclassified

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

Interim Statement of Changes in Shareholders' Equity
In adjusted shekels of September 2003

| | <u>Share capital</u> | <u>Capital reserve — share premium</u> | <u>Capital reserve in respect of transactions between the Company and a controlling shareholder</u> | <u>Dividend proposed subsequent to the balance sheet date</u> | <u>Retained earnings (deficit)</u> | <u>Total</u> |
|---|--------------------------|--|---|---|--|------------------|
| | NIS thousands | | | | | |
| Nine months ended September 30, 2003 | | | | | | |
| Balance as at December 31, 2002 (audited) | 6,140,991 | 941,910 | 37,926 | 187,167 | (691,395) | 6,616,599 |
| Allotment of shares (unaudited) ... | 23,342 | 77,920 | — | — | — | 101,262 |
| Dividend paid (unaudited) | — | — | — | (187,167) | 1,074 | (186,093) |
| Net earnings (unaudited) | — | — | — | — | 1,808 | 1,808 |
| Balance as at September 30, 2003 (unaudited) | <u>6,164,333</u> | <u>1,019,830</u> | <u>37,926</u> | <u>—</u> | <u>(688,513)</u> | <u>6,533,576</u> |
| Three months ended September 30, 2003 | | | | | | |
| Balance as at July 1, 2003 (unaudited) | 6,140,991 | 941,910 | 37,926 | — | (603,396) | 6,517,431 |
| Allotment of shares (unaudited) ... | 23,342 | 77,920 | — | — | — | 101,262 |
| Net loss (unaudited) | — | — | — | — | (85,117) | (85,117) |
| Balance as at September 30, 2003 (unaudited) | <u>6,164,333</u> | <u>1,019,830</u> | <u>37,926</u> | <u>—</u> | <u>(688,513)</u> | <u>6,533,576</u> |
| Nine months ended September 30, 2002 | | | | | | |
| Balance as at December 31, 2001 (audited) | 6,140,991 | 941,910 | 37,926 | — | 412,220 | 7,533,047 |
| Net loss (unaudited) | — | — | — | — | (142,268) | (142,268) |
| Balance as at September 30, 2002 (unaudited) | <u>6,140,991</u> | <u>941,910</u> | <u>37,926</u> | <u>—</u> | <u>269,952</u> | <u>7,390,779</u> |
| Three months ended September 30, 2002 | | | | | | |
| Balance as at July 1, 2002 (unaudited) | 6,140,991 | 941,910 | 37,926 | — | 608,071 | 7,728,898 |
| Net loss (unaudited) | — | — | — | — | (338,119) | (338,119) |
| Balance as at September 30, 2002 (unaudited) | <u>6,140,991</u> | <u>941,910</u> | <u>37,926</u> | <u>—</u> | <u>269,952</u> | <u>7,390,779</u> |
| Year ended December 31, 2002 | | | | | | |
| Balance as at December 31, 2001 (audited) | 6,140,991 | 941,910 | 37,926 | — | 412,220 | 7,533,047 |
| Net loss (audited) | — | — | — | — | (916,448) | (916,448) |
| Dividend proposed subsequent to the balance sheet date (audited) | — | — | — | 187,167 | (187,167) | — |
| Balance as at December 31, 2002 (audited) | <u>6,140,991</u> | <u>941,910</u> | <u>37,926</u> | <u>187,167</u> | <u>(691,395)</u> | <u>6,616,599</u> |

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

Interim Consolidated Statement of Cash Flows
In adjusted shekels of September 2003

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|--|---|--------------------------------------|--|--------------------------------------|------------------------------------|
| | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2002 (Audited) NIS thousands |
| Cash flows from operating activities | | | | | |
| Net earnings (loss) | 1,808 | (142,268) | (85,117) | (338,119) | (916,448) |
| Adjustments to reconcile net earnings (loss) to net cash flows from operating activities (see A below) | 1,983,565 | 1,970,805* | 638,618 | 869,263* | 3,758,017* |
| Net cash derived from operating activities | 1,985,373 | 1,828,537 | 553,501 | 531,144 | 2,841,569 |
| Cash flows from investing activities | | | | | |
| Investment in fixed assets | (1,166,705) | (907,411) | (442,840) | (364,776) | (1,359,365) |
| Proceeds from disposal of fixed assets | 61,112 | 13,570 | 52,866 | 5,290 | 24,790 |
| Proceeds from disposal of investment in affiliated companies | — | 109,950 | — | — | 117,286 |
| Investment in long-term deposits and investments | (16,427) | (147,919)* | (11,441) | (59,698)* | (287,422)* |
| Proceeds from long-term deposits and investments | 35,794 | 150,714 | 9,032 | 25,381 | 160,388 |
| Increase in short-term investments, net | (169,730) | (419,454) | (49,155) | (420,994) | (757,347) |
| Decrease (increase) in materials and spare parts | (21,584) | (18,989) | 8,646 | (20,114) | 22,861 |
| Acquisition of a partnership consolidated for the first time (see B below) | — | — | — | — | (3,876) |
| Investment in investee companies .. | (158,223) | (298,654) | (42,494) | (77,976) | (360,963) |
| Investment in other assets | (43,250) | (98,822) | (10,278) | (13,559) | (126,837) |
| Net cash used in investing activities | (1,479,013) | (1,617,015) | (485,664) | (926,446) | (2,570,485) |
| Cash flows from financing activities | | | | | |
| Issuance of debentures (subsequent to deduction of issuance expenses) | — | 107,417 | — | — | 107,417 |
| Repayment of debentures | (180,025) | (201,093) | (27,189) | (25,461) | (222,277) |
| Receipt of long-term loans | 418,359 | 193,814 | 217,001 | 1,812 | 208,167 |
| Repayment of long-term loans | (415,060) | (548,381) | (128,900) | (307,504) | (829,932) |
| Receipt (repayment) of short-term bank credit, net | (331,690) | (46,627) | (273,599) | 172,701 | 76,244 |
| Proceeds from allotment of shares ... | 101,262 | — | 101,262 | — | — |
| Dividend paid | (186,093) | — | — | — | — |
| Net cash used in financing activities | (593,247) | (494,870) | (111,425) | (158,452) | (660,381) |
| Decrease in cash and cash equivalents | (86,887) | (283,348) | (43,588) | (553,754) | (389,297) |
| Balance of cash and cash equivalents at the beginning of the period | 977,653 | 1,366,950 | 934,354 | 1,637,356 | 1,366,950 |
| Balance of cash and cash equivalents at the end of the period | 890,766 | 1,083,602 | 890,766 | 1,083,602 | 977,653 |

* Reclassified

The notes to the financial statements are integral part thereof.

Interim Consolidated Statement of Cash Flows (Contd.)
In adjusted shekels of September 2003

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|---|---|--------------------------------------|--|--------------------------------------|------------------------------------|
| | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2002 (Audited) NIS thousands |
| A — Adjustments to reconcile net earnings to net cash flows provided by operating activities | | | | | |
| Revenue and expenses not involving cash flows: | | | | | |
| Depreciation | 1,624,829 | 1,715,804 | 537,975 | 573,831 | 2,279,330* |
| Deferred taxes | 8,171 | 46,237 | (24,349) | (3,973) | 30,271 |
| Company's equity in losses of affiliated companies | 228,018 | 238,867 | 71,521 | 114,027 | 341,896 |
| Minority share in losses of a consolidated company | (585) | (2,268) | (351) | (739) | (3,019) |
| Decrease in employee severance benefits, net | (413,418) | (216,915) | (353,195) | (117,200) | (282,101) |
| Loss (gain) on disposal of fixed assets .. | 8,574 | (7,184) | 4,707 | (1,785) | (12,790) |
| Provision for impairment in value of fixed assets | 52,625 | — | 52,625 | — | — |
| Provision for decrease in value of investments | 63,169 | 392,713 | 28,008 | 392,713 | 1,237,616 |
| Erosion (appreciation) and interest on long-term investments and debts | 55,368 | (200,766) | (69,415) | (26,357) | (205,163)* |
| Erosion of short-term investments, net .. | (43,856) | 66,306 | (21,574) | 4,908 | 57,145 |
| Appreciation (erosion) of long-term liabilities: | | | | | |
| Debentures | 97,368 | 141,718 | 97,087 | 16,857 | 205,810 |
| Long-term loans | (62,720) | 20,580 | 56,484 | 31,915 | (13,434) |
| Amortization of deferred expenses and other adjustments | 96,637 | 177,865 | 19,179 | 58,621 | 230,585* |
| Changes in current assets and liabilities: | | | | | |
| Decrease (increase) in trade receivables | (8,430) | (6,074)* | (15,627) | (20,220)* | 29,540* |
| Decrease (increase) in receivables and debit balances | 57,899 | (23,564) | (53,095) | 4,382 | 4,905 |
| Decrease (increase) in inventory | 61,163 | (56,899) | 13,708 | 13,199 | (44,983) |
| Increase (decrease) in trade payables ... | (98,130) | (173,198) | 136,164 | (114,495) | 51,263 |
| Increase (decrease) in other current liabilities | 269,178 | (129,737) | 162,583 | (52,135) | (131,945) |
| Decrease in deferred revenues | (12,295) | (12,680) | (3,817) | (4,286) | (16,909) |
| | <u>1,983,565</u> | <u>1,970,805*</u> | <u>638,618</u> | <u>869,263*</u> | <u>3,758,017*</u> |
| B — Partnership consolidated for the first time | | | | | |
| Working capital (excluding cash and ... cash equivalents) | | | | | 6,530 |
| Fixed assets | | | | | (6,043) |
| Long-term liabilities | | | | | 797 |
| Minority rights as at the acquisition date | | | | | 726 |
| Investment in an affiliated company | | | | | 1,071 |
| Goodwill | | | | | (6,957) |
| | | | | | <u>(3,876)</u> |
| C — Non-cash transactions | | | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit ... | <u>171,213</u> | <u>153,820</u> | <u>171,213</u> | <u>153,820</u> | <u>209,091</u> |
| Sale of fixed assets on credit | <u>—</u> | <u>5,821</u> | <u>—</u> | <u>5,821</u> | <u>5,824</u> |

* Reclassified

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

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited)**

NOTE 1 — GENERAL

A. The interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim financial statements. These statements should be read in conjunction with the Company's annual financial statements as at December 31, 2002 and for the year then ended and the related accompanying notes.

B. In the notes to the interim financial statements, the Company presents only the 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, the opening of these markets to competition and decisions of the Ministerial Committee for Privatization to reduce the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2002. The significant changes that occurred from the date of those annual financial statements to the date of these financial statements, are as follows:

1. In March 2003 the Committee for Regulating the Tariffs of Bezeq presented a report containing its recommendations. The recommendations were approved and amended by the Ministers, and on August 5, 2003, the Knesset Finance Committee approved the recommendations with certain modifications. The changes in the Company's tariffs as approved by the Finance Committee are as follows:

a. Commencing on September 1, 2003, the overall average level of the Company's tariffs will be lowered compared with the level set in the last tariff update (May 1, 2002) by an average of 5.97% in nominal terms, through a combined process whereby call tariffs will be reduced by 23.84%, fixed monthly fees will be increased by 12.8% (monthly fees for reduced use remain unchanged) and call completion tariffs in a telecommunications network and international interconnect tariffs will be reduced by an average 8.2%.

The lowering of the Company's tariffs includes cancellation of the minimum call tariff (set at 22.5 agorot including VAT), setting tariffs of 13 agorot (including VAT) per call minute during peak hours and 5.5 agorot (including VAT) per call minute in off-peak hours.

b. Tariff updates in the future will be based on the rise in the CPI less an "efficiency coefficient" of minus 2.5% as long as the Company's average output growth is in the range of minus 1% to minus 3% per year (the efficiency coefficient will decrease by one half of one percent with each decrease of 1% in the growth rate beyond minus 3% and will increase by one half of one percent with each successive rise of one percent in the growth rate beyond minus 1%).

c. This arrangement will remain in effect until December 31, 2007, with an option to extend it for a further year, where the date of the tariff update (after the first one) will be June 1st of each year.

The above changes in the Company's tariffs took effect on September 1, 2003, and led to a decrease in the revenues and operating income of the Company. The Company believes, based on its projections, that the above tariff reductions can be expected to have a materially adverse effect on its revenues and operating income.

2. Further to Note 1E(1) in the financial statements as at December 31, 2002, concerning a reduced deduction rate for the cellular companies due to the bad debts component generated in respect of calls from Company subscribers to cellular company subscribers, in July 2003 the Ministry of Communications announced its decision on the matter as follows:

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

- a. For the period from October 2, 2000, through August 31, 2003, the deduction rate will be 1.1%. This rate will be applied to all the cellular operators even if the Company had reached arrangements with some of them.
- b. For the period from September 1, 2003, and thereafter, the Company will be required to transfer interconnect fees to the cellular companies according to actual traffic minutes, with no deduction of any kind. Based on the recommendation in the report of the Committee for Regulating Communications Tariffs, this matter will be reflected in the next Company tariff update in September 2003, subject to receipt of the approvals required by law. (It is noted that in accordance with the decision of the Ministers to approve the recommendations of the Committee for Regulating Communications Tariffs, the additional revenues deriving to the Company in respect of their decision, compared with the recommendations of the committee, include the component of the bad debts).
- c. With reference to the period from March 1, 2000, to October 1, 2000 — an appeal filed by Partner against the Company is pending in the Supreme Court. It is proposed that the decision regarding the 1.1% rate of deduction should apply also to this period if the parties agree, subject to the decision of the court.

The significance of such a decision is that the Company's demand for a deduction rate of 2.5% until January 1, 2003, and a rate higher than 1.1% for the period thereafter, which would reflect the bad debts and collection expenses — was not accepted. Both the Company and Partner, each for its own reasons, refused the proposal and notified the court that, even after the Minister's decision, its ruling on the appeal was needed. The legal advisers of the Company are unable, at this stage, to estimate the outcome of the appeal filed by Partner.

In the past, the Company's financial statements included a provision for the effect of the decision of the Minister of Communications on a temporary deduction rate of 1.1% of the volume of traffic for the period starting on October 2, 2000. Therefore, the decision to set that rate as a fixed percentage for that period has no further effect on the Company's financial statements. However, the decision of the Minister of Communications to cancel the deduction starting on September 1, 2003, will mean a decrease of approximately NIS 50 million per year (based on airtime data for 2002 compared with a deduction of 2.5%). The Company has appealed the decision.

3. Further to Note 1E(2) to the financial statements as at December 31, 2002, on August 11, 2003, the Ministry of Communications published draft regulations for the proceedings and conditions for receipt of a general license for providing international telecommunications services. On September 29, 2003, a consolidated company, Bezeq International Ltd., submitted its remarks on the draft. The management of the consolidated company, Bezeq International Ltd. is unable, at this stage, to estimate the implications of opening the market to competition on its financial position and the results of its operations.
4. Further to Note 1E(3) to the financial statements as at December 31, 2002, concerning a petition filed by a cellular company against the Company and against the Minister of Communications, demanding cancellation of a directive issued to it to disconnect the direct connections that it makes for business customers and which bypass the Company's network, the cellular company and the Ministry of Communications reached an agreement whereby a transition period of nine months will be allowed for disconnection of the direct connections. Despite the objection of the Company to the duration of the transition period, the Supreme Court decided to strike the petition as requested by the petitioner.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

5. Regarding the settlement agreement between the Company and the State of Israel and the Israel Lands Administration relating to the Company's rights in real estate assets transferred to the Company, see Note 5 below.
6. On July 24, 2003, the State approached several institutions, requesting offers for the purchase of 86,500,000 ordinary shares of par value NIS 1 each of the Company held by the State. Subsequently, on July 29, 2003, the State sold those shares to Gmul Sahar Underwriters Ltd. (which made the highest offer) at NIS 4.338 per share.

This share sale was carried out as part of the framework agreement between the State and the Company as described in Note 8 below. Accordingly, the Company allotted to the State, on July 30, 2003, the entire balance of its unissued registered capital, a total of 23,342,462 ordinary shares of par value NIS 1 each. The total consideration received in respect of this issuance was NIS 101,261,807. After increasing the registered capital of the Company as described in Note 8 below, the Company allotted to the State, on October 30, 2003, the balance of the shares in respect of the shares sold by the State to Gmul Sahar Underwriters Ltd., as well as additional shares in accordance with the framework agreement (a total of 64,398,076 additional shares). The consideration in respect of this additional allotment was NIS 279,364,943. Out of the consideration in respect of these two allotments, the Company transferred to the State a commission of 1% in accordance with the framework agreement (see Note 8A).

NOTE 2 — ACCOUNTING POLICIES

The significant accounting policies employed in preparation of these financial statements, are the same as those employed in the preparation of the latest annual financial statements, except for the following:

1. In July 2001 the Israeli Institute for Accounting Standardization ("IIAS") published two new standards:
 - a. Accounting Standard No. 12 — Termination of adjustment of financial statements. This standard eliminates adjustment for the effects of the general purchasing power of the Israeli shekel in financial statements, commencing from January 1, 2003.

In December 2002, the IIAS published Standard No. 17, postponing the application of Standard No. 12 to January 1, 2004. Thus, the adjustment of the financial statements will end on that date. Until December 31, 2003, the Company will continue to prepare statements adjusted in accordance with Opinion No. 36 of the Institute of Certified Public Accountants in Israel ("ICPAI"). The adjusted amounts included in the financial statements as at December 31, 2003, will serve as the starting point for the nominal reporting commencing on January 1, 2004. Implementation of Standard No. 12 is liable to have material implications for the reported business results of the Company, the extent of which depends on the rate of inflation, the composition of assets and the Company's financing sources.
 - b. Accounting Standard No. 13 — Effects of changes in foreign currency exchange rates. The standard deals with the translation of foreign currency transactions and the translation of the financial statements of overseas operations for integration in the financial statements of the reporting corporation. The Standard supercedes the provisions of Clarifications 8 and 9 to Opinion No. 36, which will become null and void when Accounting Standard No. 12, described above, takes effect.
2. In February 2003 the IIAS published Accounting Standard No. 15 — Impairment of Asset Value. The Standard determines procedures with which a corporation must comply in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their recoverable amount, which is the higher of the net sale price and the present value of the estimated future cash flows expected to

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

derive from the use and realization of the asset. In addition, the Standard lays down rules of statement and disclosure for assets whose value is impaired. The Standard applies to financial statements for the periods starting from January 1, 2003. Application of the Standard has no effect on the interim financial statements.

NOTE 3 — FINANCIAL STATEMENTS IN ADJUSTED VALUES

The financial statements were prepared on the basis of the historical cost convention adjusted for changes in the general purchasing power of the Israeli currency. The changes that occurred in the Consumer Price Index ("CPI") and in foreign currency exchange rates are as follows:

| | <u>Consumer Price Index</u> | <u>Exchange rate of the US dollar</u> | <u>Exchange rate of the euro</u> |
|---|---------------------------------|---|--------------------------------------|
| | % | % | % |
| During the nine month period ended: | | | |
| September 30, 2003 | (1.481) | (6.249) | 4.336 |
| September 30, 2002 | 6.988 | 10.303 | 22.830 |
| During the three-month period ended: | | | |
| September 30, 2003 | (0.992) | 2.992 | 5.228 |
| September 30, 2002 | 0.648 | 2.139 | 1.388 |
| During the year ended December 31, 2002 | 6.496 | 7.269 | 27.182 |

NOTE 4 — INVESTMENTS IN INVESTEE COMPANIES

A. D.B.S. Satellite Services (1998) Ltd. ("DBS")

The Company's investment in DBS as at the balance sheet date amounts to approximately NIS 1,223 million. The Company's share in the accumulated losses of DBS is approximately NIS 940 million, of which approximately NIS 190 million was recorded in the nine months ended September 30, 2003. The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 61.8 million.

Further to Note 8E to the financial statements as at December 31, 2002, on August 31, 2003, the additional shares in DBS were allotted to the Company, thereby increasing the Company's holdings in DBS to approximately 49.8%. The increase in the Company's holdings in DBS generated an excess cost to the Company of approximately NIS 129 million.

Since commencing operations DBS has accumulated considerable losses and negative cash flows. The loss for the year 2002 amounted to approximately NIS 712 million and the loss arising in the nine month period ended September 30, 2003, amounted to approximately NIS 416 million. As a result of these losses, the capital deficit and the negative working capital of DBS as at September 30, 2003, amounted to approximately NIS 2,676 million and approximately NIS 1,678 million, respectively. The negative working capital includes bank credit of about NIS 1,242 million.

On May 23, 2001, a financing agreement ("the Financing Agreement") was signed between DBS and certain banks ("the Banks"), stipulating, *inter alia*, undertakings by DBS to meet certain suspending conditions and to comply with cumulative milestones and financial stipulations ("the Conditions").

An economic study carried out by the Banks at the beginning of 2002 determined that in order to finance the operations of DBS, additional financing would be required which considerably exceeds the financing requirements defined in the Financing Agreement.

On December 30, 2002, DBS, the shareholders and the Banks signed an agreement increasing the credit facility from the Banks ("the Interim Credit Facility"), which will be implemented concurrently with additional investments of the shareholders in an amount not less than a sum equal to 150% of the amount that will be injected by the Banks. Receipt of the Interim Credit Facility is subject, *inter alia*, to DBS's compliance with financial and operating

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

conditions set out in this agreement. At the same time as the aforementioned signing, discussions were being held between the parties regarding the expansion of the Interim Credit Facility within the framework of an amendment to the Financing Agreement ("the Amendment Agreement").

As at the date of approval of these financial statements, the shareholders and the Banks have transferred approximately \$36 million and approximately \$24 million, respectively to DBS, which is their entire obligation in the Interim Credit Facility. Nevertheless, some of the conditions in the Financing Agreement and the Interim Credit Facility are not being met.

An economic study carried out by the Banks during the reporting period determined that the overall financing needs of DBS do not exceed the Interim Credit Facility plus the increment to the Interim Credit Facility as part of the Amendment Agreement (including the proportional part of the shareholders).

On August 6, 2003, the Amendment Agreement was signed by the Banks and DBS. Under that agreement, the Banks will make additional amounts available to DBS, in excess of those made available under the Financing Agreement and the Interim Credit Facility, subject to DBS's compliance with the Conditions and milestones determined in the Amendment Agreement, including additional investments by the shareholders in amounts not less than 150% of the amounts made available by the Banks. The Amendment Agreement will take effect only after certain suspending conditions are met, and at the latest by August 20, 2003, or by a later date agreed upon by the parties. As at the date of these financial statements, not all the suspending conditions have been met. Nevertheless, principal shareholders and the Banks made further credit available to DBS, beyond the Interim Credit Facility and on account of the Amendment Agreement.

As at the date of approval of the financial statements, the credit made available by the shareholders and the Banks to DBS on account of the Amendment Agreement amounted to approximately \$25.2 million and approximately \$10 million, respectively.

The grant of additional loans by the Company to DBS is subject, *inter alia*, to the approval of the Ministerial Committee for Privatization ("the Committee"). On January 14, 2003, the Committee gave its approval for the Company to invest in DBS up to the percentage of its holding in DBS multiplied by \$600 million and up to an exposure ceiling of \$300 million. The Board of Directors of the Company approved the Company's investment in DBS as derived from the Financing Agreement, the Interim Credit Facility and the Amendment Agreement. The management of DBS estimates that the total investments approved for the Company by the Committee cover the Company's proportional part of the Interim Credit Facility plus its proportional part of the Amendment Agreement.

DBS's continued operation is contingent upon the Amendment Agreement taking effect as aforesaid and upon the receipt of additional loans from the shareholders.

The management of DBS believes that there is a good chance of meeting the aforementioned suspending conditions, of the Amendment Agreement taking effect and of the arrangement of the financial resources required by DBS in the coming year.

B. Goldnet Communications Services — a registered partnership ("the Partnership")

Further to Note 8H to the financial statements as at December 31, 2002, in the matter of notice to the Company of exercise of the Put option held by Malam Systems Ltd. ("Malam") relating to the Company, for the sale of 20.9% of its holding in the Partnership, on May 5, 2003, after receipt of the approvals required by law for the change in the holdings in the Partnership and after the consideration of approximately NIS 6.4 million was paid by the Company, the Company's holdings in the Partnership increased to 74.9%, while the holdings of Malam in the Partnership decreased accordingly to 25.1%. Under the amendment to the Government Companies Law, 5735-1975, in June 2003 that law could apply to the Partnership as long as the Company remains a government company.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

C. Adanet For Business Group Ltd. ("Adanet")

Further to Note 8G to the financial statements as at December 31, 2002, and in view of the uncertainty regarding the realization of the business plan of Adanet as planned, as well as regarding the outcome of the discussions with the banks for arranging the financing that Adanet requires, there is considerable concern regarding Adanet's continued existence as a going concern. As noted in the financial statements as at December 31, 2002, the Company, and Clal Information Technologies Ltd. and managers at Adanet have, upon fulfillment of certain conditions, a Call option and a Put option, respectively, for the remaining 50% of Adanet's shares, subject to the approvals required by any law. The exercise price of the aforementioned option is approximately \$5.5 million.

In view of the aforesaid, the Company recorded a provision of approximately NIS 52 million in respect of its investments in Adanet, which is included in the line other expenses, net, in the Statement of Operations for the nine month period ended September 30, 2003. On November 10, 2003, Adanet filed an application for a stay of proceedings order while a recovery plan is formulated for the group.

D. Pelephone Communications Ltd. ("Pelephone")

In May 2003 the Company received a partial update of the estimated value of Pelephone, indicating a rise in its value to between \$800 million and \$1 billion and in August 2003 the Company received an additional partial update indicating a further rise in Pelephone's value to between \$900 million and \$1.1 billion. In view of the uncertainty of the continuing existence over time of the factors that led to this update, at this stage no change has been made to the provision for impairment in value in Pelephone recorded in 2002. The Company will re-examine the value of Pelephone at a later date.

NOTE 5 — FIXED ASSETS

- A.** Further to Note 9C to the financial statements as at December 31, 2002, on May 15, 2003, the Company signed a settlement agreement with the Government of Israel on behalf of the State of Israel and the Israel Lands Administration ("the Administration"). The agreement regulates the dispute between them relating to the rights of the Company in various real estate assets that were transferred to the Company when it commenced operations in 1984, under an asset transfer agreement which was signed between the Company and the State ("the Asset Transfer Agreement").

Under the settlement agreement, 14 properties will be returned to the State out of the 28 which are in the Company's possession under renewable lease status (complete properties which were leased to the Company for a period of two years and renewable each time for a further two years, unless the State exercised its right to end the lease on terms and conditions laid down in the Asset Transfer Agreement), in addition to three properties which were returned to the Administration prior to the settlement agreement and the Administration will allocate three substitute properties instead of some of those properties which the Company will return to the State. The remainder of the properties in the Company's possession under renewable lease and properties which were leased to the Company under the Asset Transfer Agreement, will remain in the Company's possession under capitalized lease terms as set out in the Agreement. The Administration will also allocate and lease to the Company, after completion of planning stages, a net area of 70 dunams at the Sakia site, on lease terms set out in the Agreement. The Agreement also includes a number of individual arrangements in the matter of specific disputes between the parties, some of which related to certain of the properties in dispute and some of which related to other properties which were not part of the dispute. Under these arrangements, it was agreed, *inter alia*, that the Company will return several additional properties (one of which was never in dispute), as set out in the Agreement.

The Agreement was approved by the Audit Committee of the Board of Directors of the Company, the Board of Directors and the General Meeting of the Shareholders of the

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

Company conducted on August 6, 2003 (since it is an extraordinary transaction between the Company and its controlling shareholder — the State of Israel) and also requires the approval of the Israel Lands Council. The Agreement will take effect after being validated by a decision of the court in which the claim was filed by the State, the Administration and the Development Authority against the Company in the matter of the dispute.

In the opinion of the Company's Management, the aforementioned is not expected to have a material effect on the financial statements of the Company.

- B.** During September 2003 a proportionally consolidated company signed an agreement for technological upgrading of sites used for the CDMA system to 1X technology. The value of the agreement is approximately \$95 million. The upgrade will considerably increase the capacity and quality of the existing network and will allow the provision of advanced services to customers. The deployment of the network is planned in stages, commencing in 2003, with most of the deployment expected to be completed by the end of 2004 and installation being completed in 2006. Concurrently, the company implementing the network upgrade undertook to buy back old equipment for \$41 million.

During September 2003 a proportionally consolidated company signed an appendix to an earlier agreement from April 2002, for the additional purchase and installation of a cellular communication system in 1X technology (CDMA 2000) for approximately \$19 million (the value of the basic contract is approximately \$147 million).

- C.** In September 2003 the Board of Directors of the Company adopted a resolution to close the Inmarsat station (a satellite communication station) and to attempt to sell the equipment and/or the operation. In view of the uncertainty as to the consideration that will be received, if any, the Company reduced the entire balance of its investments in property relevant to the station by approximately NIS 36 million. The Ministry of Communications notified the Company that it is not authorized to decide on closure of the station. The Company disputes the position of the Ministry and has requested a hearing on the matter.
- D.** As part of an investigation carried out by a consolidated company with the assistance of an outside expert and following the application of the provisions of Accounting Standard No. 15, the consolidated company charged a deduction for impairment of assets (mainly switching equipment and transmission equipment) in the amount of approximately NIS 17.1 million during the period of the third quarter of 2003 report. The deduction is included in the Statement of Operations in the line Other expenses, net, and its amount was determined in accordance with the provisions of Standard 15, based on the valuation of the outside expert referred to above and the assessment by management of the net selling price and the usage value of the assets of the consolidated company.

NOTE 6 — LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Early retirement plan

In September 2000, the Company reached an agreement with workers' representatives for extension of the 1997 collective agreement for early retirement. Under the agreement 1,770 additional employees would take early retirement from April 1, 2001, through December 31, 2006, (with an option to extend the final retirement date for certain employees through December 31, 2008). The agreement also stated that the Company would be able to terminate the employment of employees in a severance payment track in excess of the aforementioned quota. In the opinion of the Company's Management, the possibility of additional employees retiring under the aforementioned track is low and accordingly, no provision has been made in the financial statements. Under this plan, 838 employees had taken early retirement by September 30, 2003.

In May 2003 the Knesset approved the Israeli Economy Recovery Plan (Legislative amendments for achieving budgetary goals and the economic policy for fiscal years 2003 and 2004), 5763-2003. The law includes, *inter alia*, an amendment of the Supervision of Insurance Business Law, 5741-1981, which relates to the old pension funds operating at a deficit,

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

including the pension fund with which the Company is associated in an agreement. The effect of this amendment on the Company as a whole and on the early retirement plan in particular, are still unclear.

The aforementioned amendment has expedited the implementation of the early retirement plan beyond the original plan, and in July and August 2003 347 employees retired. In addition, it was agreed with the workers' representatives that by in 2004 the quota would be 100 employees who would retire in accordance with the provisions and terms of the agreement.

In view of the uncertainty generated by the enactment of the law, including with regard to the possible considerable increase in the costs of implementing the retirement agreement in the future and the manner of its financing, Company Management and the workers' representatives agreed that without derogating from the validity of the agreement, each of the parties may, on its own initiative, hold talks with the other party on everything relating to the changes and/or implementation of the provisions of the agreement and the other party would consent to such talks.

Due to the aforementioned uncertainties, the Company is unable to estimate, at this stage, the effects of the law, if any, and therefore no provision has been made in the financial statements for possible additional costs in respect of the early retirement agreement.

- B.** The Company filed a claim against the Makefet Fund ("the Fund") by means of which the early retirement plan is executed. Under the collective agreements applicable to labor relations in the Company and in accordance with agreements with the Fund, Company employees who are "transferred employees" have the option to retire on one of two retirement tracks. The method of calculating the cost of early retirement of the transferred employees is determined in the provisions of several agreements and documents which were drawn up between the Company and the Fund during the years 1990-1996, including a letter of understanding drawn up and signed by the parties in 1996. The Company contends that the Fund violated the provisions of the agreements in general and those of the letter of understanding in particular, in that when it calculated the costs of early retirement for transferred employees, the Fund determined those data on the basis of the assumption that those employees had chosen the track with the higher cost of purchase, irrespective of the track which those employees had actually chosen. According to an actuarial opinion prepared for the Company, the gap between the payments collected by the Fund from the Company according to its calculations and the rate of those costs had they been made, as the Company alleges, on the basis of the retirement track actually chosen by those employees, is a nominal cumulative amount of more than NIS 128 million, the reimbursement of which the Company is suing the Fund. On November 3, 2003, the Company submitted to the Fund letters of demand for additional amounts of approximately NIS 80 million. The Company is in talks with the Fund for reaching an arrangement on all the issues in dispute.

NOTE 7 — 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 Company's financial statements for the year ended December 31, 2002. No significant changes occurred in respect of the contingent liabilities through the date of signing these financial statements, except for the following:

1. On May 4, 2003, a derivative statement of claim was received at the Company's offices, which includes an application to the court to approve the filing of the claim as a derivative claim (a claim which is filed by a shareholder or director of a company in the name of the company, with the approval of the court). The claim was filed by a shareholder of the Company against 20 directors serving the Company and certain senior managers who were employed by the Company during October and November

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

2000 ("the Officers") and against the Company. The statement of claim alleges as the main cause of the action, the negligent conduct of the Officers in the "Pelephone-Shamrock" transaction. In that transaction, Motorola Israel Ltd.'s shares in Pelephone were sold to Pelephone Holding L.L.C., a corporation registered in the U.S.A. ("the Foreign Corporation"), in consideration of approximately \$591 million.

The consideration of the purchase was financed partly by a loan of \$240 million extended by the Company against convertible debentures for 80% of the shares of the Foreign Corporation (a detailed description of the transaction appears in the financial statements of the Company starting from the year 2000). This negligence is mainly reflected, according to the statement of claim, in that the Officers did not ensure that the Company received collateral for the above loan extended to the Foreign Corporation by the Company. The claim further alleges that as a result of the negligence of the Officers, the Company was obliged to record a provision in its books for the full amount of the loan, which is tantamount to an admission that the chances of collecting the loan are non-existent and therefore, the loss to the Company as a result of the Officers' negligence amounts to approximately \$240 million. The plaintiff petitioned the court to order the Officers to pay the Company the amount of the loss it sustained, i.e. approximately \$240 million.

It is noted that the Company rejected a prior approach sent to it by the plaintiff's lawyer, demanding full exercise of the rights of the Company in the matter by way of filing suit, citing as the reasons, *inter alia*, that the facts creating the cause of action were not described in accordance with the requirements of the Companies Law, 5759 — 1999 and that in any case, since the loan extended by the Company would fall due only in two years' time and since the Company still has an option to convert the loan to shares of the Foreign Corporation, and thus, legally speaking, the claim is speculative. It is further noted that contrary to the statement of claim, which alleges that the Company did not receive collateral for the loan it extended, the Company has registered a second ranking lien on the shares of Pelephone Holding L.L.C. in Pelephone against the same loan (convertible debenture) (after a first lien was given to the bank that financed part of the transaction — see also Note 8D(2) to the financial statements as at December 31, 2002).

The Company filed an application for the dismissal *in limine* of the claim, citing as its reason that the plaintiff had not filed a preliminary application for approval of his claim as a derivative claim, as required by law. Concurrently, the Company filed an application for extension of the date for filing a statement of defence until a decision will be given on the application for dismissal *in limine*. The Company's application to extend the date was allowed. On January 18, 2004, a hearing will be held on the application to dismiss the claim *in limine*. At this stage, the chances of the claim and of the application filed by the Company for dismissal *in limine* of the claim, cannot be estimated.

2. On May 27, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which was filed in the Tel Aviv District Court against the Company. The plaintiff, who describes himself as "a private Internet user", alleges in his claim that the Company refuses to install splitters for high speed Internet lines of the broadband ADSL/frame relay type used for Internet service in condominiums and does so in order to increase its profits. The plaintiff, who is seeking to represent all the Internet users in Israel, further alleges that the Company's refusal to install the splitters causes losses of thousands of shekels per year to every private Internet user in Israel, since the connection of a number of tenants in a condominium on one telephone line using the aforementioned splitters would considerably reduce the fees paid to the Company by each consumer. The causes of the claim as appear in the statement of claim, are cited by virtue of the Anti-Trust Law, the Torts Ordinance and the Unjust Enrichment Law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law. The amount of the claim is

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

estimated by the plaintiff at NIS 2.5 billion (NIS 10,000 per consumer), which he alleges is the loss sustained by the plaintiffs. The plaintiff also petitions to charge the Company, in addition, with special and punitive damages, and for an order for the Company give accounts for all private Internet users in respect of the amounts received from them from the time each user started using the service until the date of the reply. On September 30, 2003, the Company filed its response to the application. No hearing of the application has yet been scheduled. The Company, relying on its legal advisers, is unable at this stage to estimate the outcome of the claim and therefore no provision was made in respect of the claim in the financial statements.

3. On June 5, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which was filed in the Tel Aviv District Court against the Company by two of its subscribers. According to the allegations in the statement of claim, the Company overcharged its subscribers by NIS 0.021 (plus VAT) compared with the charge defined in the regulations, for calls from Company subscribers to subscribers in the cellular networks of Cellcom and Pelephone, during a period (estimated) from June 1996 to August 31st of that year. The plaintiffs allege that in so doing, the Company violated the ban on misleading consumers as laid down in the Consumer Protection Law, breach of duties under the Contracts Law, the Torts Ordinance and the Sale Law, as well as unjust enrichment. The group in whose name the claim is filed is defined by the plaintiffs as "A group of Bezeq subscribers in Israel who dialed to subscribers of Cellcom and Pelephone in June, July, August 1996" and estimated by them as numbering more than four million subscribers. (It is noted that at the relevant time, the Company's subscribers numbered about 2.5 million.) Based on the (erroneous, as aforementioned) estimate of the number of subscribers and the average "loss" to the plaintiffs (NIS 7.5), the plaintiffs estimate the amount of their claim at about NIS 30 million and are claiming compensation in respect of that loss. A calculation made by the Company found that the difference between actual collection and collection by the applicants' method amounts to about NIS 6 million. Alternatively, the plaintiffs are requesting that the court recognize the claim as a claim for declaratory relief or as a claim for a mandamus against the Company. Nevertheless, and according to the statement of claim, claims for similar cause were filed against Cellcom and Pelephone and the claim against Pelephone was dismissed by the District Court, while an appeal in respect of that case is pending in the Supreme Court (the plaintiffs have stated that they are concerned that the ruling of the Supreme Court in this proceeding will be given after elapse of the date for filing their claim, due to limitation). The Company, relying on its legal advisers, is unable at this stage to estimate the chances of the outcome of the claim, and therefore no provision is included in the financial statements in respect of the claim.
4. Further to Note 19A(1) to the financial statements as at December 31, 2002, concerning an application for approval of a claim as a class action against the Company and the consolidated company Bezeq International Ltd. (which was stricken from the proceeding), alleging misleading advertising about the method of debiting international calls, a decision was given on August 11, 2003 in the additional hearing that upheld the decision of the Supreme Court dismissing the plaintiff's application to file a class action.
5. Further to Note 19A(2) to the financial statements as at December 31, 2002, concerning an appeal against a claim filed in the Regional Labor Court by the Histadrut in the name of a group of employees, in an application for declaratory relief for the pension rights of the employees in the group, who are employees who were transferred from the Ministry of Communications. On September 23, 2003, decision was given by the National Labor Court which rejected the appeal.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

6. Further to Note 19A(4) to the financial statements as at December 31, 2002, concerning the claim of senior employees for a wage increment of 33%, the court has given its decision which rejected the claim in full. The plaintiffs have appealed the decision.
7. Further to Note 19A(8) to the financial statements as at December 31, 2002, concerning a claim filed against the Company in respect of violation of undertakings and representations, as it were, that the Company made to the plaintiff for the purchase of public telephone boxes, the court recommended to the parties, on May 5, 2003, that they apply for a conciliation proceeding. Following that recommendation, the case has been transferred for conciliation.
8. Further to Note 19A(11) to the financial statements as at December 31, 2002, concerning denial of an application for approval as a class action against the Company according to which the Company unlawfully collected monies from its subscribers in respect of certain services which it provides, on July 1, 2003, the Supreme Court denied the application for leave to appeal which was filed in respect of that decision (and which was heard as an appeal).
9. Further to Notes 19A(12), 19A(14) and 19A(17) to the financial statements as at December 31, 2002, relating to class actions filed against the Company, for which the source of authority for filing the claims is Regulation 29 of the Civil Procedures Regulations. In April 2003 a ruling of principle and precedent was issued by the Supreme Court in a case in which the Company is not a party, whereby it was determined that a class action cannot be filed by virtue of Regulation 29 of the Civil Procedures Regulations where no specific arrangement has been determined for filing the action in primary legislation. It is noted that in respect of this decision, an application for a further hearing has been filed in the Supreme Court (and has been allowed).
10. Further to Note 19A(12) to the financial statements as at December 31, 2002, concerning an action together with an application for approval of the action as a class action which was filed against the Company, in which it is alleged that the Company unlawfully collected payment differences for the fixed monthly fee for a telephone line, and further to Note 7A(9) above in view of the ruling of the Supreme Court, the plaintiff filed, with the consent of the Company, an application to strike the claim and the application for its approval. The court allowed the application.
11. Further to Note 19A(15) to the financial statements as at December 31, 2002, concerning two class actions and an application for their approval as class actions which were consolidated into one case, in the matter of charging subscribers telephone lease fees, which the plaintiffs allege was unlawful, on June 10, 2003, the Supreme Court denied the application for approval of the claim as a class action. The plaintiffs filed an appeal in the Supreme Court against the decision of the court. According to a decision of the Supreme Court Registrar, the Company must file its written summations in the matter of the appeal by January 5, 2004.
12. Further to Note 19A(17) to the financial statements as at December 31, 2002, concerning an action and an application for recognition as a class action against the Company, Bezeq International and the other international communications operators, alleging that the Company unlawfully collected VAT at 17% for some of the collect calls arriving from abroad and accepted by its subscribers in Israel, and further to Note 7A(9) above, in view of the ruling of the Supreme Court, the court decided, on August 25, 2003, to strike the application for approval of the claim as a class action and, as a result, also the action itself. An appeal has been filed against this decision in the Supreme Court.
13. Further to Note 19A(25) to the financial statements as at December 31, 2002, concerning a letter of demand in the name of the Moshav Porath Committee which was received in October 2001, in April 2003 the Company received at its offices a statement of claim filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

Sharon region, including the estates of deceased persons, for compensation due to physical harm pursuant to the Torts Ordinance. The statement of claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the "Hillel" broadcasting station, which is near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to banned radiation from the broadcasting station and bodily harm, most of which ended in the death of some of the plaintiffs.

The amount of the claim stated by the plaintiffs is "more than NIS 15 million", and the same claim notes that the plaintiffs will also petition to split the reliefs so that they will reserve the right to sue later for other financial damages which are not bodily harm, such as damage to crops and loss of value of land. According to the notice of the plaintiffs' lawyer, which was given before the claim was filed, this claim is an initial claim and it is intended that additional claims of other residents who have been harmed by radiation from the "Hillel" station will be filed later.

The Company filed an application for dismissal of the claim *in limine*. Nevertheless, it is unable, at this stage, to estimate the chances of the outcome and the exact financial extent of the claim, or the chances and extent of additional claims that might be filed, if filed, against it. It is noted that in reply to the letter of demand which was sent to the Company by the plaintiffs' lawyer (in October 2001 as referred to above and a short time prior to the filing of the claim), the Company rejected the allegations made by the plaintiffs and repeated that its activities in the "Hillel" station were carried out in accordance with the provisions of the law and the directives and permits granted it by the competent authorities which are responsible for the broadcasting actions taking place in the station. It is further noted that the Company rejected a proposal made by the plaintiffs' lawyer prior to filing the claim, to negotiate a settlement with the plaintiffs before the claim was filed. The hearing of the application to dismiss *in limine* and the other applications are still in progress, except for the application of the Company — which was allowed — to dismiss the claim of some of the plaintiffs that relates to deceased persons who died before the Company commenced operating the broadcasting station.

Furthermore, on March 16, 2003, the Company received an additional letter demanding that the Company evacuate the "Hillel" station and in which notice was given of the intention to file a claim in respect of liability for health damages as a result of operation of the station. The Company rejected the demand and for the sake of caution, gave notice of the demand to the relevant insurance companies and to the Ministry of Communications, the Ministry for the Environment and the Broadcasting Authority.

In addition, during April 2003, a petition was filed in the High Court of Justice against the Minister of Environment, the Minister of Defense, the Broadcasting Authority and the Company, by the head of the Zuran Council, in which an order is requested for the immediate cessation of operation of the "Hillel" broadcasting station, since operation of the station is causing radiation that endangers the health of the residents of Moshav Zuran. After the Government decided to close the station until December 31, 2003, the petitioners withdrew the petition on July 2, 2003, and retained the right to renew it if the station is not closed and the antennae are not removed by that date. Subject to the aforesaid, it was decided to strike the petition.

14. Further to Note 19A(26) to the financial statements as at December 31, 2002, concerning private claims of employees and former employees, in the matter of recognition of various wage components as pension components, and to Note 19A(32) to the financial statements as at December 31, 2002, relating to "Notice of a party in a collective dispute" in the matter of recognition of certain payments as pension components, the National Labor Court ruled on the appeal filed by seven former employees of the Company, recognizing one of the above payments as a pension component in view of

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

the factual circumstances in that case. According to the legal advisers of the Company, the ruling significantly increases the risk in respect of that component. Nevertheless, the above ruling does not address a number of legal allegations which were made in the statement of allegations filed on behalf of the Company in its response to the "Notice of a party in a collective dispute" and on which the Court will have to rule.

In the matter of the ruling given by the National Labor Court in another case (to which the Company is not a party), which could have adversely affected the situation of the Company as regards a different component, on October 20, 2003, the High Court of Justice gave an order *nisi* against that ruling. In the opinion of the legal advisers of the Company, the chances of the Company in the matter of this component cannot be estimated.

It is noted that the total exposure involved in all these claims could amount to a considerable sum for the Company and may, under certain assumptions, *inter alia* concerning the population of relevant employees and the relevant periods, reach as much as NIS 3.5 billion. In the opinion of the legal advisers of the Company, presentation of the financial implications of the claim before the Court will support and strengthen the legal claims of the Company.

This being the case, the Management and its legal advisers believe that it is not possible, at this stage, to estimate the outcome of the above claims in relation to certain components, and therefore no additional provision was made in the financial statements beyond the provision made in accordance with the assessment of the Management prior to the decision given by the National Labor Court in the other case, in which the Company is not involved. Nevertheless, in respect of the particular component in which the Company and its legal advisers see a material risk, these financial statements include a provision which was calculated on the basis of certain assumptions which the Company believes to be appropriate.

In respect of the group of employees who filed a claim against the Company concerning the inclusion of several components as part of the salary which determines the pension, the Company is in discussion with that group of employees. The financial statements include a suitable provision which was made on the basis of the Management's assessment.

15. Further to Note 19A(27) to the financial statements as at December 31, 2002, in connection with guarantees on which the Ministry of Communications of India demanded to foreclose, the proceeding was stricken for "inaction" and an application was filed to revive the proceeding. The Indian lawyer who is handling the case for the Company believes that there is a good chance that the application to revive the proceeding will be allowed.
16. Further to Note 19A(29) to the financial statements as at December 31, 2002, concerning the customer allocation process of a consolidated company, the supplementary referendum which commenced on July 1, 2002, was completed in February 2003, subsequent to postponements. An examination carried out by the consolidated company found that the effects of the results of the referendum on its financial statements are insignificant.
17. Further to Note 19A(34) to the financial statements as at December 31, 2002, concerning a class action against all the cellular companies in Israel and against the Company as a formal defendant, whereby the defendant cellular companies unlawfully collected and collect payments for cellular calls. The parties reached a consensus regarding striking the class action and the action has been stricken by the court.
18. Further to Note 19A(35) to the financial statements as at December 31, 2002, concerning a claim and an application for recognition of the claim as a class action both by virtue of Regulation 29 of the Civil Procedures Regulations and by virtue of the Anti-Trust Law — following the ruling of the Supreme Court in another case that a class

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

action cannot be filed by virtue of Regulation 29 only, the parties filed an agreed application, which was allowed, to strike the parts relating to approval of the claim as a class action on the basis of Regulation 29. The plaintiffs have filed an amended application relying only on the Anti-Trust Law.

19. Further to Note 19A(36) to the financial statements as at December 31, 2002, relating to a class action filed against Pelephone in respect of over-collection, the claim was stricken on November 14, 2002.
20. Further to Note 19A(38) to the financial statements as at December 31, 2002 in the matter of a petition filed in the High Court of Justice by the Ganei Tikva Local Council against the Minister of Communications, the Company and Golden Channels Co., that the Minister of Communications direct the Company to relocate the cable network which is in the Council's jurisdiction and which the Company maintains for Golden Channels to an underground infrastructure (instead of overhead). The parties acceded to the proposal of the court that the works be carried out by the Company and thereafter the question of liability for the expenses incurred in carrying out the works will be arbitrated. The parties subsequently reached agreement and the petition was stricken.
21. Further to Note 19A(5) to the financial statements as at December 31, 2002, in the matter of the statement of claim and application for recognition of the claim as a class action against the Company, Bezeq International, the Chairman of the Board of Bezeq International and the then CEO of Bezeq International, alleging that Bezeq International unfairly exploited its status in the international calls market and implemented a deliberate policy of misleading the public on the subject of the tariffs of international calls, a hearing was held in the Supreme Court on May 28, 2003, at which it was determined that the District Court had erred procedurally, since it should have decided only in relation to the application to add another plaintiff to the class action and not on the question of dismissal of the application for approval of the claim as a class action. The appeal of Bezeq International was therefore allowed, and the case was returned to the District Court, where a hearing will be scheduled.
22. Further to Note 19A(42) to the financial statements as at December 31, 2002, in the matter of a claim filed against Bezeq International Ltd. in which it was alleged that Bezeq International Ltd. unlawfully cancelled an agreement for the supply and installation of a customer care and billing system — Bezeq International filed a statement of defense on May 26, 2003, and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was cancelled since the plaintiff violated its undertakings in the agreement. On September 14, 2003, the plaintiff filed a statement of counter-reply in which the allegations of the Company are denied. At this stage, the legal advisers of Bezeq International are unable to estimate the chances of the outcome of the claim and therefore no provision has been made in respect thereof in the financial statements of Bezeq International.
23. On March 25, 2003, an application was filed in the District Court against DBS for approval as a class action of a claim in connection with imposing the cost of the electricity consumption required for operation of satellite receiver dishes on the tenants of the building in which the dish was installed. The group in whose name the application was filed is all the houses in Israel in which a satellite dish was installed. The claim is for declaratory relief determining that DBS must pay for the electricity consumption of the installations connected by and/or for it on the various premises, and that it must reimburse the members of the group for all the monies they paid for the electricity consumption of DBS's installations, as well as compensation and/or restoration of monies paid in respect of such electricity consumption. The amounts assessed as damages for which the applicants are demanding restoration is NIS 25 million.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

At this stage, in the opinion of the legal advisers of DBS it is difficult to estimate whether the claim will be approved as a class action and if approved — its chances. Accordingly, DBS has not included a provision in respect of this claim.

24. On April 3, 2003, a petition was filed in the High Court of Justice against DBS, its shareholders (including the Company), the Government of Israel and others, in which the High Court is requested, *inter alia*, to declare DBS a government company in view of the level of the investments of the Company in DBS, and to revoke the decision of the Ministerial Committee for Privatization that enabled the Company to increase its investment in DBS. It is noted that in fact, Bezeq's holdings in DBS today are less than 50%. In the hearing of the petition on July 30, 2003, the Supreme Court recommended that the petitioner withdraw the petition, and subsequently, on the same day, the petitioner gave notice on his behalf that he was withdrawing his petition in the hope that the Attorney General would examine and regulate the question raised in its entirety. Following the notice, the petition was denied.
 25. In April 2003 an application was filed in the Tel Aviv District Court for approval of a class action in a total amount of NIS 90 million against Pelephone and against all the other cellular operators. The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming in to the network of each of them. The plaintiffs allege that this is a uniform, exaggerated, unreasonable and unfair tariff. The period to which the claim relates is March-June 2002 and up to the date of filing the claim. In October 2003 Pelephone filed its response to the application. At this stage Pelephone and its legal advisers are studying the material related to the claim and are unable to estimate the chances of the outcome.
- B.** On November 3, 2003, the Audit Committee of the Board of Directors and the Board of Directors approved grant of an undertaking to indemnify the officers of the Company in the matter of the framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State as allowed under the framework agreement. The undertaking was limited in amount to NIS 890,000,000 (the amount of capital raised), linked to the Consumer Price Index published after completion of raising the capital for the Company in accordance with the framework agreement, and requires the approval of the General Meeting of the Shareholders of the Company.
- C. Guarantees**

In May 2003 the Company, in accordance with the requirement of the Ministry of Communications, gave a bank guarantee in the amount of \$10 million in connection with its general license for carrying out telecommunications activities and for providing telecommunications services.

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

D. Futures Contracts

1. Hedging Contracts

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Amounts receivable</u> | <u>Amounts payable</u> |
|--|-------------------------------|-----------------------------|-------------------------------------|-------------------------------|----------------------------|
| | NIS millions | | | | |
| Contracts at predetermined interest rates | | | | | |
| | Dollars | CPI-linked NIS | February 2005 | 787 | 854 |
| | Euro | CPI-linked NIS | September 2005 | 1,150 | 1,036 |
| Contracts at predetermined exchange rate (excluding premium/discount) | | | | | |
| | Dollars | NIS | May 2004 | 304 | 330 |
| | Euro | NIS | September 2004 | 363 | 375 |
| | CPI-linked NIS | NIS | June 2004 | 79 | 79 |
| Call options purchased . . . | Dollar | NIS | March 2004 | 13 | 14 |

2. Contracts not for hedging purposes

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Fair value</u> | <u>Amount</u> |
|--|-------------------------------|-----------------------------|-------------------------------------|-------------------|---------------|
| | NIS millions | | | | |
| Transactions at a predetermined exchange rate | | | | | |
| | Dollar | NIS | December 2003 | (8) | 89 |

NOTE 8 — SHARE CAPITAL

A. On January 13, 2002, a framework agreement was signed between the State and the Company, whereby capital would be raised by way of a private sale of the Company shares held by the State in accordance with Sections 15A and 15C(b) of the Securities law, 5728 — 1968 (in one sale or several). Concurrently with that sale, the Company would issue shares to the State for a consideration of the proceeds received by the State in respect of the sale of the shares less a margin of 1%, where the total cumulative number of shares to be issued to the State by the Company will at no time exceed the number of shares sold by the State and the State's holdings in the Company will not fall below 51.02%. The proceeds from raising the capital would be designated to financing the costs involved in the retirement of Company employees.

The framework agreement determined that the price at which the shares would be sold would be not less than NIS 6 net per share. According to a resolution of the General Meeting of the Shareholders of the Company, registered share capital not issued as part of the process of raising capital through February 28, 2003, or until another date on which the State would hold 51.02% (at full dilution) of the share capital of the Company (whichever would be the earlier date) would be cancelled. Since the capital was not raised by February 28, 2003, registered capital of 130,000,000 shares was cancelled.

Subsequently, on July 28, 2003, an amendment to the framework agreement was signed, whereby the minimum price set for sale of the shares (NIS 6) was cancelled and the last

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

date for the final sale according to the framework agreement was cancelled. Instead, it was decided that if the State sold shares in a total number exceeding the limit of the Company's registered share capital on that date and the Company's registered share capital did not have enough shares for issuance to the State, the Company's obligation to allot shares to the State would be postponed against receipt of the consideration in respect thereof not later than 120 hours from the time of increasing the share capital of the Company. In addition, on November 3, 2003, an amendment to the agreement for raising capital for the Company was made such that the limitation on reducing the State's holding in the Company, subsequent to completion of raising the capital, to a minimum percentage of 51.02% was amended to a minimum of 30%-40%.

With the cancellation of 130,000,000 shares of the Company's share capital (as described above), the Company held 23,342,462 shares as its unissued registered capital. As explained in Note 1 above, the Company allotted these 23,342,462 shares to the State in accordance with the framework agreement.

On October 23, 2003, the registered share capital of the Company was increased by 190,000,000 shares and the registered share capital of the Company was increased to 2,625,000,000 shares. On October 31, 2003, the Company issued 64,398,076 shares to the State in accordance with the terms of the framework agreement described above.

- B.** On January 27, 2003, the Special General Meeting of the Shareholders of the Company approved the recommendation of the Board of Directors, dated January 2, 2003, that a cash dividend be distributed to the holders of the Company's shares who are registered in the Shareholders Register at the end of the business day on February 5, 2003. The X-date was February 6, 2003, and the payment date was February 20, 2003. The total cash dividend of approximately NIS 190 million represents 7.8784 agorot per share.

NOTE 9 — REVENUES FROM TELECOMMUNICATION SERVICES

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|--|--|---------------------|---|---------------------|------------------------------------|
| | 2003 (Unaudited) | 2002 (Unaudited) | 2003 (Unaudited) | 2002 (Unaudited) | 2002 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues from communication services — | | | | | |
| Domestic fixed-line communications .. | 1,582,053 | 1,713,761 | 518,211 | 576,519 | 2,272,399 |
| Fixed fees | 1,691,982 | 1,562,128 | 590,676 | 521,423 | 2,115,423 |
| Cellular telephone | 1,508,090 | 1,619,741 | 523,309 | 559,446 | 2,102,715 |
| International communications and internet services | 510,510 | 501,372 | 177,420 | 168,472 | 665,434 |
| Installation and sale of equipment to subscribers | 428,383 | 403,379 | 163,511 | 137,726 | 528,713 |
| Other | 48,884 | 72,475* | 12,626 | 21,247* | 93,886* |
| | 5,769,902 | 5,872,856 | 1,985,753 | 1,984,833 | 7,778,570 |
| Other revenues | 268,015 | 229,812 | 101,748 | 70,742 | 317,339 |
| | 6,037,917 | 6,102,668* | 2,087,501 | 2,055,575* | 8,095,909* |

* Reclassified

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

NOTE 10 — OPERATING AND GENERAL EXPENSES

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|--|--|--------------------------|---|--------------------------|------------------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and related expenses | 1,490,741 | 1,480,969 | 507,371 | 480,168 | 1,989,745 |
| General expenses | 557,431 | 555,163* | 218,022 | 192,840* | 730,980* |
| Materials and spare parts | 433,063 | 436,709 | 152,807 | 150,673 | 602,149* |
| Cellular telephone expenses | 350,467 | 328,931* | 122,508 | 120,192* | 475,045 |
| Building maintenance | 262,285 | 274,215 | 93,800 | 90,126 | 353,098 |
| Services and maintenance by sub-contractors | 205,744 | 208,524* | 62,928 | 64,560* | 256,512* |
| International communications expenses | 104,775 | 115,051 | 27,892 | 51,712 | 152,797 |
| Vehicle maintenance expenses | 91,049 | 73,370 | 30,874 | 25,419 | 97,002 |
| Collection fees | 26,087 | 24,479 | 5,325 | 7,568 | 34,959 |
| | <u>3,521,642</u> | <u>3,497,411</u> | <u>1,221,527</u> | <u>1,183,258</u> | <u>4,692,287</u> |
| Less — salaries charged to investment in fixed assets | <u>149,180**</u> | <u>107,284</u> | <u>58,474</u> | <u>28,890</u> | <u>148,141</u> |
| | <u><u>3,372,462</u></u> | <u><u>3,390,127*</u></u> | <u><u>1,163,053</u></u> | <u><u>1,154,368*</u></u> | <u><u>4,544,146*</u></u> |

* Reclassified

**See Note 12C

NOTE 11 — OTHER EXPENSES, NET

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|--|--|----------------|---|----------------|------------------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Provision for decrease in value of investment in convertible debentures ⁽¹⁾ | — | 382,430 | — | 382,430 | 1,214,179 |
| Provision for impairment of value of fixed assets ⁽²⁾ | 52,625 | — | 52,625 | — | — |
| Provision for decrease in value of investments in other companies | 63,169 | 10,296 | 28,008 | 10,296 | 23,437 |
| Provision for severance pay ⁽³⁾ | 195,000 | — | 195,000 | — | — |
| Capital gains, net | 8,574 | (7,184) | 4,707 | (1,785) | (12,790) |
| Others | 2,075 | (221) | 1,814 | (90) | (124) |
| | <u>321,443</u> | <u>385,321</u> | <u>282,154</u> | <u>390,851</u> | <u>1,224,702</u> |

(1) See Note 4D

(2) See Notes 5C and 5D

(3) See Note 7A14

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

NOTE 12 — CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. Statement of Operations

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|--|--|--------------------------------------|---|--------------------------------------|------------------------------------|
| | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2002 (Audited) NIS thousands |
| Revenues from telecommunication services (Note 12B) | 4,006,618 | 4,163,756* | 1,348,327 | 1,377,607* | 5,468,989* |
| Costs and expenses | | | | | |
| Operating and general expenses (Note 12C) | 1,796,488 | 1,797,278* | 621,339 | 591,745* | 2,409,383* |
| Depreciation | 1,345,812 | 1,427,097 | 445,517 | 478,306 | 1,896,111 |
| Royalties to the Government of Israel .. | 138,064 | 132,026 | 46,968 | 38,812 | 179,748 |
| | <u>3,280,364</u> | <u>3,356,401</u> | <u>1,113,824</u> | <u>1,108,863</u> | <u>4,485,242</u> |
| Operating income | 726,254 | 807,355 | 234,503 | 268,744 | 983,747 |
| Financing expenses, net | 50,693 | 129,225 | 19,408 | 54,570 | 117,606 |
| Earnings after financing expenses, net | 675,561 | 678,130 | 215,095 | 214,174 | 866,141 |
| Other expenses, net | 291,886 | 385,548 | 257,311 | 390,725 | 1,212,040 |
| Earnings (loss) before income tax | 383,675 | 292,582 | (42,216) | (176,551) | (345,899) |
| Income tax | 175,272 | 204,726 | 9,005 | 38,657 | 230,565 |
| Earnings (loss) after income tax | 208,403 | 87,856 | (51,221) | (215,208) | (576,464) |
| Company's equity in losses of investee companies | 206,595 | 230,124 | 33,896 | 122,911 | 339,984 |
| Net earnings (loss) | <u>1,808</u> | <u>(142,268)</u> | <u>(85,117)</u> | <u>(338,119)</u> | <u>(916,448)</u> |

* Reclassified

B. Revenues from Telecommunications Services

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|---|--|--------------------------------------|---|--------------------------------------|------------------------------------|
| | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2003 (Unaudited) NIS thousands | 2002 (Unaudited) NIS thousands | 2002 (Audited) NIS thousands |
| Revenues from communications services | | | | | |
| Domestic fixed-line communications ... | 1,592,543 | 1,732,559 | 521,650 | 582,817 | 2,294,826 |
| Fixed fees | 1,612,858 | 1,469,227 | 562,430 | 478,598 | 1,986,684 |
| Cellular telephone | 356,116 | 469,528 | 107,636 | 158,639 | 548,328 |
| International communications | 99,656 | 110,770 | 32,760 | 38,119 | 136,340 |
| Installation and sale of equipment to subscribers | 108,173 | 118,682 | 41,444 | 38,884 | 152,824 |
| Other | 52,066 | 76,782* | 13,773 | 22,126* | 99,476* |
| | <u>3,821,412</u> | <u>3,977,548</u> | <u>1,279,693</u> | <u>1,319,183</u> | <u>5,218,478</u> |
| Other revenues | 185,206 | 186,208 | 68,634 | 58,424 | 250,511 |
| | <u>4,006,618</u> | <u>4,163,756*</u> | <u>1,348,327</u> | <u>1,377,607*</u> | <u>5,468,989*</u> |

* Reclassified

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

C. Operating and General Expenses

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|---|--|-------------------|---|-----------------|------------------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and related expenses | 1,119,613 | 1,145,625 | 369,412 | 369,218 | 1,530,734 |
| General expenses | 249,530 | 226,157* | 107,297 | 74,832* | 305,705* |
| Materials and spare parts | 68,808 | 37,447 | 29,459 | 14,032 | 65,988 |
| Building maintenance | 240,514 | 238,842 | 85,239 | 79,543 | 325,335 |
| Services and maintenance by sub-contractors | 158,096 | 165,371* | 51,300 | 52,861* | 206,748* |
| International communications expenses | 6,132 | 4,232 | 1,718 | 1,078 | 4,963 |
| Vehicle maintenance expenses | 77,242 | 61,268 | 26,191 | 20,300 | 83,176 |
| Collection fees | 25,733 | 25,620 | 9,197 | 8,771 | 34,875 |
| | <u>1,945,668</u> | <u>1,904,562</u> | <u>679,813</u> | <u>620,635</u> | <u>2,557,524</u> |
| Less — salaries charged to investments in fixed assets | 149,180** | 107,284 | 58,474 | 28,890 | 148,141 |
| | <u>1,796,488</u> | <u>1,797,278*</u> | <u>621,339</u> | <u>591,745*</u> | <u>2,409,383*</u> |

* Reclassified

** Commencing February 2003, following the installation of a new reporting system at the Company which enables accurate measurement of direct costs of employees of the Engineering and Information Technologies Divisions, the Company capitalized an additional amount for Company-built fixed assets. The additional amount in respect of the nine month period ended September 30, 2003, is approximately NIS 33 million (and for the three month period then ended, approximately NIS 15 million).

NOTE 13 — SEGMENTS OF BUSINESS OPERATIONS

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

| | For the nine month period ended September 30, 2003 | | | | | |
|---|---|-----------------------|---|----------------|------------------|------------------|
| | Domestic fixed line communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues | | | | | | |
| Revenues from external sources | 3,841,668 | 1,497,662 | 514,882 | 183,705 | — | 6,037,917 |
| Inter-segment revenues .. | 164,950 | 5,932 | 7,923 | 26,594 | (205,399) | — |
| Total revenues | <u>4,006,618</u> | <u>1,503,594</u> | <u>522,805</u> | <u>210,299</u> | <u>(205,399)</u> | <u>6,037,917</u> |
| Segment results | <u>726,254</u> | <u>49,672</u> | <u>63,162</u> | <u>17,026</u> | <u>489</u> | <u>856,603</u> |
| | For the three month period ended September 30, 2003 | | | | | |
| | Domestic fixed line communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues | | | | | | |
| Revenues from external sources | 1,289,590 | 549,240 | 181,076 | 67,595 | — | 2,087,501 |
| Inter-segment revenues .. | 58,737 | 973 | 3,257 | 8,714 | (71,681) | — |
| Total revenues | <u>1,348,327</u> | <u>550,213</u> | <u>184,333</u> | <u>76,309</u> | <u>(71,681)</u> | <u>2,087,501</u> |
| Segment results | <u>234,503</u> | <u>56,221</u> | <u>14,238</u> | <u>19,071</u> | <u>162</u> | <u>324,195</u> |

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

For the year ended December 31, 2002

| | Domestic fixed line communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
|--------------------------------------|--|-----------------------|---|----------------|------------------|-------------------|
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues | | | | | | |
| Revenues from external sources | 5,262,335* | 1,966,464 | 673,148 | 193,962 | — | 8,095,909* |
| Inter-segment revenues .. | 206,654 | 7,673 | 8,306 | 29,563 | (252,196) | — |
| Total revenues | <u>5,468,989*</u> | <u>1,974,137</u> | <u>681,454</u> | <u>223,525</u> | <u>(252,196)</u> | <u>8,095,909*</u> |
| Segment results | <u>983,747</u> | <u>(62,924)</u> | <u>108,458</u> | <u>(8,649)</u> | <u>648</u> | <u>1,021,280</u> |

* Reclassified

NOTE 14 — CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD.

1. Bezeq International Ltd.

A. Balance sheet

| | September 30 2003 | September 30 2002 | December 31 2002 |
|-----------------------------|------------------------------|------------------------------|----------------------------|
| | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Audited) NIS thousands |
| Current assets | 147,540 | 180,549 | 194,381 |
| Investments | 12,759 | 19,675 | 10,737 |
| Fixed assets | 484,421 | 418,672 | 486,136 |
| Other assets | 3,309 | 9,797 | 8,464 |
| | <u>648,029</u> | <u>628,693</u> | <u>699,718</u> |
| Current liabilities | 291,719 | 319,809 | 373,178 |
| Long-term liabilities | 172,399 | 170,347 | 171,445 |
| Shareholders' equity | 183,911 | 138,537 | 155,095 |
| | <u>648,029</u> | <u>628,693</u> | <u>699,718</u> |

B. Statements of Operations

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|--|--|---------------|---|---------------|------------------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Revenues from international telecommunication services | 522,805 | 509,705 | 184,320 | 169,973 | 681,469 |
| Operating expenses | 315,651 | 295,596 | 117,532 | 108,239 | 381,639 |
| Gross profit | 207,154 | 214,109 | 66,788 | 61,734 | 299,830 |
| Marketing, general and administrative expenses | 143,992 | 148,216 | 52,551 | 41,001 | 191,369 |
| Operating income | 63,162 | 65,893 | 14,237 | 20,733 | 108,461 |
| Financing expenses (income), net | 19,589 | (7,097) | 2,215 | 2,963 | (1,589) |
| Earnings after financing, net | 43,573 | 72,990 | 12,022 | 17,770 | 110,050 |
| Other expenses (income), net | 11,941 | (13) | 7,088 | (5) | (34) |
| Earnings before income tax | 31,632 | 73,003 | 4,934 | 17,775 | 110,084 |
| Income tax | 2,194 | 1,031 | 1,288 | 401 | 10,581 |
| Earnings after income tax | 29,438 | 71,972 | 3,646 | 17,374 | 99,503 |
| Company's equity in losses (earnings) of an affiliated company | 622 | 13,311 | (84) | 2,020 | 24,284 |
| Net earnings | <u>28,816</u> | <u>58,661</u> | <u>3,730</u> | <u>15,354</u> | <u>75,219</u> |

**Notes to the Interim Consolidated Financial Statements
as at September 30, 2003 (Unaudited) (cont'd)**

2. Pelephone Communications Ltd.

A. Balance sheet

| | September 30 2003 | September 30 2002 | December 31 2002 |
|--|------------------------------|------------------------------|----------------------------|
| | (Unaudited) NIS thousands | (Unaudited) NIS thousands | (Audited) NIS thousands |
| Current assets | 1,254,246 | 1,322,660 | 1,319,365 |
| Long-term trade receivables | 186,179 | 161,209 | 156,794 |
| Investment in partnership | 1,790 | — | — |
| Deferred income taxes | 335,361 | 313,245 | 330,854 |
| Fixed assets, net | 2,937,239 | 2,699,541 | 2,752,188 |
| Other assets | 370,989 | 483,692 | 452,812 |
| | <u>5,085,804</u> | <u>4,980,347</u> | <u>5,012,013</u> |
| Current liabilities | 1,822,597 | 1,917,123 | 2,049,487 |
| Provision for losses of investee company | 5,129 | 3,972 | 4,432 |
| Long-term liabilities | 1,428,543 | 1,168,499 | 1,108,463 |
| Shareholders' equity | 1,829,535 | 1,890,753 | 1,849,631 |
| | <u>5,085,804</u> | <u>4,980,347</u> | <u>5,012,013</u> |

B. Statement of Operations

| | For the nine month period ending September 30 | | For the three month period ending September 30 | | For the year ending December 31 |
|--|--|-------------------|---|-----------------|------------------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues from cellular services, sales and services | 3,007,186 | 2,956,946 | 1,100,424 | 1,017,305 | 3,948,273 |
| Cost of cellular services, sales and services | <u>2,446,982</u> | <u>2,620,261*</u> | <u>827,165</u> | <u>899,017*</u> | <u>3,469,045</u> |
| Gross profit | 560,204 | 336,685 | 273,259 | 118,288 | 479,228 |
| Sales and marketing expenses | 350,529 | 345,761* | 122,531 | 118,590* | 467,928 |
| General and administrative expenses | 112,430 | 113,878* | 39,005 | 36,625* | 154,475 |
| | <u>462,959</u> | <u>459,639</u> | <u>161,536</u> | <u>155,215</u> | <u>622,403</u> |
| Operating income (loss) | 97,245 | (122,954) | 111,723 | (36,927) | (143,175) |
| Financing expenses, net | 119,104 | 53,301 | 47,227 | 45,949 | 93,270 |
| Other income, net | (1,056) | (875) | (452) | (77) | (1,474) |
| Loss before income tax | (20,803) | (175,380) | 64,948 | (82,799) | (234,971) |
| (Tax benefit) | (4,506) | (56,726) | (1,502) | (29,583) | (74,336) |
| Earnings (loss) after income tax | (16,297) | (118,654) | 66,450 | (53,216) | (160,635) |
| Minority equity in losses of a consolidated company | — | (4,537) | — | (1,479) | (5,727) |
| Company's equity in losses (earnings) of an affiliate | <u>3,799</u> | <u>326</u> | <u>2,879</u> | <u>344</u> | <u>657</u> |
| Net earnings (loss) | <u>(20,096)</u> | <u>(114,443)</u> | <u>63,571</u> | <u>(52,081)</u> | <u>(155,565)</u> |

* Reclassified

DBS SATELLITE SERVICES (1998) LTD.

CONDENSED INTERIM FINANCIAL STATEMENTS

**AS OF SEPTEMBER 30, 2003
(Unaudited)**

Table of Contents

| | <u>Page</u> |
|--|-------------|
| Auditors' Review Report | 210 |
| Condensed Financial Statements — In Adjusted New Israeli Shekels (NIS): | |
| Balance sheet | 211 |
| Statements of operations | 212 |
| Statements of changes in capital deficiency | 213 |
| Statements of cash flows | 214-215 |
| Notes to financial statements | 216 |

November 5, 2003

The Board of Directors of

DBS Satellite Services (1998) Ltd.

Kfar Saba.

Dear Sirs,

Re: Review of unaudited condensed interim financial statements for
the periods ended September 30, 2003

At your request, we have reviewed the condensed interim balance sheet of DBS Satellite Services (1998) Ltd. (hereafter — the Company) as of September 30, 2003 and the condensed interim statements of operations, changes in capital deficiency and cash flows for the nine and three month periods ended on that date. Our review was performed in accordance with the procedures prescribed by the Institute of Certified Public Accountants in Israel. Inter alia, these procedures included: reading the financial statements referred to above, reading the minutes of meetings of shareholders and of the board of directors and its committees and making inquiries of Company officers responsible for financial and accounting matters.

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

In performing our review, nothing came to our attention that indicates that material adjustments need to be made to the condensed interim financial statements referred to above, in order for them to be considered as having been prepared in accordance with accounting principles generally accepted in Israel and with the Israeli Securities Regulations (Periodic and Immediate Reports), 1970.

We draw attention to note 3 to the condensed financial statements regarding the financial position of the Company. As stated in said note, the Company's continued activity depends on the execution of the amendment to the financing agreement signed with banks and on the receipt of additional loans from shareholders.

Sincerely yours,

Kesselman & Kesselman
Certified Public Accountants (Isr.)

Condensed Balance Sheet
as of September 30, 2003
In adjusted NIS

| | September 30 | | December 31, |
|---|--------------|-------------|--------------|
| | 2003 | 2002 | 2002 |
| | (Unaudited) | | (Audited) |
| | In thousands | | |
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | 6,631 | 3,862 | 1,655* |
| Short-term deposit | | | 2,799* |
| Accounts receivable: | | | |
| Trade | 95,572 | 111,371 | 104,678 |
| Other | 5,645 | 9,019 | 4,773 |
| Total current assets | 107,848 | 124,252 | 113,905 |
| Broadcasting rights: | | | |
| Cost | 276,834 | 310,044 | 248,127 |
| Less — utilized rights | 133,636 | 115,277 | 110,663 |
| | 143,198 | 194,767 | 137,464 |
| Fixed assets: | | | |
| Cost | 2,068,107 | 1,860,909 | 1,921,687 |
| Less — accumulated depreciation (see note 5) | 884,025 | 513,415 | 603,995 |
| | 1,184,082 | 1,347,494 | 1,317,692 |
| License fees — advance on account of royalties | | 12,770 | 6,386 |
| | 1,435,128 | 1,679,283 | 1,575,447 |
| Liabilities, net of capital deficiency | | | |
| Current liabilities: | | | |
| Accounts payable and accruals: | | | |
| Trade | 462,007 | 591,521 | 530,208 |
| Other | 81,890 | 60,522 | 77,686 |
| Total current liabilities | 543,897 | 652,043 | 607,894 |
| Bank credit | 1,241,849 | 1,055,568 | 1,108,763 |
| | 1,785,746 | 1,707,611 | 1,716,657 |
| Long-term liabilities: | | | |
| Liability for employee rights upon retirement | 3,728 | 2,569 | 2,798 |
| Customer deposits, net | 28,996 | 42,202 | 41,431 |
| Other liabilities | 54,362 | 20,387 | 14,122 |
| Total long-term liabilities | 87,086 | 65,158 | 58,351 |
| Shareholders' loans | 2,238,447 | 1,977,103 | 2,060,117 |
| Total liabilities | 4,111,279 | 3,749,872 | 3,835,125 |
| Capital deficiency | (2,676,151) | (2,070,589) | (2,259,678) |
| | 1,435,128 | 1,679,283 | 1,575,447 |

* Reclassified

Date of approval of the financial statements: November 5, 2003.

Katriel Moriah
Deputy Financial Officer

Shlomo Liran
Chief Executive Officer

David Brodet
Chairman of the
Board of Directors

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

Condensed Statements of Operations
for the 9 and 3 month periods ended September 30, 2003
In adjusted NIS

| | 9 months ended September 30 | | 3 months ended September 30 | | Year ended December 31, |
|---|--------------------------------|----------------|--------------------------------|----------------|----------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | | (Unaudited) | | (Audited) |
| | In thousands | | | | |
| Revenues | 617,299 | 481,020 | 217,375 | 186,739 | 662,526 |
| Operating expenses | 743,844 | 802,714 | 247,889 | 275,349 | 1,073,456 |
| Gross loss | <u>126,545</u> | <u>321,694</u> | <u>30,514</u> | <u>88,610</u> | <u>410,930</u> |
| Selling, marketing, general and administrative expenses: | | | | | |
| Selling and marketing | 79,441 | 96,599 | 28,063 | 27,930 | 117,573 |
| General and administrative | <u>69,695</u> | <u>86,268</u> | <u>23,336</u> | <u>25,959</u> | <u>115,282</u> |
| | 149,136 | 182,867 | 51,399 | 53,889 | 232,855 |
| Loss from ordinary operations | 275,681 | 504,561 | 81,913 | 142,499 | 643,785 |
| Financial expenses (income), net | 136,375 | (2,444) | 50,510 | 54,758 | 47,366 |
| Other expenses (see note 6) | <u>4,417</u> | <u>20,733</u> | <u>48</u> | <u>20,733</u> | <u>20,797</u> |
| Loss for the period | <u>416,473</u> | <u>522,850</u> | <u>132,471</u> | <u>217,990</u> | <u>711,948</u> |

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

Condensed Statements of Changes in Capital Deficiency
for the 9 and 3 month periods ended September 30, 2003
In adjusted NIS

| | <u>Share capital and premium</u> | <u>Accumulated deficit</u> In thousands | <u>Total</u> |
|--|--|--|--------------------|
| Balance as of January 1, 2003 (audited) | 20 | (2,259,698) | (2,259,678) |
| Changes during the 9 months ended September 30, 2003 (unaudited) — loss | — | (416,473) | (416,473) |
| Balance as of September 30, 2003 (unaudited) | <u>20</u> | <u>(2,676,171)</u> | <u>(2,676,151)</u> |
| Balance as of January 1, 2002 (audited) | 11 | (1,547,750) | (1,547,739) |
| Changes during the 9 months ended September 30, 2002 (unaudited) — loss | — | (522,850) | (522,850) |
| Balance as of September 30, 2002 (unaudited) | <u>11</u> | <u>(2,070,600)</u> | <u>(2,070,589)</u> |
| Balance as of July 1, 2003 (unaudited) | 20 | (2,543,700) | (2,543,680) |
| Changes during the 3 months ended September 30, 2003 (unaudited) — loss | — | (132,471) | (132,471) |
| Balance as of September 30, 2003 (unaudited) | <u>20</u> | <u>(2,676,171)</u> | <u>(2,676,151)</u> |
| Balance as of July 1, 2002 (unaudited) | 11 | (1,852,610) | (1,852,599) |
| Changes during the 3 months ended September 30, 2002 (unaudited) — loss | — | (217,990) | (217,990) |
| Balance as of September 30, 2002 (unaudited) | <u>11</u> | <u>(2,070,600)</u> | <u>(2,070,589)</u> |
| Balance as of January 1, 2002 (audited) | 11 | (1,547,750) | (1,547,739) |
| Changes during the year ended December 31, 2002 (audited): | | | |
| Issue of share capital | 9 | | 9 |
| Loss | — | (711,948) | (711,948) |
| Balance as of December 31, 2002 (audited) | <u>20</u> | <u>(2,259,698)</u> | <u>(2,259,678)</u> |

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

Condensed Statements of Cash Flows
for the 9 and 3 month periods ended September 30, 2003
In adjusted NIS

| | 9 months ended September 30 | | 3 months ended September 30 | | Year ended December 31, |
|--|--------------------------------|---------------------|--------------------------------|---------------------|----------------------------|
| | 2003 | 2002 | 2003 | 2002 | 2002 |
| | (Unaudited) | | (Unaudited) | | (Audited) |
| | In thousands | | | | |
| Cash flows from operating activities: | | | | | |
| Loss for the period..... | (416,473) | (522,850) | (132,471) | (217,990) | (711,948) |
| Adjustments required to reflect the cash flows from operating activities (a) | <u>408,409</u> | <u>516,586</u> | <u>155,365</u> | <u>253,271</u> | <u>642,797</u> |
| Net cash provided by (used in) operating activities..... | <u>(8,064)</u> | <u>(6,264)</u> | <u>22,894</u> | <u>35,281</u> | <u>(69,151)</u> |
| Cash flows from investing activities, see (b) below: | | | | | |
| Short-term deposit..... | 2,799 | | 2,799 | | (2,799) |
| Payments on account of purchase of fixed assets, see (b) below..... | (202,188) | (397,361) | (67,480) | (111,591) | (474,664) |
| Payments on account of purchase of broadcasting rights..... | (95,399) | (57,658) | (20,585) | (33,896) | (49,039) |
| Proceeds from sale of fixed assets .. | <u>12,196</u> | | <u>889</u> | | <u>10,688</u> |
| Net cash used in investing activities | <u>(282,592)</u> | <u>(455,019)</u> | <u>(84,377)</u> | <u>(145,487)</u> | <u>(515,814)</u> |
| Cash flows from financing activities: | | | | | |
| Receipt of long-term loans from shareholders | 162,546 | 335,334 | 30,105 | 70,876 | 403,617 |
| Credit from banks — net | <u>133,086</u> | <u>129,788</u> | <u>35,908</u> | <u>39,036</u> | <u>182,980</u> |
| Net cash provided by financing activities | <u>295,632</u> | <u>465,122</u> | <u>66,013</u> | <u>109,912</u> | <u>586,597</u> |
| Increase (decrease) in cash and cash equivalents | 4,976 | 3,839 | 4,530 | (294) | 1,632 |
| Balance of cash and cash equivalents at beginning of period | <u>1,655</u> | <u>23</u> | <u>2,101</u> | <u>4,156</u> | <u>23</u> |
| Balance of cash and cash equivalents at end of period | <u><u>6,631</u></u> | <u><u>3,862</u></u> | <u><u>6,631</u></u> | <u><u>3,862</u></u> | <u><u>1,655</u></u> |

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

Condensed Statements of Cash Flows
for the 9 and 3 month periods ended September 30, 2003
In adjusted NIS

| | <u>9 months ended</u> <u>September 30</u> | | <u>3 months ended</u> <u>September 30</u> | | <u>Year ended</u> <u>December 31,</u> <u>2002</u> |
|--|--|------------------|--|-----------------|---|
| | <u>2003</u> | <u>2002</u> | <u>2003</u> | <u>2002</u> | <u>(Audited)</u> |
| | (Unaudited) | | (Unaudited) | | |
| | In thousands | | | | |
| (a) Adjustments required to reflect the cash flows from operating activities: | | | | | |
| Income and expenses not involving cash flows: | | | | | |
| Depreciation and amortization | 284,252 | 223,438 | 99,015 | 76,951 | 321,933 |
| Amortization of license fees | 6,386 | 14,704 | | 6,401 | 21,301 |
| Utilized broadcasting rights | 89,884 | 99,934 | 28,160 | 33,311 | 147,154 |
| Depreciation of installation equipment | | 20,733 | | 20,733 | 20,733 |
| Liability for employee rights upon retirement, net | 930 | 1,361 | (23) | 1,434 | 1,590 |
| Capital loss | 553 | | 714 | | |
| Linkage differences on (erosion of) other long-term liabilities | (291) | | (778) | | 1,510 |
| Linkage differences on (erosion of) and interest on long-term shareholders' loans | 15,784 | (3,686) | 3,142 | 18,097 | 11,045 |
| Other | | | (252) | | 975 |
| | <u>397,498</u> | <u>356,484</u> | <u>129,978</u> | <u>156,927</u> | <u>526,241</u> |
| Changes in operating asset and liability items: | | | | | |
| Decrease (increase) in accounts receivable: | | | | | |
| Trade | 3,858 | (29,336) | 5,907 | (18,973) | (35,300) |
| Other | (872) | | 564 | | 26,531 |
| Increase (decrease) in accounts payable and accruals: | | | | | |
| Trade | 16,156 | 146,396 | 28,598 | 95,153 | 58,677 |
| Customer deposits — net | (16,167) | 31,186 | (8,702) | 5,972 | 29,427 |
| Other | 7,936 | 11,856 | (980) | 14,192 | 37,221 |
| | <u>10,911</u> | <u>160,102</u> | <u>25,387</u> | <u>96,344</u> | <u>116,556</u> |
| | <u>408,409</u> | <u>516,586</u> | <u>155,365</u> | <u>253,271</u> | <u>642,797</u> |
| (b) Supplementary information on investing activities not involving cash flows: | | | | | |
| Decrease in suppliers' credit in respect of purchase of fixed assets | <u>(44,045)</u> | <u>(103,772)</u> | <u>(2,177)</u> | <u>(47,594)</u> | <u>(91,726)</u> |
| Increase (decrease) in suppliers' credit in respect of purchase of broadcasting rights | <u>219</u> | <u>3,870</u> | <u>175</u> | <u>(7,366)</u> | <u>2,406</u> |

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

Notes to Condensed Financial Statements

(Unaudited)

as of September 30, 2003

1. General

The interim financial statements as of September 30, 2003 and for the nine and three month periods then ended (hereafter — the interim statements) were drawn up in condensed form, in accordance with Accounting Standard No. 14 of the Israel Accounting Standards Board (hereafter — the IASB) and in accordance with the Securities (Periodic and Immediate Reports) Regulations, 1970.

The accounting principles applied in the preparation of the interim statements are consistent with those applied in the preparation of the annual financial statements. However, the interim statements do not include all the information and explanations required for the annual financial statements.

Standard 14 of the IASB, which superseded Opinion 43 of the Institute of Certified Public Accountants in Israel, is applicable to financial statements for periods commencing on and after January 1, 2003; application of the standard at the beginning of 2002 would not have affected the comparative data presented in the interim statements.

2. Activities

DBS Satellite Services (1998) Ltd. (hereafter — the Company) was incorporated in Israel on December 2, 1998. In January 1999, the Company received a license from the Ministry of Communications to broadcast in Israel television broadcasts by means of satellite (hereafter — the License). The License is for a period of ten years from the date of its receipt, and can be extended for an additional period of six years, subject to certain conditions. The Company is subject to the Telecommunications Law, 1982 (hereafter — the Telecommunications Law), the regulations and rules promulgated thereunder and the terms of the License.

In July 2000, the Company completed the development stage and began to provide its customers with multi-channel television broadcasts in accordance with the License granted to it under the Telecommunications Law.

3. The Company's financial position

- a) Since the commencement of its operations, the Company has accumulated significant losses and sustained negative cash flows. The loss for 2002 amounted to approximately adjusted NIS 712 million, and the loss for the nine months ended September 30, 2003 amounted to approximately adjusted NIS 416 million. As a result of these losses, the capital deficiency and the working capital deficit as of September 30, 2003 aggregated approximately adjusted NIS 2,676 million and approximately adjusted NIS 1,678 million, respectively. The working capital deficit includes approximately adjusted NIS 1,242 million in bank credit (see also b below).
- b) On May 23, 2001, the Company entered into a financing agreement (hereafter — the financing agreement) with certain banks (hereafter — the Banks). The financing agreement includes, inter alia, undertakings by the Company to meet certain suspending conditions as well as specified cumulative milestones and financial stipulations (hereafter — the terms).

A financial review performed by the Banks at the beginning of 2002 determined that the amount of finance required for the Company's activities substantially exceeds the financing requirements defined in the financing agreement.

On December 30, 2002, the Company, its shareholders and the Banks signed an agreement regarding the expansion of the credit facility provided by the Banks (hereafter — the interim facility), which is to be carried out in parallel with additional investments by the shareholders, in an amount not less than 150% of the amount infused by the Banks. Receipt of the finance under the interim facility is, inter alia,

Notes to Condensed Financial Statements (cont'd)

(Unaudited)

as of September 30, 2003

conditional upon the Company's meeting certain financial and operating conditions, as stipulated in the aforesaid agreement.

At the same time as the aforesaid agreement was being signed, discussions were being held between the parties regarding the expansion of the interim facility within the framework of an amendment to the financing agreement (hereafter — the amendment agreement).

To date of approval of these financial statements, the shareholders and the Banks have transferred to the Company approximately U.S. \$36 million and U.S. \$24 million, respectively, which constitutes the full amount of their commitments under the interim facility. Despite this, not all the terms stipulated in the financing agreement and the interim facility have yet been fulfilled.

A financial review performed by the Banks during the reporting period has determined that the overall amount of finance required for the Company does not exceed the amount of the interim facility, together with the addition thereto provided under the amendment agreement (including the shareholders' proportionate share).

On August 6, 2003, the Banks and the Company signed the amendment agreement. Pursuant to the amendment agreement, the Banks are to provide the Company with further facilities, in addition to those provided under the financing agreement and the interim facility, this being subject to the Company complying with the conditions and achieving the milestones stipulated in the amendment agreement, which include the shareholders making additional investments amounting to not less than 150% of the amount to be infused by the Banks. The amendment agreement will only become effective after compliance with certain specified suspending conditions, and in any event not later than August 20, 2003 or such later date as agreed between the parties. To date of approval of these financial statements, certain suspending conditions have not been met. Nevertheless, principal shareholders and the Banks continued to provide the Company with additional credit, in addition to the sums already provided under the interim facility, on account of the amounts due under the amendment agreement. To date of approval of these financial statements, the amount of credit provided to the Company by the shareholders and the Banks on account of the amounts due under the amendment agreement aggregates approximately U.S. \$25.2 million and U.S. \$10 million, respectively.

- c) The receipt of additional loans from a principal shareholder is conditional, inter alia, upon the approval of the Ministerial Committee for Privatization (hereafter — the Committee). The Committee has given approval for the shareholder to increase his investment up to the sum arrived at by multiplying the percentage of his holding in the Company's share capital by U.S. \$480 million. On January 14, 2003, the Committee gave its approval for the shareholder to invest, beyond the abovementioned amount, an additional \$60 million in the Company. In the opinion of the Company's management, the total amount of investment approved by the Committee covers the principal shareholder's proportionate share in the interim facility as well as his proportionate share under the amendment agreement.
- d) The continuation of the Company's activity depends on the execution of the amendment agreement as explained in section b above, and the receipt of additional loans from shareholders.

The Company's management believes that there is a good chance that the aforementioned suspending conditions will be met, that the amendment agreement will come into effect and that arrangements will be made for the financing resources required for the coming year.

Notes to Condensed Financial Statements (cont'd)
(Unaudited)
as of September 30, 2003

4. Contingent liabilities

- a) On December 3, 2002, an application for the approval of a class action against the Company, the Cable and Satellite Broadcast Council and the Ministry of Communications was filed in connection with the broadcasts of Sports Channel 5+. The applicants allege that the broadcasts of Channel 5+ contravene the terms stipulated in the Council's approval for its broadcasts, by draining Channel 5 of content in contravention of the aforementioned approval. The applicants accuse the Company of alleged deceit, breach of contractual obligations of trust and good faith, fundamental breach of the contract between the Company and its customers, and unjust enrichment. In respect of the above, the applicants estimate that the action amounts to NIS 126 million as of the date of submitting the claim, with a further NIS 10.5 million being added for every month between the date the claim was submitted until the judgment date.

The Company has submitted its response to the application, requesting that the application be rejected in limine or, alternatively, that the underlying claim or the application for its approval as a class action be rejected.

In the opinion of the Company's legal counsel, it is difficult at this stage to estimate the chances of the claim being approved as a class action, and — if it is so approved — what the chances are of its success. Therefore, no provision has been made in respect of this action.

- b) On March 25, 2003, an application was filed with the District court for the approval of a claim as a class action. The claim relates to the imposition of the cost of the electricity required for the operation of satellite dishes on the tenants of the building in which the dish was installed. The group of claimants includes all the buildings on which satellite dishes have been installed.

The action is for declaratory relief, requiring the Company to pay for the electricity usage of the devices installed by the Company and/or on its behalf on various premises, and to reimburse the claimants all the monies paid by them in respect of the electricity usage of the Company's devices and to compensate and/or indemnify the claimants in respect of such amounts. The estimated amount of damages the reimbursement of which is demanded is NIS 25 million.

In the opinion of the Company's legal counsel, it is difficult at this stage to estimate the chances of the claim being approved as a class action, and — if it is so approved — what the chances are of its success. Therefore, no provision was made in respect of this action.

- c) The Company has a dispute with ICP Israel Cable Programming Co. Ltd (hereafter — ICP) regarding a debt. The dispute was referred to arbitration.

In December 2002, ICP filed a claim with the arbitrator for NIS 11,065,000, with the addition of linkage differences and interest until payment date.

In the opinion of the Company's legal counsel, the outcome of the claim cannot be estimated at this stage. Therefore, no provision was included in respect of this claim, over and above the amount included in ICP's supplier account.

5. The Company capitalizes costs of installation of broadcasting and receiving equipment to fixed assets. The costs of installation in apartments are amortized based on an estimate of the average term of engagement with subscribers. The costs of installation on condominium buildings are amortized based on the estimated useful life of the installation costs.

In the first quarter of 2003, the Company completed a reassessment of the estimate of the average term of engagement with subscribers. Based on this reassessment, market conditions and the experience gained by the Company, commencing 2003, costs relating to installation in apartments are now amortized at the rate of 17%.

Notes to Condensed Financial Statements (cont'd)
(Unaudited)
as of September 30, 2003

In addition, during the first quarter of 2003, the Company completed an engineering review of the estimated useful life of costs of installation on condominium buildings. Based on this engineering review, commencing 2003, costs of installation as above are now amortized at the rate of 6.7%.

The abovementioned changes increased the depreciation expense for the 9-month and 3-month periods ended September 30, 2003 by approximately adjusted NIS 26 million and approximately adjusted NIS 8.5 million, respectively.

6. Composition of other expenses:

| | 9 months ended September 30, 2003 <u>(Unaudited)</u> | 3 months ended September 30, 2003 <u>(Unaudited)</u> In thousands | Year ended December 31, 2002 <u>(Audited)</u> |
|---|--|--|--|
| Advances on account of disallowed expenses in respect of previous years . . . | 2,621 | | |
| Provision for impairment of installation equipment | | | 20,733 |
| Other | <u>1,796</u> | <u>48</u> | <u>64</u> |
| | <u>4,417</u> | <u>48</u> | <u>20,797</u> |

7. As prescribed by Accounting Standards Nos. 12 and 17 of the IASB, the adjustment of financial statements for the effects of inflation will be discontinued as from January 1, 2004. The inflation-adjusted amounts as of December 31, 2003 will be the base for the nominal-historical financial reporting in the following periods. Accounting Standard No. 13, which will come into effect concurrently with the abovementioned standards, will supersede Clarifications Nos. 8 and 9 to Opinion 36.

8. Data regarding the changes in the exchange rate of the U.S. dollar (hereafter — the dollar) and in the consumer price index:

| | <u>Exchange rate of the dollar</u> | <u>Consumer price index</u> |
|--|--|---------------------------------|
| Nine months ended September 30: | | |
| 2003 | (6.25)% | (1.49)% |
| 2002 | 10.3% | 6.99% |
| Three months ended September 30: | | |
| 2003 | 2.99% | (0.99)% |
| 2002 | 2.14% | 0.65% |
| Year ended December 31, 2002 | 7.22% | 6.49% |

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