"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2005

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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, 2005 and 2004, the consolidated balance sheets as at such dates and the related statements of income, changes in shareholders' equity and cash flows for each of the three years the last of which ended on December 31, 2005. 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, whose assets included in the consolidation constitute approximately 37.7% and approximately 36.3% of the total consolidated assets as at December 31, 2005 and 2004 and whose revenues included in the consolidation constitute approximately 60%, 49% and 37% of the total consolidated revenues for the years ended December 31, 2005, 2004, and 2003, respectively. Furthermore, we did not audit the financial statements of affiliates in which the investment was approximately NIS 75 million and approximately NIS 70 million as at December 31, 2005 and 2004, respectively, and the Group's equity in their operating losses is approximately NIS 13 million, approximately NIS 135 million and approximately NIS 341 million for the years ended December 31, 2005, 2004 and 2003, respectively. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said reports of the 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 of the Company, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the 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, 2005 and 2004 and the results of their operations, the changes in shareholders' equity and their cash flows for each of the three years the last of which ended December 31, 2005, 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 2B, the financial statements for dates and reporting periods subsequent to December 31, 2003 are stated in reported amounts, in accordance with the accounting standards of the Israel Accounting Standards Board. The financial statements for dates and reporting periods that ended through the aforementioned date are stated in values that were adjusted to that date according to 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 continuing 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 early retirement, as described in Note 16D.

3. Claims made against the Company and against investee companies, as described in Note 19A.

4. The financial position of a consolidated company, as mentioned in Note 8E. In the opinion of the Management of the consolidated company, based on the 2006 work plan and on the alternative business plan, the chances of arranging sources of finance required by the consolidated company in the forthcoming year are good.

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

March 1, 2006

Balance Sheets

		Consolidated		Company	
		December 31 2005	December 31 2004	December 31 2005	December 31 2004
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets					
Cash and cash equivalents	3	**2,158,773**	1,457,107	**1,679,244**	1,327,731
Short-term investments	4	**2,398,525**	1,287,809	**2,045,901**	1,285,920
Trade receivables	5	**2,113,512**	2,115,070	**896,415**	970,766
Other receivables and debit balances	6	**321,507**	416,113	**444,403**	370,284
Inventory		**220,404**	314,549	**–**	–
		7,212,721	5,590,648	**5,065,963**	3,954,701
Materials and spare parts		**88,881**	130,922	**88,881**	130,922
Broadcasting rights					
Cost		**238,260**	234,757	**–**	–
Less – rights utilized		**83,760**	94,261	**–**	–
		154,500	140,496	**–**	–
Investments and long-term receivables					
Investments, deposits and debit balances	7	**766,840**	872,575	**401,096**	570,541
Investments in investee companies	8	**75,467**	70,308	**5,945,899**	6,484,476
		842,307	942,883	**6,346,995**	7,055,017
Fixed assets	9				
Cost		**30,627,629**	34,311,281	**21,286,880**	22,124,083
Less – accumulated depreciation		**20,684,981**	23,570,947	**15,766,843**	15,993,634
		9,942,648	10,740,334	**5,520,037**	6,130,449
Other assets					
Goodwill		**1,699,546**	1,792,658	**–**	–
Deferred charges and other assets	10	**380,483**	387,904	**10,056**	13,434
Deferred taxes	11	**344,786**	446,136	**315,708**	339,280
		2,424,815	2,626,698	**325,764**	352,714
		20,665,872	20,171,981	**17,347,640**	17,623,803

	Note	Consolidated December 31 2005 NIS thousands	Consolidated December 31 2004 NIS thousands	Company December 31 2005 NIS thousands	Company December 31 2004 NIS thousands
Current liabilities					
Bank credit	12	**75,191**	88,102	**–**	–
Current maturities of:					
Long-term bank loans	13	**1,262,583**	1,304,916	**531,402**	473,578
Debentures	14	**527,167**	240,481	**410,827**	210,481
Trade payables	15	**1,400,714**	1,675,569	**540,459**	648,218
Employee severance benefits, net	16	**567,878**	592,474	**567,878**	592,474
Other current liabilities	17	**1,387,955**	1,402,140	**901,642**	909,194
		5,221,488	5,303,682	**2,952,208**	2,833,945
Long-term liabilities:					
Long-term loans	13	**2,151,960**	2,860,934	**34,522**	529,734
Debentures	14	**4,903,056**	3,824,539	**6,012,584**	6,114,628
Employee severance benefits, net	16	**297,427**	680,096	**274,883**	658,355
Other long-term liabilities	18	**34,081**	47,375	**15,583**	21,374
Loans extended by the minority in a consolidated company:					
Loans		**1,114,498**	1,057,988	**–**	–
Less – minority share in deficit of a consolidated company		**(1,114,498)**	(1,057,988)	**–**	–
		7,386,524	7,412,944	**6,337,572**	7,324,091
Minority rights		**–**	(10,412)	**–**	–
Contingent liabilities	19				
Shareholders' equity	20	**8,057,860**	7,465,767	**8,057,860**	7,465,767
		20,665,872	20,171,981	**17,347,640**	17,623,803

Moshe Arkin	**Yacov Gelbard**	**Ron Eilon**
Chairman of the Board	President & CEO	Deputy CEO and CFO

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B.

Date of approval of the financial statements: March 1, 2006.

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

Statements of Operations for the Year Ended December 31

		Consolidated			Company		
		2005	2004	2003	2005	2004	2003
		Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues	21	**11,098,686**	9,269,804	7,981,268	**4,723,734**	4,959,691	5,230,561
Costs and expenses							
General and operating expenses	22	**7,193,468**	5,565,090	4,485,300	**2,346,451**	2,347,448	2,366,547
Depreciation	9	**2,330,711**	2,092,475	2,160,011	**1,390,435**	1,495,909	1,776,279
Royalties to the State of Israel		**257,429**	220,691	242,608	**135,575**	145,318	181,116
		9,781,608	7,878,256	6,887,919	**3,872,461**	3,988,675	4,323,942
Operating income		**1,317,078**	1,391,548	1,093,349	**851,273**	971,016	906,619
Financing expenses, net	23	**(417,309)**	(217,529)	(157,522)	**(80,897)**	(93,216)	(62,372)
Earnings after financing expenses		**899,769**	1,174,019	935,827	**770,376**	877,800	844,247
Other income (expenses), net	24	**109,386**	79,680	(983,178)	**201,012**	109,904	(846,948)
Earnings (loss) before income tax		**1,009,155**	1,253,699	(47,351)	**971,388**	987,704	(2,701)
Income tax	11	**(429,594)**	(497,485)	(48,013)	**(332,118)**	(387,079)	(33,513)
Earnings (loss) after income tax		**579,561**	756,214	(95,364)	**639,270**	600,625	(36,214)
Equity in earnings (losses) of investee companies	8	**(12,645)**	(134,773)	(343,334)	**(63,412)**	20,200	(401,622)
Minority share in loss (earnings) of a consolidated company		**8,942**	(616)	862	**–**	–	–
Earnings before the cumulative effect of a change in accounting method		**575,858**	620,825	(437,836)	**575,858**	620,825	(437,836)
Cumulative effect of a change in accounting method as at the beginning of the year**	11	**15,000**	–	–	**15,000**	–	–
Net earnings		**590,858**	620,825	(437,836)	**590,858**	620,825	(437,836)

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B

** See Note 2P

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

Statements of Operations for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Primary and diluted earnings per NIS 1 par value of common shares (in NIS):						
Earnings before the cumulative effect of a change in accounting method	**0.222**	0.238	(0.179)	0.222	0.238	(0.179)
Cumulative effect of a change in accounting method	**0.005**	–	–	**0.005**	–	–
Net earnings per share	**0.227**	0.238	(0.179)	**0.227**	0.238	(0.179)

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B
** See Note 2P

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

Statements of Changes in Shareholders' Equity

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands					
Balance as at January 1, 2003	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Changes in 2003 –						
Net loss	–	–	–	–	(437,836)	(437,836)
Dividend paid	–	–	–	(186,416)	1,070	(185,346)
Allotment of shares	192,755	685,289	–	–	–	878,044
Balance as at December 31, 2003	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Reported amounts*					
	NIS thousands					
Balance as at January 1, 2004	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942
Changes in 2004 –						
Net earnings	–	–	–	–	620,825	620,825
Balance as at December 31, 2004	6,309,133	1,623,423	37,775	–	(504,564)	7,465,767
Changes in 2005 –						
Net earnings					**590,858**	**590,858**
Payment by the State for Company privatization	**–**	**–**	**1,235**	**–**	**–**	**1,235**
Dividend proposed for payment	**–**	**–**	**–**	**1,200,000**	**(1,200,000)**	**–**
Balance as at December 31, 2005	**6,309,133**	**1,623,423**	**39,010**	**1,200,000**	**(1,113,706)**	**8,057,860**

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B.

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

Statements of Cash Flows for the Year Ended December 31

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands			NIS thousands		
Cash flows from operating activities						
Net earnings (loss)	**590,858**	620,825	(437,836)	**590,858**	620,825	(437,836)
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	**2,127,730**	2,229,782	3,129,581	**929,074**	1,490,414	2,552,780
Cash flow generated by operating activities	**2,718,588**	2,850,607	2,691,745	**1,519,932**	2,111,239	2,114,944
Cash flows from investing activities						
Investment in fixed assets	**(1,694,071)**	(1,650,557)	(1,413,803)	**(814,783)**	(842,224)	(853,166)
Proceeds from disposal of fixed assets and sale of operations	**147,810**	131,576	86,492	**117,121**	44,897	7,742
Investment in long-term deposits and investments	**(10,068)**	(42,064)	(159,564)	**(10,068)**	(42,064)	(150,808)
Realization of long-term deposits and investments	**91,431**	18,094	77,216	**91,431**	18,094	67,176
(Increase) decrease in short-term investments, net	**(972,260)**	135,602	(107,137)	**(627,681)**	135,509	(107,137)
Acquisition of companies consolidated for the first time (see C below)	**–**	(246,935)	–	**–**	–	–
Investment in investee companies	**(18,836)**	(142,753)	(190,037)	**(74,173)**	(2,376,699)	(188,542)
Repayment of loan to subsidiary	**–**	–	–	**539,860**	–	–
Dividend from a subsidiary	**–**	–	–	**–**	18,838	–
Investments in other assets	**(91,893)**	(130,700)	(51,124)	**–**	(2,598)	–
Net cash outflow used for investment activities	**(2,547,887)**	(1,927,737)	(1,757,957)	**(778,293)**	(3,046,247)	(1,224,735)
Cash flows from financing activities						
Issue of other debentures (after deduction of issue expenses)	**1,702,265**	1,528,092	–	**330,993**	1,322,171	–
Repayment of other debentures	**(267,332)**	(601,481)	(207,623)	**(211,752)**	(601,481)	(207,623)
Receipt of long-term loans	**474,521**	314,900	493,191	**–**	–	–
Repayment of long-term loans	**(1,365,578)**	(2,605,012)	(557,302)	**(509,367)**	(354,469)	(378,828)
Repayment of short-term bank credit, net	**(12,911)**	(56,612)	(374,137)	**–**	–	–
Proceeds from allotment of shares	**–**	–	878,044	**–**	–	878,044
Dividend paid	**–**	–	(185,346)	**–**	–	(185,346)
Net cash generated by (used for) financing activities	**530,965**	(1,420,113)	46,827	**(390,126)**	366,221	106,247
Increase (decrease) in cash and cash equivalents	**701,666**	(497,243)	980,615	**351,513**	(568,787)	996,456
Cash and cash equivalents at beginning of year	**1,457,107**	1,954,350	973,735	**1,327,731**	1,896,518	900,062
Cash and cash equivalents at end of year	**2,158,773**	1,457,107	1,954,350	**1,679,244**	1,327,731	1,896,518

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B

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

Statements of Cash Flows for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	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	**2,330,711**	2,092,475	2,160,011	**1,390,435**	1,495,909	1,776,279
Disposal of assets and provision for impairment of fixed assets	**–**	–	327,295	**–**	–	198,686
Deferred taxes	**144,035**	219,975	(137,670)	**50,397**	113,330	(182,167)
Company's equity in (earnings) losses of affiliated companies	**12,645**	134,773	343,334	**63,412**	(20,200)	401,622
Minority share in losses (gains) of a consolidated company	**(8,942)**	616	(862)	**–**	–	–
Increase (decrease) in employee severance benefits, net	**(407,265)**	(110,334)	46,488	**(408,068)**	(112,974)	47,662
Gain from disposal of fixed assets	**(5,715)**	(7,338)	(1,634)	**(5,385)**	(5,674)	(1,570)
Gain from sale of an operation	**(103,869)**	(35,033)	–	**(103,869)**	(35,033)	–
Provision for decrease in value of investments	**5,868**	26,000	14,603	**5,868**	26,000	14,603
Erosion (appreciation) of and interest on long-term deposits and investments	**22,170**	31,199	36,407	**22,118**	(6,023)	36,407
Appreciation of short-term investments, net	**(60,396)**	(10,584)	(75,381)	**(52,424)**	(10,555)	(75,378)
Appreciation (erosion) of long-term liabilities:						
Other debentures	**(69,730)**	115,674	207,133	**(20,939)**	115,674	207,133
Long-term loans and other long-term liabilities	**129,032**	(17,104)	(77,647)	**(118,565)**	(9,971)	(82,015)
Amortization of other assets and deferred expenses	**196,015**	110,083	127,191	**4,618**	6,098	(8,466)
Changes in asset and liability items:						
Increase in broadcasting rights	**(14,004)**	(17,516)	–	**–**	–	–
Decrease (increase) in trade receivables	**(63,298)**	52,827	29,835	**74,351**	50,501	67,096
Decrease (increase) in other receivables and debit balances	**24,600**	(8,223)	129,706	**44,375**	(54,988)	163,158
Decrease (increase) in inventory	**75,943**	(122,824)	78,083	**–**	–	–
Decrease (increase) in materials and spare parts	**24,952**	625	(260)	**24,952**	625	(260)
Decrease in trade payables	**(112,461)**	(102,466)	(123,852)	**(63,777)**	(23,124)	(30,925)
Increase (decrease) in other current liabilities	**20,733**	(126,652)	63,054	**27,366**	(26,451)	45,460
Increase (decrease) in deferred revenues	**(13,294)**	3,609	(16,253)	**(5,791)**	(12,730)	(24,545)
	2,127,730	2,229,782	3,129,581	**929,074**	1,490,414	2,552,780

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B

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

Statements of Cash Flows for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands			NIS thousands		
B – Non–cash transactions						
Acquisition of fixed assets, other assets, materials and spare parts on credit	**124,719**	102,687	313,119	**17,089**	25,553	180,463
Sale of fixed assets on credit	**17,089**	1,196	–	**–**	1,196	–
Investment against a loan to a consolidated company	**–**	–	–	**–**	2,560,089	–
C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company						
Operating capital (excluding cash and cash equivalents)	**–**	2,057,632	–	**–**	–	–
Fixed assets	**–**	(2,967,819)	–	**–**	–	–
Long-term liabilities	**–**	2,322,740	–	**–**	–	–
Minority loans to a consolidated company	**–**	1,048,637	–	**–**	–	–
Less minority share in the deficit	**–**	(1,048,637)	–	**–**	–	–
Minority rights as of acquisition date	**–**	(16,549)	–	**–**	–	–
Investment in an affiliate	**–**	178,339	–	**–**	–	–
Goodwill	**–**	(1,821,278)	–	**–**	–	–
	–	(246,935)	–	**–**	–	–

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B.

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

NOTE 1 – GENERAL

A. The financial statements have been prepared in conformity with the generally accepted accounting principles as required and in accordance with the Securities Regulations (Preparation of annual financial statements), 5753-1993.

B. "Bezeq" The Israel Telecommunication Corp. Limited ("the Company") is a public company whose shares are traded on the Tel Aviv Stock Exchange. Commencing October 11, 2005, control in the Company was transferred from the State of Israel, as described in Note 1F. The Company operates under a general license for implementing telecommunications activities and providing telecommunications services, which was granted pursuant to the Communications Law (Telecommunications and broadcasts), 5742-1982 ("the Communications Law"). The Company, together with the subsidiaries ("the Group"), is a main provider of communications services in Israel.

C. Most of the Group companies are required to pay royalties to the Government of Israel. Since January 2001, the revenue base on which the royalties are calculated has been broadened, together with a gradual reduction of the royalty rate, until a uniform rate is attained for all communications operators. The rate of royalties in 2003 was 4% and from 2004 onwards, it was lowered to 3.5%. The Ministries of Communications and Finance intend to act to amend the relevant regulations so that effective from January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by the said licensees operating in domestic fixed-line telecommunications, international telecommunications and cellular services, until reaching a rate of 1% in the year 2010. The regulations have not yet been amended.

D. The Company was declared a monopoly in the principal fields in which it operates. An appeal filed by the Company against the non-revocation of the declaration of the Company as a monopoly in the basic telephony field, is pending in the Antitrust Tribunal.

E. All the segments of operation of the Group operate in a competitive environment. The Group's operations are generally subject to administrative regulation and supervision. The principal changes that occurred during the period of the financial statements are described below:

(1) Domestic fixed-line communication services

a. Most of the tariffs for the Company's services are set according to Section 15 of the Communications Law and are updated in accordance with the regulations. Tariff updates are based on the change in the Consumer Price Index less a depreciation factor which is set at minus 2.5% as long as the average growth rate of the Company is within a range of minus 1% to minus 3% per year (the depreciation factor will be reduced by one half of one percent with each decrease of one percent in the growth rate beyond minus 3%, and will increase by one half of one percent with each rise of one percent in the growth rate beyond minus 1% continuously). This tariff arrangement will remain in force until December 31, 2007, with an option to extend it for an additional year.

On June 1, 2005, the Company's controlled tariffs were reduced by an average rate of approximately 2.2%. The said reduction was based on a change of approximately 1.2% in the Consumer Price Index and an average efficiency factor at a rate of approximately 3.4%. It should be noted that the update includes, *inter alia*, a reduction of approximately 3.2% in the call tariffs and an increase of approximately 1.2% in the user charges. The reduction also included the amendment of the calculation method of the annual efficiency factor. It should be noted that the interconnect tariffs were reduced by a rate of 3.2%, effective from September 1, 2005.

Following the reduction in the rate of VAT to 16.5% in September 2005, the Company's tariffs were updated accordingly. Subsequently, part of the Company's tariffs were amended (and published in the regulations) in effect from November 1, 2005, in order to maintain "round" tariffs for these services, while including the new rate of VAT.

NOTE 1 – GENERAL (CONTD.)

E (CONTD.)

(1) Domestic fixed-line communication services (contd.)

b. In November 2003, a partnership owned by the cable companies was granted a general license for providing domestic fixed-line telecommunications services, including telephony, data communications and access to internet providers. The partnership is obligated to gradually provide its services nationwide. In November 2004, the partnership commenced providing services under its license on a commercial basis, and in 2005 it stepped up its marketing efforts.

c. On July 5, 2004, regulations were published relating to procedures and conditions for the receipt of a special general license for the provision of domestic fixed-line communications services with no universal service obligation. Under the regulations, the licensee is to be the owner and operator of the telecommunications network by means of which the services are to be provided to its subscribers, but at the same time, the licensee will be entitled to use the infrastructure of others, provided that it is the owner and operator of the switch via which the services are provided to its subscribers. In December 2005, such a license was granted to one operator.

d. On August 1, 2004, a temporary order took effect pursuant to which, for a period of two years or until the creation of a difference of up to 1.05 billion traffic minutes between the Company's network and the network of another domestic fixed-line operator (with the exception of a special licensee and the Company), whichever is the earlier of the two, interconnect fees will not be paid for call completion between networks of such domestic fixed-line operator. The Company receives compensation in respect of non-payment of interconnect fees in the form of a reduction in the royalties paid to the State. This compensation will be up to NIS 40 million.

e. On November 30, 2004, the Ministry of Communications published a policy paper regarding "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator". On April 20, 2005, the Ministry of Communications notified, *inter alia*, the Company and its subsidiaries, that in the course of the completion of the preparation of the policy and after an examination of the response that had been given in answer to their application, it was considering amending the main policy paper so that the Company or a subsidiary of the Company would be entitled to provide VOB services after the Company's market share in the domestic fixed-line telephony sector in a certain customer segment dropped below 85%. The Company deems such an amendment to be a potential worsening of its situation and that of its subsidiaries, and it submitted its objection to the policy paper to the Ministry of Communications. The Company clarified, *inter alia*, that Bezeq should not be denied the possibility of providing VOB services, and such a denial would be in contravention of the license and the law, it would be unprecedented around the world and it would severely damage the Group and its customers.

As at the date of publication of these reports, the marketing trial license granted to Bezeq International was extended to provide the service until the end of August 2006, and the Ministry of Communications published a notice stating the Bezeq International would be able to provide VOB services on restrictive terms. Pelephone Communications Ltd. also received a marketing trial license.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(1) Domestic fixed-line communication services (contd.)

f. On March 29, 2005, the Economic Policy for Financial Year 2005 Law (Legislative amendments), 5765-2004 was passed, which includes, *inter alia*, an amendment to the Communications Law (Telecommunications and broadcasts), 5742-1982, whereby the Minister of Communications will prepare a numbering plan for number portability with regard to a general licensee (including a special general licensee) for the provision of domestic fixed-line communication services and with regard to a general licensee for the provision of cellular services, and they will receive directions regarding the implementation and operation of the plan by September 1, 2006 (should the Ministers of Communications and Finance learn that a genuine need has arisen therefor, and for special reasons, they may defer by order, with the approval of the Knesset Economic Committee, the implementation and operation of the plan for a period that shall not exceed three months).

On August 22, 2005, a numbering plan was signed by the Ministry of Communications for the registration of number portability.

As the Company noted in its position paper which was sent to the Ministry of Communications, it is not possible to meet the timeframe determined in the law for the application of the plan. In addition, in the Company's opinion, the application of number portability is likely to require the Company to make significant financial investments in changing software versions and hardware in the Company's switching network, to a material extent. Furthermore, large financial investments will be required in the area of the Company's information systems, which could also cause a deferment of the Company's development plan in this field. In addition, the operation of number portability involves costs in respect of joint records and management with the relevant operators. These are costs whose full scope cannot yet be estimated. In addition to the aforesaid expected costs, the implementation of number portability, which is expected to facilitate customer transfer between the networks of competing communications operators, could have an adverse effect on the way the Company deals with the competition as well as on the other companies of the Group.

The Company and other communications operators have requested postponement of the date for implementation of the plan. The postponement has not yet been approved.

g. On April 10, 2005, the Company received a copy of a letter by the Director-General of the Ministry of Communications, dated April 6, 2005, addressed to the Director of the Government Companies Authority, regarding clarifications to the participants in the proceeding for the privatization of the Company. Pursuant to that stated in the document, it includes clarifications of the main issues that were raised by the participants who took part in the privatization proceeding, clarifications which were given based on the Ministry of Communications' current policy to promote competition in the communications sector and the provisions of the law and the existing licenses, and they should not be deemed to be a basis for an expectation or reliance of any kind by the participants.The clarifications address, *inter alia*, the following issues: the licensing policy for the provision of telephony services by means of broadband access (VOB), the Company's tariffs and volume discounts, baskets of services, payments for interconnect services, royalties, a structural separation, universal service, the Telecommunications Order, use by the subsidiary, DBS, of ADSL for the purpose of the provision of its services, a minimum payment for the creation of a cellular call, the convergence of fixed-line and cellular services and number portability. In the Company's opinion, the clarifications contained in the document of the Director-General of the Ministry of Communications do not significantly reduce the regulatory uncertainty in which the Group and the Company are operating. In addition, the clarifications concern, in general, future actions, which the Company is unable to assess, if and when they will occur, and therefore the Company is also unable to assess their implications on the operations of the Company and the subsidiaries in the Group and or their financial results.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(1) Domestic fixed-line communication services (contd.)

g. (Contd.)
In addition, the Company believes that no progress has been made on several issues on which the Ministry of Communications gave notice, in an explanatory document of their investigation, and it notified the Ministry that these delays are making it difficult for the Company to prepare for intensifying competition.

(2) Cellular services

a. On December 14, 2005, the Minister of Communications announced his decision obligating the Company to transfer interconnect fees to Cellcom according to the report on the volume of traffic which actually passed from the Company's network to Cellcom's, irrespective of the amounts collected and without deducting a collection commission, and with a deduction of 1.1% relating to the period from March 1, 2000 to October 1, 2000. The Company's financial statements include a provision for the effects of the Minister's decision which the Company believes to be appropriate.

b. On December 5, 2004, the Minister of Communications notified Pelephone and the Company that as part of a process of re-examination of interconnect fees for a cellular network, the Ministry of Communications had decided to amend the Communications Regulations (Telecommunications and broadcasts) (Payments for interconnect), 5760-2000 ("the Interconnect Regulations") ("the Regulations") in a way that will reduce the interconnect fees to a cellular network for call completion, SMS messages and the computation of the duration to be charged.

The main amendments are:
(1) Reduction of payments receivable from a domestic operator or a cellular operator for the completion of one traffic minute on a cellular network from 45 agorot per traffic minute to a maximum tariff of 32 agorot, as from March 1, 2005, to a maximum tariff of 29 agorot as from March 1, 2006, to a maximum tariff of 26 agorot as from March 1, 2007 and a maximum tariff of 22 agorot as from March 1, 2008.
(2) Reduction of payments receivable from an international licensee for completion of a traffic minute on a cellular network from 25 agorot per minute to a maximum tariff of 22 agorot per minute, as from March 1, 2008.
(3) Reduction of payments receivable from a cellular operator for the transfer of an SMS message in a cellular network from 28.5 agorot per traffic minute to a maximum tariff of 5 agorot per minute as from March 1, 2005 and 2.5 agorot per minute as from March 1, 2006.
(4) From March 1, 2006, an annual updating mechanism will be introduced for call completion and SMS tariffs in a cellular network, whereby the tariffs will be updated once a year according to the rate of change in the CPI.
(5) For counting the traffic minutes for computation of the payment for call completion to a cellular network, from January 1, 2009, billing will be according to segments of one second, rather than 12 seconds as is the practice today.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(3) International communication services

On April 22, 2004, the Communications Regulations (Telecommunications and broadcasts) (Procedures and conditions for receipt of a general license to provide international telecommunication services), 5764-2004, came into effect. Pursuant to these Regulations, the Ministry of Communications has granted general licenses to provide international telecommunication services to three additional operating companies, all of which had commenced operation by the end of 2004 (so that in all, six operators are now active). The broadening of competition has led to a further lowering of international call prices, although unlike when competition started in 1997, the volume of international traffic has not increased significantly as a result, since in the period prior to the broadening of the competition, the cost of the calls was not a factor that deterred the public from using the service. In addition, the broadening of the competition had an adverse effect on the results of operations of Bezeq International in the international call sector, however, since prices and market shares of international calls have not yet finally stabilized, as at the date of publication of these financial statements, Bezeq International and the Company are unable to estimate, at this stage, the extent of the overall effect of the broadening of competition in the field.

The increasing competition and the entirety of the changes in the communications market as described above, are expected to have an adverse effect on the business results of the Group. That effect cannot be assessed.

F. On May 10, 2005, Ap.Sb.Ar. Holdings Ltd. ("Ap.Sb.Ar.") was selected as the preferred bidder in the off-market proceeding for the sale of 781,513,683 shares of the Company held by the State (which constitute approximately 30% of the Company's shares) and options to purchase 277,697,862 shares of the Company held by the State (which constitute approximately 10.66% of the Company's shares) in accordance with the terms set forth in the sale agreement ("the State's Holdings").

On October 11, 2005, the process of transfer of the State's Holdings to Ap.Sb.Ar. was completed, for a sum of approximately NIS 4,246 million. The shares of Ap.Sb.Ar. in the Company are being held in trust by Romema Holdings Co. Ltd.

As a result of the completion of the transaction and the grant of approval for control of the Company to be transferred to Ap.Sb.Ar. in accordance with the Communications Law, the Company was released from certain restrictions which had been imposed on it as a company controlled by the State of Israel, including the cancellation and/or modification of part of the provisions of its Articles of Association, which are similar to certain provisions in the Government Companies Law, 5735 – 1975. In addition, lenders, whose balance of the loan amounts to approximately NIS 344 million, are entitled to declare the bonds which they hold to be immediately due and payable. The bonds were classified in the Company's balance sheet as short-term liabilities (see also Note 14C).

As the Company was informed, in accordance with the agreement between the State and Ap.Sb.Ar., Ap.Sb.Ar. may request that the State vote together with it (as per the restrictions set forth in the agreement with regard to certain matters) in respect of 10.66% of the Company's shares which are held by the State and which Ap.Sb.Ar. received an option to purchase, and in respect of 1.01% of the Company's shares which will remain in the State's possession in the period commencing on October 11, 2005 (the transaction completion date) and ending at the end of the option exercise period, and in respect of 4.71% of the Company's shares held by the State, which are designated for allotment as described below – for the aforesaid period or until the transfer of ownership of these shares to the Company's employees, whichever is the earlier of the two.

NOTE 1 – GENERAL (CONTD.)

G. Pursuant to an offer for sale and public offering pursuant to the Company's prospectus dated May 24, 2004, and the closing of the sale of the controlling interest in the Company in October 2005, the Company's employees are entitled to compensation by means of an allotment of 4.71% of the shares of the Company held by the State. The share allotment will be made by way of a stock options plan pursuant to the description published by the Company on November 15, 2005, as follows:

(1) The Offered Securities

a. Up to 122,697,648 options registered by name, each of which may be exercised into one ordinary share of NIS 1 par value each of the Company (subject to adjustments).

b. The options will not be listed for trading on the stock exchange. The ordinary (registered) shares of NIS 1 par value each which are designated for allotment against the exercise of the options are listed for trading on the stock exchange.

(2) Proceeds of the Securities and the Exercise Price

a. The options are being offered to eligible employees, including a group of former employees ("Offerees") without consideration.

b. The exercise price of each of the options will be NIS 4.037 ("the Exercise Price").
It should be noted that the Exercise Price reflects a weighted price according to 20% of the Company's share price in the public offering according to the prospectus (NIS 5.0239, adjusted to the Consumer Price Index of September 2005) and 80% of the average share price on the stock exchange in the 30 trading days preceding the completion date (NIS 5.9531) less a 30% discount.

The Exercise Price will be linked to the Consumer Price Index (without interest being added) and with adjustments for the distribution of dividends by the Company and for the issue of bonus shares and for the bonus element in the rights issue.

(3) Exercise of the Options

Commencing January 1, 2008, each of the Offerees will be entitled to exercise one-third of the options offered to him ("the First Portion") and to submit an exercise notice, as defined below – subject to the provisions of section 102 – at any time from this date to the expiration of four years and twenty business days from the determining date. At the end of the third year from the determining date, the Offeree will be entitled to exercise an additional third of the total number of options ("the Second Portion"). The Offeree will be entitled to submit an exercise notice, as defined below, for the options included in the Second Portion – subject to the provisions of section 102 – at any time from the expiration of three years from the determining date to the expiration of four years and twenty business days from the determining date.

At the expiration of four years from the determining date, the Offeree will be entitled to exercise an additional third of the total number of options ("the Third Portion"). The Offeree will be entitled to submit an exercise notice, as defined below, for the options included in the Third Portion – subject to the provisions of section 102 – not later than at the expiration of four years and twenty business days. Should the Offeree fail to exercise options pursuant to his entitlement in a particular portion, the options will be added to the next portion.

NOTE 1 – GENERAL (CONTD.)

G. (CONTD.)

(3) (contd.)

The estimated fair value of each option for a share, calculated according to the share price as at September 30, 2005, is NIS 1.49. This estimate was calculated by applying the Black-Scholes-Merton formula for the pricing of options, less a discount at a rate of 25% due to a lack of marketability. The formula includes a standard deviation at a rate of 27%, based on the historical fluctuations of the share and a risk-free interest rate of 2.9%. The total bonus value in the plan is approximately NIS 183 million.

Standard No. 24 of the Israeli Accounting Standards Board - "Share-Based Payment" took effect on January 1, 2006. The Company completed the allotment before that date and therefore this Standard, including its transition provisions, does not apply to the said allotment. Accordingly, expenses in respect of the bonus element contained in the allotment were not be included in the financial statements. The tax benefit to which the Company is entitled will be recorded under a capital reserve, on the date on which the expense is recognized.

H. On March 1, 2006, the Board of Directors of the Company resolved to recommend to the General Meeting of its shareholders the distribution of a cash dividend to the shareholders in the amount of NIS 1,200 million (out of retained earnings accumulated in 2004 and 2005), which as at the date of distribution constitutes NIS 0.46 per share and approximately 46% of the Company's issued and paid up capital. The Board of Directors has called a Special General Meeting of the shareholders of the Company, the agenda of which includes approval of distribution of a dividend to the shareholders as detailed above.

Pursuant to a resolution of the Board of Directors on March 1, 2006, resolutions concerning the distribution of a dividend will be passed specifically according to the financial results of the Company, its financial condition and other relevant circumstances and data. This resolution supersedes earlier resolutions on the matter of dividend policy.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. DEFINITIONS

In these financial statements –

(1) the Company – Bezeq, The Israel Telecommunication Corp. Limited.

(2) the Group - Bezeq, The Israel Telecommunication Corp. Limited and its investee companies, as listed in Appendix A – List of Group Companies.

(3) Subsidiaries – Companies, including a partnership or joint venture, whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.

(4) Proportionately consolidated companies – Companies, including a partnership or joint venture, whose financial statements are partially (proportionately) consolidated, directly or indirectly, with the financial statements of the Company.

(5) Affiliated companies – Companies other than subsidiaries or proportionately consolidated companies and including a partnership, in which the Company's investment is stated, directly or indirectly, on the equity basis.

(6) Investee companies – Subsidiaries, proportionately consolidated companies or affiliated companies.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY CONTD.)

A. DEFINITIONS (CONTD.)

(7) Investments in venture capital funds – Investment in a fund in which two conditions obtain:
- a. The principal business of the fund is research, development or marketing of innovative and high-tech products or processes;
- b. The source of at least 90% of the fund's financing is shareholder capital (including shareholder loans and credit guaranteed by the shareholders), with the support of State authorities or research grants.

(8) Related parties – As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel ("ICPAI").

(9) Interested parties – As defined in Paragraph (1) of the definition of an "Interested Party" in a corporation, in Section 1 of the Securities Law.

(10) Controlling shareholder – As defined in the Securities Regulations (Presentation of transactions between a company and its controlling shareholder in financial statements), 5756-1996.

(11) CPI – The Consumer Price Index published by the Central Bureau for Statistics.

(12) Adjusted value – A nominal historical amount adjusted in accordance with the provisions of Opinions 23, 34 and Opinions 36, 37 and 50.

(13) Reported value – An amount adjusted for inflation to the transition date (December 31, 2003), with the addition of amounts in nominal values added after the transition, and less amounts deducted after the transition date.

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

(15) Nominal financial reporting – Financial reporting based on reported amounts.

B. FINANCIAL STATEMENTS IN REPORTED AMOUNTS

(1) In October 2001, the Israeli Accounting Standards Board ("IASB") published Accounting Standard No. 12 – "Discontinuance of Adjustment of Financial Statements". Pursuant to this Standard, and Accounting Standard No. 17 published in December 2002, the adjustment of financial statements for inflation was discontinued from January 1, 2004. Until December 31, 2003, the Company continued to prepare adjusted statements in accordance with Opinion 36 of the ICPAI. From January 1, 2004, the Company applies the provisions of the Standard and accordingly, adjustment has been discontinued.

(2) In the past, the Company prepared its financial statements on the basis of historical cost adjusted for the CPI. The adjusted values included in the financial statements as at December 31, 2003 served as the starting point for nominal financial reporting which commenced on January 1, 2004. Additions made during the period were included in nominal values.

(3) Values in respect of non–monetary assets do not necessarily represent market value or an up-to-date economic value, but rather, the reported values of those assets.

(4) In the financial statements, "cost" means cost at the reported value.

(5) All comparative data for prior periods up to January 1, 2004, are stated adjusted to the CPI of December 2003.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

C. REPORTING PRINCIPLES

(1) Balance sheets

a. Non-monetary items are stated at reported values.
b. Monetary items are stated in the balance sheet at historical nominal values as at the balance sheet date.
c. Equity of investments in investee companies is based on the reported financial statements of those companies.

(2) Statements of operations

a. Revenues and expenses deriving from non-monetary items or from provisions included in the balance sheet are derived from the difference between the reported value opening balance and the reported value closing balance.
b. The remaining items of the statement of operations are stated at nominal values.
c. The Company's share in the operating results of investee companies and the share of the rights of the outside shareholders in the results of the subsidiaries are based on the reported financial statements of those companies.

(3) Data of the Company in historical nominal values for tax purposes are given in Note 30.

D. CONSOLIDATION OF FINANCIAL STATEMENTS

(1) The consolidated financial statements include the financial statements of the Company and the financial statements of those companies over which the Company has control. Jointly controlled companies are consolidated in the financial statements by the proportionate consolidation method.

(2) A list of the companies whose reports are included in the consolidated financial statements, the percentage of the holding in shares which grant voting rights and the percentage of the holding in shares granting a share in profits, is presented in Appendix A to the financial statements. In addition, a list of companies of the Corporation which were not consolidated is also presented in Appendix A to the financial statements.

(3) For the purpose of the consolidation, the amounts included in the financial statements of the companies that were consolidated were taken into account after the adjustments necessary in order to apply uniform accounting principles used by the Group.

(4) a. The excess cost of the investment over the fair value of its identified assets less the fair value of the identified liabilities (after allocation of taxes deriving from temporary differences) at the acquisition date, is recorded as goodwill.

b. The excess cost allocated to assets and liabilities is recorded under the appropriate items in the balance sheet.

(5) The Company applies Accounting Standard No. 20 concerning the period of amortization of goodwill. Goodwill is stated in the consolidated balance sheet under "Other assets and deferred charges" and is systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which the Company can expect to derive future economic benefits from the goodwill.

(6) Material inter-company balances between the consolidated companies were eliminated. Earnings from inter-company sales not yet realized outside the Group, were also eliminated.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

D. CONSOLIDATION OF FINANCIAL STATEMENTS (CONTD.)

(7) a. The consolidated financial statements include the proportional part of the items of the assets, liabilities, expenses and revenues of the proportionately consolidated companies according to the percentage of the holding in those companies.

b. Earnings from the sales of the holding company to proportionately consolidated companies not yet realized outside the Group – were eliminated at a rate proportional to the holding.

c. Earnings from the sales of the proportionately 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.

E. 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 of contingent assets and liabilities disclosed in the financial statements, as well as amounts of revenues and expenses for the reporting period. Actual results may differ from these estimates.

F. CASH AND CASH EQUIVALENTS

Cash and cash equivalents include short-term bank deposits and marketable government bonds with an original maturity at the time of making the investment that did not exceed three months.

G. SECURITIES

(1) Marketable securities

Marketable securities held as a current investment are stated at the realizable value on the stock exchange at the balance sheet date. The changes in the values of securities are charged to the statement of operations in full. Marketable securities held as a permanent investment are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount), less a provision for reduction in value of a non-temporary nature (see also section G(3) below).

(2) Non-marketable securities

Non-marketable securities are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount) which, in the opinion of Management, does not exceed the realizable value (see also section G(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. The review is carried out upon the existence of signs indicating that the value of permanent investments might have been impaired, including falling market 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 in Management's opinion are 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.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

H. 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 considered, 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, the collateral they provided and the accumulated experience of the Company and its external lawyers who handle the collection of past debts. Doubtful debts which Management and its legal advisers believe cannot be collected are written off in the Company's books following a Management decision. Advance payment transactions with credit companies for transactions made with customers by credit card for payment in installments, where the risk of collection was transferred in full to the credit companies, are removed in full from the books. The financial statements also include a general provision in respect of doubtful debts.

I. INVENTORY

Inventory of subscriber equipment and user equipment is stated 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, Pelephone upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers. The value of the returned inventory is stated at the lower of cost or value to the business. Inventory also includes spare parts which are used by Pelephone, *inter alia*, for the repair of user equipment as part of the repair service it provides for its customers.

J. MATERIALS AND SPARE PARTS

Materials and spare parts are valued at the lower of cost (which is determined by the moving average method) or value to the business. Materials are intended primarily for installation in fixed assets. The Company customarily reduces the value of slow moving materials and spare parts purchased in previous years.

K. 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 as they are included in the financial statements of the companies, after adjustments necessitated by the application of accepted accounting principles, are taken into account.

(2) Regarding goodwill amortization policy – see D(5) above.

L. IMPAIRMENT OF INVESTMENTS IN INVESTEE AND NON–INVESTEE COMPANIES

Regarding impairment of investments in investee and non-investee companies, see G(3) above and BB below.

M. COMPANY INVESTMENT IN VENTURE CAPITAL FUNDS

(1) The Company's holdings in venture capital funds are stated at adjusted cost less a provision for impairment, if a decrease in value occurs which is not of a temporary nature.

(2) See also G(3) above.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

N. FIXED ASSETS

(1) Fixed assets are stated at cost.

(2) The cost of an asset which the Company is constructing for itself includes materials, subcontractors, wages and financing expenses in the construction period, but not exceeding their recoverable amount.

(3) Improvements and enhancements are charged 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 the assets to the business, a provision is recorded accordingly. Regarding provision for the impairment of assets, see section BB below.

(5) Real financing expense for loans and credit used for financing the construction or purchase of fixed assets and other costs relating to the purchase or construction of the fixed assets, are charged to the cost of those assets in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs. (See also U below).

(6) Depreciation is calculated by the straight-line method, based on the estimated useful lives of the assets.

Annual depreciation rates:

	% depreciation	% principal depreciation
Buildings	4	4
Digital switching equipment	5-20	10
Transmission and power equipment	10-20	20
Network equipment	5-20	5
Subscriber equipment and public telephones	20	20
Motor vehicles	15	15
Internet equipment	25	25
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) On change of estimate, see Note 9(G).

O. DEFERRED CHARGES AND OTHER ASSETS

(1) Costs of issue of debentures and raising loans
Costs of issue of debentures and raising loans (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 subscriber acquisition
Since 1999, Pelephone has been deferring and recording as an asset its net direct costs paid to a third party ("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 over the period of the subscribers' undertaking, which is up to 36 months.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

O. DEFERRED CHARGES AND OTHER ASSETS (CONTD.)

(3) Frequencies
Regarding Pelephone's investment in cellular communication frequencies in third generation technology, see Note 8D(2).

P. DEFERRED TAXES

(1) In July 2004, the Israeli Accounting Standards Board ("IASB") published Accounting Standard No. 19 – "Taxes on Income" ("the Standard"). The new Standard applies to financial statements for periods commencing on January 1, 2005. Adoption of the Standard will be implemented by way of a cumulative effect of change in accounting method. The transition to Accounting Standard No. 19 amounted to a one-time effect on the profit, in the amount of NIS 15,000,000, which is mainly attributable to an increase in deferred tax assets in respect of buildings and land.

(2) The Group companies allocate taxes in respect of temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value. Deferred tax balances (asset or liability) are calculated according to the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, based on the tax rates and tax laws enacted or the legislation of which is all but completed by the balance sheet date.

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

a. A temporary difference generated at the time of first recognition of goodwill.

b. A temporary difference generated at the time of initial recognition of an asset or liability in a transaction which is not a business combination and on the date of first recognition, there is no effect on either accounting income or taxable income (loss for tax purposes).

c. Investments in investee companies, where the Company intends to continue to hold these investments, and not to realize them.

d. A tax benefit receivable in respect of temporary differences, where the likelihood of realizing the benefit is in doubt.

(3) The tax benefits in respect of grants of capital instruments to employees, in respect of which no expense was recognized, will be recorded under shareholders' equity in the period in which the deduction will be permitted for tax purposes.

Q. CLASSIFICATION OF PROFIT AND LOSS ITEMS

Profit and loss items were classified and stated in the order dictated by the character of the Company's business as a communications company.

R. REVENUE RECOGNITION

(1) Sales of products

Revenue from product sales are recorded at the time of dispatch to the customer, on transfer of the main risks and rewards involved in the ownership of the products being sold.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

(2) Revenue from service

Revenue from service is charged proportionally over the term of the agreement, or upon provision of the service if the probability of the flow of the economic benefit attributed to providing the service is certain.

(3) Sales on credit

Sales on long-term credit (more than a year) are recorded at the present value, where the interest which serves for capitalization is at market rate on the date of the sale.

(4) Revenues from the development of communications infrastructure are charged upon completion of the work.

(5) A consolidated company, D.B.S. Satellite Services (1998) Ltd. ("DBS"), leases digital satellite decoders to its customers under operational leases. The revenues from the lease fees are charged proportionally over the term of the lease agreement.

(6) DBS collects deposits from its customers in respect of the digital satellite decoders at the customer's premises, in an amount that does not exceed the cost of the set top boxes, where, upon termination of the agreement with DBS, the customers are entitled to the proportional part which remains of the deposit, in accordance with the agreement with them. The revenues from amortization of the deposits are charged to the statement of operations in accordance with the terms of the agreement with the customers (for a period of five or ten years).

(7) The Company does not include in the cellular revenues/expenses items the revenues/expenses from interconnect fees from the cellular operators; rather, they are recorded net in accordance with the tests prescribed in Clarification 8 to Standard 25, since the Company's tariffs (including interconnect fees) are set by the State in regulations. In 2005, these interconnect fees amounted to approximately NIS 1.2 billion (2004 – approximately NIS 1.5 billion, 2003 – approximately NIS 1.6 billion). Interconnect fees at Pelephone, using the same tests, are recorded gross.

S. ADVERTISING EXPENSES

Advertising expenses are charged to the statement of operations as incurred.

T. SUPPLIER DISCOUNTS

Current discounts from suppliers are included in the financial statements as received.

Discounts received from suppliers at the end of the year, for which the Company is not required to meet certain targets, are included in the financial statements upon making the proportional purchases that entitle the Company to those discounts.

U. CAPITALIZATION OF CREDIT COSTS

The Company capitalizes credit costs in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs, which requires the capitalization of specific and non-specific credit costs to qualified assets, as defined in the Standard. Non-specific 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. See Note 9A.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

V. EARNINGS PER SHARE

Earnings (loss) per share are calculated in accordance with Opinion No. 55 of the ICPAI.

W. SOFTWARE DEVELOPMENT COSTS

The costs of software development for internal use are treated according to the position paper of the American Institute of Certified Public Accountants – SOP 98-1: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. The costs of software development for internal use are capitalized after completion of the preliminary design stage, the project is expected to be completed and the software will be used for its designated purpose. The capitalization is halted when the software is effectively complete and ready for its designated use. Capitalized software development costs are amortized by the straight-line method according to the estimated useful life of the software. Significant improvements to the software are also capitalized to the cost of the software and current maintenance costs are recorded in the statement of operations.

X. 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.

X. FOREIGN CURRENCY AND LINKAGE (CONTD.)

Details of the CPI and foreign currency exchange rates are as follows:

	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro
				%	%	%
Year ended December 31, 2005	**103.0**	**4.603**	**5.466**	**2.386**	**6.848**	**(7.334)**
Year ended December 31, 2004	100.6	4.308	5.877	1.207	(1.621)	6.217
Year ended December 31, 2003	99.4	4.379	5.533	(1.848)	(7.557)	11.350

Y. DERIVATIVES

(1) The results of derivatives held for hedging of existing assets and liabilities are charged to the statement of operations in parallel with the accounting treatment of the results of the hedged assets and liabilities.

(2) Derivatives not designated for hedging are stated in the balance sheet at their fair value. Changes in the fair value are charged to the financing item in the statement of operations in the period in which they occurred.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

Z. BROADCASTING RIGHTS

Broadcasting rights in a consolidated company are stated at cost, less the rights that were exercised. Costs of broadcasting rights acquired for the screening of films and television programs include the amounts of contracts with suppliers of the rights, with the addition of direct costs incurred in order to adapt said films and programs for screening in Israel. Broadcasting rights are amortized in accordance with the terms of their acquisition agreement, based on actual screening (the portion not amortized by the end of the term of the agreement being fully amortized upon termination), or in accordance with the term of the rights agreement. The costs of independent productions which, in the opinion of the consolidated company, can be broadcast a number of times or sold, are charged to the broadcasting rights and amortized on the basis of the estimated duration of their utilization.

AA. SEGMENTAL REPORTING

Segmental reporting is stated in accordance with Accounting Standard No. 11. See also Note 26.

BB. IMPAIRMENT OF ASSETS

The Group companies apply Accounting Standard No. 15 – Impairment of Assets (“the Standard”), which defines procedures which the Company must apply 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 net selling prices and usage value (the present value of the estimated future cash flows expected to derive from the use and disposal of the asset).

The Standard applies to all the assets in the consolidated balance sheet except inventory, tax assets and monetary assets (excluding monetary assets which are investments in investee companies that are not subsidiaries). The Standard also lays down the rules of presentation and disclosure for assets whose value has been impaired. Where the value of an asset in the consolidated balance sheet exceeds its recoverable amount, the Company recognizes a loss from impairment in the amount of the difference between the book value of the asset and its recoverable amount. The loss so recognized will be cancelled only if changes occur in the estimates that were used to determine the recoverable amount of the asset, from the date on which the last loss from impairment was recognized.

In September 2003, the IASB published Clarification No. 1 concerning the accounting treatment of an impairment of an investment in an investee company which is not a subsidiary (“the Clarification”). The Clarification states that in the reporting periods subsequent to the period in which the provision for impairment was first created in respect of an investee company which is not a subsidiary, the investment in the investee company should be stated according to the lower of the recoverable amount and the investment account according to the equity method, where the recoverable amount is calculated in each reporting period in which there are indications that a change has occurred in the recoverable amount. Losses from the impairment of an investment in an investee company that is not a subsidiary, which were recognized or cancelled during the period, are included in the Company's equity in the earnings (losses) of investee companies item.

CC. DIVIDEND DECLARED SUBSEQUENT TO BALANCE SHEET DATE

In accordance with Accounting Standard No. 7 – "Post Balance Sheet Events", the liability relating to a dividend proposed or declared subsequent to the balance sheet date is expressed in the accounts only in the period in which the declaration was made. In addition, separate expression is given in the statement of changes in shareholders' equity to the dividend amount to be distributed against a reduction in the retained earnings balance.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

DD. PRESENTATION OF ACTIVITIES BETWEEN A CORPORATION AND ITS CONTROLLING SHAREHOLDER

Transactions between the Company and its controlling shareholder are presented according to the Securities Regulations (Presentation of activities between a corporation and its controlling shareholder) in financial statements), 5756-1996.

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

(1) In July 2005, the IASB published Accounting Standard No. 22 – “Financial Instruments: Disclosure and Presentation” ("the Standard"). The Standard sets out the rules for the presentation of financial instruments in the financial statements and details the proper disclosure required in respect thereof. In addition, the Standard determines the manner of classification of financial instruments as liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which financial assets and financial liabilities should be offset. The new Standard will apply to the financial statements for the periods commencing January 1, 2006 or thereafter. The Standard determines that it should be adopted "from now on".

The comparative amounts stated in the financial statements for periods commencing on the date of the inception of the Standard will not be restated. In the opinion of Company and the other companies of the Group, the application of the Standard is not expected to have a material effect on the results of operations and the financial position of the Company and the other companies in the Group.

(2) In September 2005, the IASB published Accounting Standard No. 24 – “Share-Based Payment”. The Standard requires recognition of share-based payment transactions in the financial statements, including transactions with employees or other parties that must be settled in equity instruments, in cash or by other assets. In accordance with the Standard, share-based payment transactions in which goods or services are received will be reported at their fair value.

In addition, the Standard prescribes various disclosure requirements regarding the nature and volume of the share-based payment arrangements that existed during the period, and regarding the manner in which fair value was determined for these arrangements.

The Standard will apply to financial statements for periods commencing on January 1, 2006. Early application is recommended. The provisions of the Standard should be applied to any share-based payment transaction made subsequent to March 15, 2005, and which had not yet vested by the date of inception of the Standard. In addition, the comparative data relating to the periods from March 15, 2005 must be restated.

The application of the new Standard is not expected to have a material effect on the results of operations and the financial position of the Company. With regard to the allotment of shares to employees through an option plan, following the sale of the controlling interest in the Company, see Note 1G. Future plans, if any, will be influenced by application of the Standard.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

EE. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION (CONTD.)

(3) In February 2006, the IASB published Accounting Standard No. 25 – “Income" ("the Standard"). The Standard prescribes the required accounting treatment (rules of recognition, measurement, presentation and disclosure) for income arising from the sale of goods, the provision of services and the use made by others of the entity's assets, which generates income, royalties and dividends. The Standard will apply to financial statements for periods commencing on January 1, 2006 or thereafter. An entity which has not previously stated its income in accordance with the requirements of the Standard, with regard to the reporting of income as gross or net, will apply the provisions of the Standard retroactively with regard to its income for all the reported periods as comparative amounts in the financial statements for the periods commencing on the date of the inception of the Standard. Assets and liabilities included in the financial statements as at December 31, 2005, in amounts which are different from the amounts which would have been recognized had the provisions of the Standard been applied, will be adjusted on January 1, 2006, to the amounts which would have been recognized in accordance with the provisions of this Standard. The effect of the adjustment of the amounts of assets and liabilities, as stated, to January 1, 2006, will be recognized as a cumulative effect of change in accounting method. With the exception of the foregoing, the comparative amounts in the financial statements for the periods commencing on the date of the inception of the Standard will be stated as they were previously stated. The application of the new Standard is not expected to have a material effect on the results of operations and the financial position of the Company and the Group companies.

In February 2006 the IASB published Clarification No. 8 – "Reporting income on a gross basis or a net basis" ("the Clarification"). The Clarification is based on the professional publication EITF 99-19 of the Emerging Issues Task Force in the U.S.A. According to the Clarification, an entity operating as an agency or as a broker without bearing the risks and yields deriving from the transaction, will state its income on a net basis. Conversely, an entity operating as a principal supplier and bearing the risks and yields deriving from the transaction will state its income on a gross basis. The Clarification provides a list of indicators to be considered in order to determine the basis on which income should be reported – gross or net. The Clarification is applicable with respect to financial statements for the period commencing January 1, 2006. Since in the past the Company treated the matter of gross or net income in accordance with the provisions of EITF 99-19, the application of the new Clarification is not expected to influence the Company and the other Group companies in any way.

(4) In February 2006, the IASB published Accounting Standard No. 21 – “Earnings per Share" ("the Standard"). The Standard prescribes that an entity will calculate the amounts of the basic earnings per share with regard to profit or loss, attributed to the ordinary shareholders of the reporting entity, and also that the entity will calculate the amounts of the basic earnings per share with regard to profit or loss from continuing activities, attributed to the ordinary shareholders of the reporting entity, in the event that such earnings are stated. The basic earnings per share will be calculated by dividing the profit or loss which is attributed to the ordinary shareholders of the reporting entity, by the weighted average of the number of ordinary shares in circulation during the period. For the purpose of calculating the diluted earnings per share, an entity will adjust the profit or the loss, which is attributed to the ordinary shareholders of the reporting entity, and the weighted average of the number of ordinary shares in circulation, in respect of the effects of all the diluted potential ordinary shares. The Standard will apply to financial statements relating to periods commencing on January 1, 2006, or thereafter. The provisions of the Standard should be applied retroactively to the comparative data of the earnings per share relating to previous periods. The Company and the other Group companies estimate that the implications of application of the Standard for the first time will have no material effect on earnings (loss) per share.

NOTE 3 – CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	**2,055,351**	1,425,433	**1,668,643**	1,322,168
Foreign currency	**103,422**	31,674	**10,601**	5,563
	2,158,773	1,457,107	**1,679,244**	1,327,731

NOTE 4 – SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government bonds				
Linked to the CPI	**764,631**	309,701	**698,232**	309,701
Unlinked	**372,075**	465,187	**310,808**	465,187
Linked to the U.S. dollar exchange rate	**1,740**	1,346	**1,740**	1,346
Securities tradable abroad	**242,519**	163,870	**195,086**	163,870
Corporate bonds	**639,923**	128,202	**561,217**	128,202
Short-term loan	**143,547**	41,006	**97,341**	41,006
Shares and options	**63,998**	42,186	**40,869**	42,186
Mutual fund participation certificates	**161,578**	112,827	**135,367**	112,827
Debentures convertible to shares	**5,361**	1,595	**5,241**	1,595
	2,395,372	1,265,920	**2,045,901**	1,265,920
Short-term bank deposits:				
Unlinked bearing interest (Prime less 2%)	**3,153**	21,889	**–**	20,000
	2,398,525	1,287,809	**2,045,901**	1,285,920

On the matter of the management of capital funds raised to finance employee retirement costs, see Note 16D.

NOTE 5 – TRADE RECEIVABLES

	Consolidated		Company	
	December 31 2005	**December 31 2004**	**December 31 2005**	**December 31 2004**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
Open accounts	**1,291,522**	1,550,725	**661,965**	732,669
Income receivable	**317,172**	240,912	**189,189**	225,579
Credit cards and checks receivable	**452,551**	458,456	**156,441**	175,696
Investee companies	-	–	**50,721**	33,125
Current maturities of long-term trade receivables (see Note 7)	**391,330**	293,261	**–**	–
	2,452,575	2,543,354	**1,058,316**	1,167,069
Less provision for doubtful accounts	**339,063**	428,284	**161,901**	196,303
	2,113,512	2,115,070	**896,415**	970,766

NOTE 6 – OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2005	**December 31 2004**	**December 31 2005**	**December 31 2004**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
Deferred tax asset (see Note 11D)	**194,634**	237,319	**132,198**	159,023
Income tax refundable	**13,160**	7,660	**7,581**	5,570
Prepaid expenses	**93,516**	86,082	**25,254**	22,081
Receivables in respect of derivatives	**4,685**	76,627	**4,685**	76,394
Loan to a consolidated company (See Note 8A(1))	**-**	–	**173,258**	–
Other receivables and debit balances	**15,512**	8,425	**101,427**	107,216
	321,507	416,113	**444,403**	370,284
Including consolidated companies	–	–	**267,273**	99,486

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2005	**December 31 2004**	**December 31 2005**	**December 31 2004**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
Investment in shares – companies that are not investee companies	**8,818**	25,954	**5,253**	22,389
Other investments (1)	**154,111**	301,437	**154,111**	301,437
Bank deposit for granting loans to employees (2)	**193,041**	203,196	**193,041**	203,196
Investment in venture capital funds	**26,335**	19,769	**26,335**	19,769
Long-term loan receivable (CPI + 6.25%)	**22,356**	23,750	**22,356**	23,750
Receivables in respect of derivatives	**1,113**	–	**–**	–
Long-term trade receivables(3)	**361,066**	298,469	**–**	–
	766,840	872,575	**401,096**	570,541

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(1) Other investments

a. Linkage and interest terms

	Interest rate	Consolidated and Company December 31 2005 NIS thousands	Consolidated and Company December 31 2004 NIS thousands
Convertible corporate bonds linked to the U.S. dollar	6 month LIBOR + 3.4	**32,221**	30,156
	3 month LIBOR + 1.65	**32,221**	30,156
Investments in fund – euro investments*	–	**32,679**	35,261
CPI-linked investments:			
Capital notes:	5.8 - 5.85	**56,990**	125,988
Galil bonds **	4	**-**	79,876
		154,111	301,437

* In September 2003 the Company invested approximately 6 million euro in a security issued by Deutsche Bank. The security was issued on August 21, 2003 and matures on August 31, 2010. The security is 90% hedged from the investment fund. The yield is contingent on the performance of a solid fund that invests in hedging funds of liquid investments. The security bears no interest.

** In November 2005 the Company's Management announced its intention to sell the bond when market conditions were suitable, and therefore the classification of the bonds was changed to short term investments..

b. Repayment dates

	NIS thousands
2007	**64,442**
2008	**-**
2009	**-**
2010	**32,679**
2011 and thereafter	**56,990**
	154,111

(2) 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. The deposit serves as collateral for the bank to extend loans to Company employees.

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(3) Long-term receivables

a. Linkage and interest terms

		Consolidated	
		December 31 2005	December 31 2004
	Interest rate	NIS thousands	
Linked to the CPI	7	**720,740**	562,743
Unlinked	7.5-6	**22,700**	20,252
Linked to the U.S. dollar	-	**3,705**	8,735
Unlinked and interest-free	-	**5,251**	-
		752,396	591,730
Less current maturity		**391,330**	293,261
		361,066	298,469

b. Repayment dates

	NIS thousands
2007	**189,059**
2008	**120,740**
2009	**49,557**
2010 and thereafter	**1,710**
	361,066

c. The balance of long-term receivables is stated net of deferred interest income which constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue and after deducting a provision for doubtful debts in the amount of NIS 49,237 thousand (for December 31, 2004 – NIS 50,167 thousand).

d. In 2005, Pelephone made forward transactions with credit companies for the final clearance of current debts amounting to NIS 262 million (2004 – NIS 276 million).

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES

A. Composition:

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Affiliated companies				
Shares – cost	**175,247**	164,006	**100,193**	90,921
Long-term loans (1)	**5,514**	1,386,504	**–**	1,357,861
Post–acquisition losses	**(39,513)**	(1,168,064)	**191**	(1,100,760)
Increase in holding percentage – company consolidated for the first time	**–**	(178,339)	**–**	(180,555)
Provision for impairment in respect of an affiliated company – see Section G below	**(59,196)**	(59,196)	**(38,078)**	(38,078)
Amortization of goodwill	**(6,585)**	(74,603)	**(6,585)**	(74,259)
	75,467	70,308	**55,721**	55,130
Consolidated subsidiaries				
Shares – cost			**1,188,111**	703,046
Loans (1)			**5,607,150**	4,733,726
Increase in holding percentage – company consolidated for the first time and assumption of full control of a proportionally consolidated company			**–**	1,194,844
Post–acquisition losses			**(742,517)**	(161,345)
Provision for impairment			**(4,716)**	(4,716)
Amortization of goodwill			**(157,850)**	(36,209)
			5,890,178	6,429,346
Proportionally consolidated company				
Shares – cost			**–**	485,065
Post-acquisition earnings			**–**	490,080
Increase in holding percentage – acquisition of minority share			**–**	(1,014,289)
Amortization of surplus equity over cost charged to fixed assets			**–**	39,144
			–	–
			5,945,899	6,484,476

(1) Loan balances of Bezeq International to Walla Communications Ltd. (a listed affiliate) (“Walla”) amounting to approximately NIS 5.5 million, linked to the CPI and interest-free. The loans will be repaid on a date soon after the date on which Bezeq International invests in Walla.
Loan balances of approximately NIS 192 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has yet been set.
Loan balances of approximately NIS 580 million linked to the CPI ("known"), bearing annual interest of approximately 11%, for which no repayment date has yet been set.
During 2001 Bezeq International received CPI-linked, interest-free loans from the Company of approximately $38 million, the amounts of which as at December 31, 2005 and 2004 are approximately NIS 173 million and NIS 169 million, respectively. On February 1, 2006, after the management of Bezeq International estimated that Bezeq International was able to repay the loans without adverse effect on the management of its current business, the Board of Directors of Bezeq International decided to bring forward the loan repayment date and repay the Company. On February 14, 2006, the CPI-linked amount of the loans was repaid. Accordingly, the balance of the loans as at the balance sheet date is stated as current maturities under the item "other receivables and debit balances.
The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has yet been set.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

The market value of Walla, a listed company, as at December 31, 2005, is approximately NIS 88.3 million (book value approximately NIS 19.7 million).

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Goodwill not yet fully amortized – consolidated in respect of investee companies	**1,703,918**	1,797,691	**1,699,554**	1,792,658

A list of the companies in the Group appears in an appendix to the financial statements.

B. INVESTMENT ACTIVITY IN 2005 IS AS FOLLOWS:

	Consolidated	Company
	NIS thousands	NIS thousands
Balance as at the beginning of the year	**70,308**	**6,484,476**
Movement during the year:		
Investment in shares	**11,241**	**9,272**
Investment in (repayment of) loans	**6,563**	**(568,145)**
Revaluation in respect of loans	**–**	**83,708**
Equity in losses of affiliates/investee companies	**(12,645)**	**(63,412)**
Balance as at the end of the year	**75,467**	**5,945,899**

C. SUMMARY OF COMPANY EQUITY IN REVENUE AND EXPENSES OF A PROPORTIONATELY CONSOLIDATED COMPANY, AS INCLUDED IN THE CONSOLIDATED STATEMENTS

	For the period ended August 26, 2004*	For the year ended December 31 2003
	NIS thousands	NIS thousands
Revenues	1,658,452	1,899,709
Costs and expenses	1,438,414	1,803,052

* On August 26, 2004, the transaction for exercise of the option to purchase the remaining 50% of the shares of Pelephone was finally closed. Since that date, Pelephone has been wholly owned by the Company. See Note 8D(1).

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

D. PELEPHONE COMMUNICATIONS LTD.

(1) On August 26, 2004, after receipt of approvals from the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner for the merger of Bezeq, Pelephone Holdings – a corporation from the Shamrock Group ("Pelephone Holdings") and Pelephone, the transaction for exercise of the option was finally closed when the Company exercised an option to purchase the remaining 50% of Pelephone's shares in consideration of an exercise price of US $60 million (approximately NIS 270 million). In addition, immediately prior to closing the option exercise, Pelephone distributed to its shareholders a dividend of approximately $8.3 million (approximately NIS 38 million). With the closing of the exercise transaction as aforesaid and conversion of the convertible debentures (of a par value of $240 million, stated in the financial statements at zero value), the Company extended a loan of NIS 1,766 million ($394 million) to Pelephone Holdings, which was used for actual clearance of the balance of the loans it had taken from the bank to finance part of the cost of purchasing the Pelephone shares. After the closing of the transaction as aforesaid, the Company recorded NIS 1,045 million of goodwill on the purchase. The amortization period was set at 20 years, which is the expected period of economic benefit.

It is noted that the approval of the Antitrust Commissioner was made contingent upon a number of conditions which in the opinion of the Company restrict business or commercial cooperation between the Company and Pelephone even more than the restriction relating to structural separation that is written into the Company's general license. It is further noted that an appeal filed in the Antitrust Court by Cellcom, petitioning for revocation of the merger approval, was struck out at its request in August 2005.

Towards the end of 2004, Pelephone Holdings transferred all its assets (including Pelephone shares) and liabilities to the Company, and as a result, all Pelephone shares are wholly owned by the Company. Pelephone Holdings is currently in voluntary liquidation.

(2) In December 2001, Pelephone won a tender for an additional band of frequencies which would be used for cellular communications with third generation technology, and Pelephone's license was extended to 2022. The grant of the frequencies was made contingent upon conditions 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 provision of a guarantee of $20 million to guarantee the terms of the license, which was amended in 2004 to $10 million. The payment determined at the award was to be paid in six installments on various dates through 2006. On the contract for purchase of the frequencies, see also Note 19B(6).

(3) On February 27, 2006, the Board of Directors of Pelephone resolved to recommend to the General Meeting of the shareholders to distribute a cash dividend in the amount of NIS 300 million on April 14, 2006.

E. D.B.S. SATELLITE SERVICES (1998) LTD.

In January 1999 DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. Since commencing operations, DBS has accumulated considerable losses. Its losses in 2005, 2004 and 2003 amounted to approximately NIS 328 million, NIS 366 million and NIS 555 million, respectively. As a result of these losses, the capital deficit and working capital deficit of DBS as at December 31, 2005, amount to approximately NIS 3,569 million and NIS 459 million, respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date was approximately NIS 1,562 million (excluding interest and linkage). The Company's equity in the accumulated losses from the date of investment in DBS (excluding amortization of goodwill) is approximately NIS 1,575 million, of which approximately NIS 305 million was recorded during the reporting period (DBS's loss net of the increase in new loans provided by the minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 88 million.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

As decided by the Minister of Communications at the end of 2004, injections of financing by the Company to DBS were limited to the following:

(1) The total amount of the planned Additional Funding was limited to a maximum of NIS 350 million (rather than NIS 440 million).

(2) With reference to the NIS 195 million of the Additional Funding already injected by the Company at that time into DBS, no further instruction was given.

(3) The balance of the sum, a maximum of NIS 155 million, will be transferred once every quarter in equal parts during 2005, on the following principles:

a. The Company's share in this amount will not exceed 55% (a maximum of NIS 82.25 million).

b. The share of the other shareholders in DBS and of the banks or institutional bodies in transfer of the remainder of the balance, will be not less than 45% (a minimum of NIS 69.75 million).

In February 2005 the above decision was revised by the then Minister of Communications as follows:

(1) The Company will be able to inject 75% of the maximum amount (NIS 64 million) by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it had transferred by the date of the letter), provided that up to the end of June 2005 the proportions of the transfer decided upon by the outgoing Minister were fully maintained.

(2) The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) during the period July 1, 2005, through the end of 2005, provided that the proportions of the transfer are maintained as set out in the Minister's directive.

In the opinion of DBS and the Company, implementation of the directives in the Ministers' notices would cause material harm to both DBS and the Company as the principal shareholder in DBS.

On January 6, 2005, the Board of Directors of the Company resolved that in view of the oppressive conditions upon which the merger of the Company and DBS (increasing the Company's holdings in DBS to more than 50%) had been made contingent by the Antitrust Commissioner ("the Commissioner") (in which, *inter alia*, the Commissioner limited the injection of funds by the Company into DBS so as not to exceed, for a period of nine months from the date of approval of the merger, the proportional part of the Company is DBS's shares, while the other part would be injected by other DBS shareholders and institutional investors), the Company would delay, at that stage, the exercise of the options for shares it received from DBS under the agreements signed between the shareholders of DBS and DBS, so that its holdings in DBS would remain, for the time being, at approximately 49.8%. In respect of injections into DBS as at December 31, 2005, the Company is entitled to shares and/or options for shares which, if exercised, will bring the Company's holdings in DBS to approximately 58.36%.The Company and DBS each filed an appeal against the decision of the Commissioner to permit it to increase the Company's holdings in DBS on conditions. The Company subsequently applied to strike its appeal, *inter alia,* since the term of the condition limiting the Company's injections of funds into DBS was about to end. DBS also filed an application to strike its appeal for the same reasons, and on September 19, 2005, the appeals were stricken.

At the beginning of January 2006, with the elapse of one year since grant of approval for the merger, the approval expired and requires new consent.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

On February 17, 2005, the Board of Directors of the Company resolved that it stands behind its resolution from March 2004 as amended in May 2004, to invest in DBS according to the approved business plan, together with the other shareholders and financial bodies. This resolution was based, *inter alia*, on an external legal opinion stating that the Minister of Communications does not have the authority to prohibit the injection of funds into DBS. On February 23, 2005, the Minister of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications would be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including considering calling in the bank guarantee which the Company had deposited as required under its general license. The Company applied to the Jerusalem District Court for a declaratory judgment determining that the decisions of the Ministers of Communications which limited the Company's transfers of funds to DBS were made *ultra vires*, and are therefore void. On March 20, 2005, the District Court ruled that the competent court for hearing the case is the High Court of Justice, and accordingly, it transferred the proceeding to that court. The Company then filed in the Supreme Court, on April 17, 2005, both an application for leave to appeal the decision of the District Court and an application – if its application for leave to appeal was dismissed – to convert the claim into a petition to the High Court of Justice. The application for leave to appeal the District Court's decision was dismissed, and on May 10, 2005 the petition on the matter was filed in the High Court of Justice. It is noted that DBS also filed a petition in the High Court of Justice, to which the cable companies were joined as respondents in the same matter. On October 11, 2005, the High Court of Justice heard the petitions filed by DBS and the Company, contesting the authority of the Minister of Communications to intervene in the transfer of funds to DBS by its shareholders, including the Company and external bodies. The petition raises questions of principle which are far from simple from both the factual and legal aspects, which were brought into focus during hearing. The High Court of Justice has not yet ruled on the petition, and the Company, relying on its legal advisers, is unable to estimate its prospects. It should be noted that concurrently with this proceeding, the Ministry of Communications gave notice of its intention to call in NIS 10 million of the Company's guarantee. On July 7, 2005, the Company, exercising its right under the terms of the general license, filed a petition against the decision of the Ministry to call in the guarantee. See also Note 19C(2).

The terms of the long-term loans which DBS received from certain banks, and the balance of which as at December 31, 2005 is NIS 1,325 million (including current maturities), impose various limitations on DBS, which include, *inter alia*, limitations concerning lien or sale of certain assets, limitations in receipt of credit from other banks without prior approval, a limitation relating to repayment of shareholders' loans and a requirement to meet financial criteria ("the Conditions"). As at December 31, 2005, DBS is in compliance with the Conditions. After grant of benefits to DBS in December 2005 relating to the maximum credit terms (see also Note 13D(2)(e)), that same month the banking corporations increased the credit facility for DBS by NIS 25 million in a document amending the loan agreement signed between them and DBS.

During 2005, DBS signed agreements with three institutional bodies, under which they extended loans to DBS in a total mount of NIS 100 million (including options for loans, which were exercised).

These loans are linked to the CPI and bear 11% interest. They are repayable together with the interest and linkage differentials on December 31, 2013, but can be repaid earlier, subject to repayment of part of the loans to the Banks on the terms set out in the agreement.

The above-mentioned loans do not meet some of the conditions and limitations imposed by Ministers of Communications as explained above and in respect of which the Company and DBS have instituted legal proceedings.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

As explained in Note 19C(10) below, the Company undertook in connection with the above three loans, that if by December 31, 2013, those loans (all or some of them) are not repaid, or under certain other conditions, the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differentials) and the amount computed according to a predetermined formula which takes into account the value of DBS at that time.

As at December 31, 2005, the Company had transferred to DBS a total of NIS 284 million out of the Additional Funding.

During 2005 and up to the date of approval of the financial statements, the additional shareholders transferred NIS 29 million to DBS.

On January 31, 2006, the Board of Directors of DBS approved the budget for 2006. According to the budget, in 2006 DBS will require additional external financing. As at the date of approval of the financial statements, DBS is seeking additional sources of finance which will enable it to attain the budgetary targets for the coming year. If no such sources can be found, DBS will operate in accordance with an alternative business plan which does not require additional resources beyond those already assured. The management of DBS believe, based on the 2006 budget and on the alternative business plan, that there is a good chance of arranging the additional financing that it will require in the coming year.

F. WALLA! COMMUNICATIONS LTD.

Bezeq International invested in Walla! Communications Ltd. ("Walla"), an Israeli company which is listed on the Tel Aviv Stock Exchange and which provides internet services and operates internet portals. As at December 31, 2005, Bezeq International held 42.85% of the rights in Walla (at full dilution – 33.94%). Following the exercise of options (Series 3) of Walla after the balance sheet date by others, the Bezeq International's holding in Walla decreased to 40.42% (at full dilution – 33.66%).

Under the investment agreement between Bezeq International and Walla and an undertaking pursuant to a prospectus, Bezeq International had invested in Walla, up to December 31, 2005, by way of investment in shares and grant of loans, a total of approximately NIS 80 million.

G. ADANET FOR BUSINESS GROUP LTD. (IN TEMPORARY LIQUIDATION) ("ADANET")

Adanet is a private company in liquidation proceedings whose business was the installation and servicing of networks and computer equipment. In 2003 the Company wrote off the balance of its investment in Adanet.

In February 2004 the Company received a letter from the temporary liquidator of Adanet and some of the Adanet Group companies, in which it is claimed that the Company had made a commitment to provide the financing required for the current operations of the companies through March 31, 2004, as well as additional financing. In the opinion of the Company, in view of Adanet's situation, the basis for the undertaking made by the Company, if and insofar as made, no longer exists, and therefore it rejected the claim of the liquidator and made no provision in its financial statements. In any case, the Company considers that there is no significant exposure arising from the liquidator's claims.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

G. ADANET FOR BUSINESS GROUP LTD. (IN TEMPORARY LIQUIDATION) ("ADANET") (CONTD.)

On March 29, 2004, the Court allowed the application of the temporary liquidator, who had meanwhile been appointed special administrator, to investigate the circumstances that led to the collapse of Adanet. On May 17, 2004, the special administrator sent summonses for questioning to five senior employees of the Company who were involved in Adanet's activities (some of them served as directors in Adanet). On January 11, 2006, documents found at the Company in connection with Adanet were submitted to the company's liquidator. It is clarified that the filing of a claim by the liquidator against a third party (including shareholders), is subject to the approval of the court which is overseeing the liquidation proceedings. The liquidator has not yet filed an application on this matter. In the opinion of the Company, relying on its legal advisers, it is difficult at this stage to assess the future steps of the liquidator relating to the possibility that he will seek to file a claim against the Company, to the alleged grounds for the claim and to the prospects for his allegations.

NOTE 9 – FIXED ASSETS

A. COMPOSITION AND ACTIVITY

Consolidated

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
				NIS thousands			
Cost –							
Balance as at January 1, 2005	2,370,469	14,760,894	11,974,435	2,841,700	190,734	2,173,049	34,311,281
Additions	**48,820**	**624,810**	**182,633**	**425,605**	**4,797**	**300,322**	**1,586,987**
Disposals (1)	**4,873**	**4,931,095**	**24,625**	**147,982**	**46,765**	**115,299**	**5,270,639**
Balance as at December 31, 2005	**2,414,416**	**10,454,609**	**12,132,443**	**3,119,323**	**148,766**	**2,358,072**	**30,627,629**
Accumulated depreciation –							
Balance as at January 1, 2005	1,547,756	9,830,363	9,211,689	1,448,153	135,602	1,272,060	23,445,623
Additions	**107,875**	**1,108,454**	**333,891**	**452,100**	**19,248**	**309,143**	**2,330,711**
Cancellation in respect of disposals (1)	**2,015**	**4,907,163**	**24,625**	**129,344**	**39,789**	**113,741**	**5,216,677**
Balance as at December 31, 2005	**1,653,616**	**6,031,654**	**9,520,955**	**1,770,909**	**115,061**	**1,467,462**	20,559,657
Provision for impairment –							
Balance as at January 1, 2005	2,371	115,467	-	-	66	7,420	125,324
Balance as at December 31, 2005	**2,371**	**115,467**	**-**	**-**	**66**	**7,420**	**125,324**
Net book value –							
As at December 31, 2005	**758,429**	**4,307,488**	**2,611,488**	**1,348,414**	**33,639**	**883,190**	**9,942,648**
As at December 31, 2004	820,342	4,815,064	2,762,746	1,393,547	55,066	893,569	10,740,334

NOTE 9 – FIXED ASSETS (CONTD.)

A. COMPOSITION AND ACTIVITY (CONTD.)

Company

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
	NIS thousands						
Cost –							
Balance as at January 1, 2005	2,177,286	6,342,750	11,974,435	738,211	110,831	780,570	22,124,083
Additions	**11,121**	**288,797**	**182,633**	**158,988**	**1,323**	**144,928**	**787,790**
Disposals (1)	**3,721**	**1,328,341**	**24,625**	**118,254**	**38,003**	**112,049**	**1,624,993**
Balance as at December 31, 2005	**2,184,686**	**5,303,206**	**12,132,443**	**778,945**	**74,151**	**813,449**	**21,286,880**
Accumulated depreciation -							
Balance as at January 1, 2005	1,440,479	4,469,504	9,211,689	364,731	88,749	383,000	15,958,152
Additions	**86,240**	**630,911**	**333,891**	**173,223**	**8,273**	**157,897**	**1,390,435**
Cancellation in respect of disposals (1)	**1,451**	**1,328,332**	**24,625**	**118,254**	**32,515**	**112,049**	**1,617,226**
Balance as at December 31, 2005	**1,525,268**	**3,772,083**	**9,520,955**	**419,700**	**64,507**	**428,848**	**15,731,361**
Provision for impairment -							
Balance as at January 1, 2005	–	35,482	–	–	–	–	35,482
Balance as at December 31, 2005	**–**	**35,482**	**–**	**–**	**–**	**–**	**35,482**
Net book value –							
As at December 31, 2005	**659,418**	**1,495,641**	**2,611,488**	**359,245**	**9,644**	**384,601**	**5,520,037**
As at December 31, 2004	736,807	1,837,764	2,762,746	373,480	22,082	397,570	6,130,449

(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 2005, fully depreciated fixed assets with a cost of approximately NIS 1,583 million in the Company and NIS 5,138 consolidated (2004 – NIS 1,847 million in the Company and consolidated) were written off the books.

(2) The cost includes the amount of NIS 7,797 thousand in the Company and consolidated, which constitute real financing expenses in respect loans and credit which were capitalized during the period of account, calculated at an average real interest rate of approximately 4.8% per annum (prior year – 6.5%).

NOTE 9 – FIXED ASSETS (CONTD.)

B. Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31,1984, and for the consideration detailed therein. 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.

On May 15, 2003, a settlement agreement was signed between the Company and the Government of Israel in the name 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 which were transferred to the Company when it commenced operations in 1984, under an asset transfer agreement signed between the Company and the State.

C. The Company's holdings in the satellite corporation Intelsat, which was privatized in 2001 when every member of Intelstat became a shareholder proportionate to the percentage of its investment in the corporation, is 0.7405%. In addition, the Company held 0.8% in a subsidiary spun off from Intelsat, called New Skies Satellites N.V. NSS ("NSS").

On November 17, 2004, the Company received approximately NIS 35 million in respect of its share of the proceeds from the sale of the operation, assets and liabilities of NSS. A capital gain in the full amount of the consideration was recorded during 2004.

In addition, on November 17, 2004, notice was received from Intelsat confirming the intention to sell the corporation for a consideration of which the Company's share amounts to approximately NIS 104 million. The sale transaction was closed on January 28, 2005, at its original price. A capital gain in the full amount of the consideration was recorded in 2005.

D. As at December 31, 2005, Pelephone had a commitment to purchase terminal assets during 2006 in a total amount of NIS 353 million.

E. As at the balance sheet date there are agreements to purchase fixed assets amounting to approximately NIS 665 million consolidated and NIS 118 million in the Company (the amounts include the assets referred to in D. above).

F. In September 2003, the Board of Directors of the Company adopted a resolution to close the Inmarsat station (a satellite communications station) and to try to sell the equipment and/or the operation. In view of the uncertainty as to the consideration it would receive, if any, a loss of approximately NIS 35 million due to impairment of assets was recorded in the 2003 financial statements and attributed to fixed assets, which was included under the "Other expenses" item in the statement of operations. The Ministry of Communications notified the Company that it is not authorized to decide on the closure of the station. Consequently, the Company (with the knowledge of the Ministry of Communications) contacted representatives of the Ministry of Defense and the Israel Defense Forces ("IDF") in an attempt to reach an arrangement for termination of the service. IDF representatives stated unequivocally that the Inmarsat service is an essential service that the IDF cannot forgo. In light of this, the Company examined a number of possible actions, including sale of the service (with the consent of the Ministry of Defense, the IDF and the Ministry of Communications), bringing in a strategic partner or continued operation of the service while subsequently significantly reducing its costs. On February 14, 2006, a Memorandum of Understanding was signed between the Company and a foreign investor concerning sale of the satellite operations of the Company (Inmarsat and Bezeq Sat) and associated assets, in consideration of $9 million. The closing of the transaction is subject to the parties signing a final agreement and to internal and external consents and approvals, including of the competent bodies of the parties, the Ministry of Defense, the Ministry of Communications and the Antitrust Commissioner. If the transaction is closed, the Company can expect to record a capital gain of approximately NIS 30 million (before tax).

NOTE 9 – FIXED ASSETS (CONTD.)

G. Depreciation policy

(1) Pursuant to the Company's policy of periodically re-examining the useful lives and the values of its assets, a committee was appointed in 2003 to assess the need to update the period of the useful life and value of the assets and to make recommendations to the Management regarding its conclusions. The examination covered only the Company's fixed assets and was based on the balance of its fixed assets as at December 31, 2003. In interim conclusions relating to the value of the assets, the committee found that due to the decline in traffic in the Company's communications network, mainly as a result of the decrease in the number of subscribers and of the decline in dial-up internet traffic, the Company had ceased using equipment having a net book value of approximately NIS 163 million. As a result, in 2003 an expense was recorded in that amount under the "Other expenses" item in the statement of operations. In May 2004, the panel submitted its recommendations to the Management of the Company regarding the estimated useful life of the assets. The panel's recommendations mainly took into consideration the Company's investment plans, technological innovations in fixed-line communications, rates of depreciation used by similar communications companies around the world as well as the regulation and opening of the fixed-line communications market to competition.

The changes in the estimated useful lives recommended in the report included shortening the life of terminal equipment used for data communications networks from 5 years to 4 years, and shortening the life of new copper cabling from the exchanges to the distribution boxes from 20 years to 15 years. Conversely, it was recommended that the lives of SDH transmission should be extended from 7 years to 8 years, and of the data communications networks (ADSL, ATM) from 5 years to 7 years. The panel also recommended extending the depreciation period of the network in which there was investment until 1991 and which should have been fully depreciated by the end of 2007, through to the end of 2010. Another recommendation was for an estimated useful life for the new transmission systems and data networks which are scheduled for operation in the near future.

The Company's Management and the Board of Directors adopted the recommendations of the panel and the new depreciation rates have been applied since January 1, 2004. As a result of adoption of the recommendations, the depreciation expense in respect of the Company's existing assets decreased by approximately NIS 77 million in 2004, by approximately NIS 74 million in 2005, and in the future will decrease NIS 62 million in 2006, NIS 75 million in 2007 and will increase by NIS 96 million in 2008.

(2) DBS depreciates its digital satellite decoders (set-top boxes – "STBs") using the straight-line method, based on the estimated duration of their use. With the accumulation of experience and data during the course of DBS's operations, during 2004 DBS decided to examine the useful life of the STBs. As part of this examination, DBS received an engineering opinion relating to the useful life of the STBs. According to this opinion, which takes into account, *inter alia*, exposure to technological changes, the useful life of an STB is no less than 6 years, and accordingly, the depreciation rate for STBs was changed from 25% to 17%, effective from April 2004. The change decreased the amount of depreciation in 2004 by approximately NIS 59 million.

H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003

As part of the preparation of its financial statements for 2003, Bezeq International conducted a comprehensive review of the book value of all its fixed assets, *inter alia* following the coming into force of Standard No. 15 of the IASB - Impairment of Assets and the potential implications of changes in the telecommunications business sector in which Bezeq International operates.

NOTE 9 – FIXED ASSETS (CONTD.)

H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003 (CONTD.)

Following the comprehensive review mentioned above, expenses derived from fixed assets in an aggregate amount of NIS 146.8 million were recorded in 2003, divided as follows: NIS 89.8 million stated in the "Other expenses, net“ item derived from the depreciation of assets (mainly undersea cables), NIS 21.1 million included mainly in the “Operating expenses” item in the statement of operations for 2003, stated in the "Operating expenses" item, deriving mainly from a change in estimate of the remaining useful economic life of part of Bezeq International’s assets as described below; and NIS 35.9 million stated in the “Other expenses” item derived from the deterioration of assets since they are no longer used. The amount of the reduction according to Standard No. 15 was determined, *inter alia*, on the basis of the assessments of experts and the assessments of the Management of Bezeq International regarding the net sale price, as derived from agreements made by Bezeq International at that time, and the usage value of the assets under review. For the purpose of determining usage value, Bezeq International used, where relevant, a discount rate of 10%.

As part of the comprehensive review of the book value of all its fixed assets which Bezeq International carried out as aforesaid, the Management of Bezeq International examined, with the assistance of external and internal experts in the field, the economic life of its assets, mainly switching equipment and systems, transmission equipment (old-generation undersea cables) and internet equipment. Based on the opinions of these experts, the remaining economic life of the assets examined, at the time of the examination, is shorter than the economic life attributed to them by Bezeq International in the past. On the basis of these opinions, the economic life of switching equipment and systems was shortened by two years (to 10 years); the economic life of the transmission equipment (underwater cables) was estimated mostly at 5-15 years (rather than the 10-20 years estimated prior to submission to Bezeq International of the expert opinion); and the economic life of internet equipment was assessed at 4 years (rather than 12). Consequently, and relying on the aforementioned opinions, starting from the date of the review, Bezeq International is depreciating the balance of the net book value of the assets which were the subject of those opinions, over the stated periods.

The above change of estimate led to an increase of NIS 21.1 million in depreciation expenses for 2003.

The amount of NIS 35.9 million, which derives from assets removed due to termination of their use in 2003, represents their net book value as at the date of their removal, and includes mainly the net book value of NIS 24.7 million of old-generation undersea cables which Bezeq International decided would no longer be operated, and the net book value of improvements to leased premises which Bezeq International had vacated, amounting to NIS 4.6 million.

NOTE 10 – DEFERRED CHARGES AND OTHER ASSETS

Consolidated

	Cost	Accumulated amortization	Balance for amortization December 31 2005	Balance for amortization December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Capitalized subscriber acquisition costs	901,453	783,770	**117,683**	113,924
Frequencies (1)	220,104	-	**220,104**	220,104
Acquisition of operations (2)	43,847	20,116	**23,731**	30,127
Rights in channels	5,477	3,757	**1,720**	2,179
Prepaid long-term expenses in respect of a lease agreement	8,535	1,346	**7,189**	8,136
	1,179,416	808,989	**370,427**	374,470
Expenses for issue of debentures and raising other loans			**10,056**	13,434
			380,483	387,904

Company

	Cost	Accumulated amortization	Balance for amortization December 31 2005	Balance for amortization December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred expenses				
Expenses for issue of debentures and raising loans and others			**10,056**	13,434

(1) Investment in cellular communication frequencies in third generation technology by Pelephone – see Note 8D(2).

(2) Acquisition of operations –

a. BezeqCall Communications acquired an operation from Nortel networks Israel (Sales and Marketing) Ltd., to obtain independent capability for providing maintenance, support and installation services to its customers. In addition, it entered into a transaction for the acquisition of the operations of Newkol Ltd., which provided NEP services for Coral exchanges and value added services for business customers.

b. In December 2003 Bezeq International acquired all the rights in the operations of Infonet, including expansion of the deployment of global communications networks and access to a wider range of advanced and quality communications services.

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 to the profit reported according to the accounting standards of the IASB. As a result, differences arise between the reported profit in the financial statements and adjusted taxable income.

On deferred taxes in respect of these differences – see Notes 2P above and 11D below.

B. INCOME TAX INCLUDED IN THE STATEMENTS OF OPERATIONS

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Current taxes	**(268,563)**	(277,818)	(220,452)
Deferred taxes	**(142,841)**	(154,935)	169,588
Adjustment of deferred taxes due to changes in tax rates	**(55,090)**	(83,881)	-
Taxes for prior years, net	**36,900**	19,149	2,851
	(429,594)	(497,485)	(48,013))
Income from taxes in respect of a change in accounting method	**15,000**	-	-
	(414,594)	(497,485)	(48,013)

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Current taxes	**(251,078)**	(274,057)	(216,941)
Deferred taxes	**(48,791)**	(49,916)	178,351
Adjustment of deferred taxes due to changes in tax rates	**(44,374)**	(78,713)	-
Taxes for prior years, net	**12,125**	15,607	5,077
	(332,118)	(387,079)	(33,513)
Income from taxes in respect of a change in accounting method	**15,000**	-	-
	(317,118)	(387,079)	(33,513)

NOTE 11 – TAXES ON INCOME (CONTD.)

C. RECONCILIATION BETWEEN THE THEORETICAL TAX ON PRE-TAX ADJUSTED EARNINGS AND THE TAX EXPENSE IN THE BOOKS

Consolidated

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	**NIS thousands**	**NIS thousands**
Tax computed at the regular tax rate	**(343,113)**	(438,795)	17,046
Increase (saving) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**-**	–	2,227
Exempt income and capital gains	**1,337**	2,270	1,411
Non-deductible expenses	**(41,813)**	(9,652)	(9,737)
Utilization of losses and benefits from prior years for which no deferred taxes were recorded	**16,864**	50,544	–
Losses and timing differences for which deferred tax assets were not created	**(94,897)**	(63,833)	(33,926)
Taxes for prior years, net	**36,900**	19,149	2,851
Revenues from taxes due to the change in accounting method	**15,000**		
Differences in the definition of equity and non-monetary assets for tax purposes	**60,384**	24,441	(27,511)
Adjustment of deferred taxes due to a change in tax rates	**(55,090)**	(83,881)	–
Decrease in deferred taxes due to the adjustment of deferred tax balances following the change in forecast			
Company consolidated for realization of the tax asset	**(21,339)**	–	–
Other	**11,173**	2,272	(374)
	(414,594)	(497,485)	(48,013)
Regular tax rate	**34**	35	36

NOTE 11 – TAXES ON INCOME (CONTD.)

C. RECONCILIATION BETWEEN THE THEORETICAL TAX ON PRE-TAX ADJUSTED EARNINGS AND THE TAX EXPENSE IN THE BOOKS (CONTD.)

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate	**(330,272)**	(345,696)	972
Increase (saving) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**–**	–	2,051
Exempt income and capital gains	**1,337**	2,199	1,275
Non-deductible expenses	**(7,220)**	(9,022)	(8,726)
Utilization of losses and benefits from prior years for which no deferred taxes were recorded	**10,274**	12,250	–
Losses and timing differences for which a deferred tax asset was not created	**(11,469)**	(9,100)	(7,678)
Taxes for prior years, net	**12,125**	15,607	5,077
Tax revenues for changes in the accounting method	**15,000**	–	–
Differences in the definition of equity and non-monetary assets for tax purposes	**32,441**	22,177	(25,755)
Adjustment of deferred taxes due to a change in tax rates	**(44,374)**	(78,713)	–
Other	**5,040**	3,219	(729)
	(317,118)	(387,079)	(33,513)
Regular tax rate	**34**	35	36

D. DEFERRED TAXES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity –				
Balance at beginning of year	**683,455**	769,536	**498,303**	611,633
Adjustment due to changes in tax rates	**(55,090)**	(83,881)	**(44,374)**	(78,713)
Charged to statement of operations for the year	**(142,841)**	(154,935)	**(48,791)**	(49,916)
Allocation of original difference to a tax asset	**-**	21,354		–
Acquisition of minority share in a proportionally consolidated company	**-**	112,540		–
Effect of the change in accounting method	**15,000**	–	**15,000**	–
Company consolidated for realization of the tax asset	**(21,339)**	–	–	–
Charged to statement of operations for prior years	**60,235**	18,841	**27,768**	15,299
Balance as at end of year	**539,420**	683,455	**447,906**	498,303

NOTE 11 – TAXES ON INCOME (CONTD.)

D. DEFERRED TAXES (CONTD.)

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Composition of deferred taxes –				
Difference between the adjusted value of fixed assets and other assets and their value for income tax purposes	**(386,209)**	(575,497)	**(28,346)**	(230,732)
Deductions and losses carried forward for tax purposes, net	**370,738**	495,101	**–**	63,726
Differences in the recognition of expenses relating to employee rights, doubtful debts and other	**554,891**	763,851	**476,252**	665,309
Total	**539,420**	683,455	**447,906**	498,303
Stated as follows:				
As part of current assets	**194,634**	237,319	**132,198**	159,023
As part of other assets	**344,786**	446,136	**315,708**	339,280
Total	**539,420**	683,455	**447,906**	498,303

Deferred taxes for companies in Israel are computed at the tax rate expected to apply on the date of the reversal – see Section E below.

NOTE 11 – TAXES ON INCOME (CONTD.)

E. AMENDMENTS TO THE INCOME TAX ORDINANCE

1. On June 29, 2004, the Knesset passed the Income Tax Ordinance Law (Number 140 and temporary provision), 5764-2004 (" the Amendment"), which prescribes a gradual reduction in the corporate tax rate from 36% to 30%, in the following manner:
During the 2004 tax year the applicable tax rate will be 35%, in 2005 the applicable tax rate will be 34%, in 2006 the applicable tax rate will be 32%, and from 2007 onwards the applicable tax rate will be 30%.

   Current taxes and deferred tax balances as at December 31, 2004 are calculated in accordance with the new tax rates set out in the Amendment. The effect of the change on the consolidated financial statements as at the beginning of 2004 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the Company balance sheet by approximately NIS 79 million, and approximately NIS 84 million in the consolidated balance sheet.

2. On July 25, 2005 the Knesset enacted an amendment to the Income Tax Ordinance (Number 147 and temporary provision), 5765-2005 ("Amendment 147"), which prescribes a gradual reduction of the corporate tax rate in the following manner:
During the 2006 tax year the applicable tax rate will be 31%, in 2007 the applicable tax rate will be 29%, in 2008 the applicable tax rate will be 27%, in 2009 the applicable tax rate will be 26% and from 2010 onwards the corporate tax rate will be 25%. In addition, commencing 2010, with the reduction of the tax rate to 25%, every real capital gain will be taxed at 25%.

   Current taxes and deferred tax balances as at December 31, 2005 are calculated in accordance with the new tax rates set out in Amendment 147. The effect of the change on the consolidated financial statements as at the beginning of 2005 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the Company balance sheets by approximately NIS 44 million, and approximately NIS 55 million in the consolidated balance sheets.

F. Realization of the deferred tax asset is contingent upon the existence of adequate taxable income in appropriate amounts in the future. The deferred tax asset is included in the financial statements since, according to the Group's business plans, its realization is anticipated.

(1) The balance of the losses and deductions carried forward, in respect of which the Company did not record deferred taxes due to uncertainty as to the possibility of realizing them, is approximately NIS 1,100,000 (2004 – NIS 26,000,000).

(2) Losses for tax purposes and capital losses carried forward of consolidated companies (except Pelephone), amount, as at the balance sheet date, to an adjusted amount of NIS 3,431 million (2004 – NIS 3,070 million). The consolidated companies did not create a tax asset in respect of losses of NIS 3,408 million.

(3) Pelephone recorded a tax asset of approximately NIS 366 million in respect of losses for tax purposes and a deduction for inflation carried forward to the following year and which, as at the balance sheet date, amount to an adjusted sum of approximately NIS 1,322 million (2004 – NIS 1,360 million). The net balance of the tax asset at Pelephone was recorded according to the assessment of Pelephone's Management that there is a high level of assurance that these losses will be realized in the foreseeable future. Realization of the balance of these deferred taxes is contingent upon the existence of adequate taxable income of in appropriate amounts in the coming years.

Realization of the balance of the losses and deductions carried forward is linked to the CPI pursuant to the law mentioned above.

NOTE 11 – TAXES ON INCOME (CONTD.)

G. FINAL TAX ASSESSMENTS

(1) The Company has final tax assessments up to and including 2001.

(2) Bezeq International has final tax assessments up to and including 2003.

Under an assessment agreement signed in November 2005 between Bezeq International and the assessment officer concerning final assessments for the years 2000 – 2003, Bezeq International's business loss carried forward as at December 31, 2004 was reduced by approximately NIS 27 million. This amount will be allowed as a tax expense in subsequent years.

(3) Pelephone has final tax assessments up to and including the year ended December 31, 2003.

(4) BezeqCall Communications has final tax assessment up to and including 2002.

(5 Self-assessments filed by DBS up to 1999 are considered final. Assessment have been issued for DBS which do not recognize expenses of NIS 463 million. DBS is disputing the contentions of the tax authorities on which those assessments are based, and has appealed the assessments.

(6) Bezeq Online has received final assessments up to and including the 2003 tax year.

H. VALUE ADDED TAX

Value Added Tax assessments amounting to approximately NIS 18 million were issued to Pelephone for the period from June 2001 to December 2003, which are in dispute and regarding which Pelephone has objections. Pelephone has included a provision in its accounts for an amount it deems sufficient.

NOTE 12 – BANK CREDIT

		Consolidated	
		December 31 2005	December 31 2004
	Interest rate	NIS thousands	NIS thousands
Unlinked loans	Prime + 1.35	**75,191**	88,102

NOTE 13 – LONG-TERM LOANS

A. Composition

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Banks	**3,306,563**	4,162,573	**565,924**	1,003,312
Pension fund	**–**	26,758	**–**	26,758
Others	**107,980**	233	**–**	–
Supplier credit	**–**	7,352	**–**	–
	3,414,543	4,196,916	**565,924**	1,030,070
Less –				
Current maturities from banks	**1,262,583**	1,304,916	**531,402**	473,578
Current maturities from others	**–**	31,066	**–**	26,758
	2,151,960	2,860,934	**34,522**	529,734

B. Linkage and interest terms

		Consolidated		Company	
		December 31 2005	December 31 2004	December 31 2005	December 31 2004
	Interest rate	NIS thousands		NIS thousands	
Loans in foreign currency US dollar (*)	LIBOR+(0.45-0.65)	**563,867**	1,004,654	**563,867**	997,302
Loans linked to the CPI	3.9 - 11.0	**1,928,222**	2,122,825	**2,057**	6,010
Pension fund	6.1	**-**	26,758	**-**	26,758
		1,928,222	2,149,583	**2,057**	32,768
Shekel/dollar loans(**)	3.67-4.36	**230,150**	215,400	**-**	-
Unlinked loans	7.13 – 7.31 Prime + (1.5-1.35)	**692,304**	827,279	**-**	-
		3,414,543	4,196,916	**565,924**	1,030,070

(*) These loans bear interest at LIBOR plus a margin.
(**) The loan is renewed every three months in a mechanism determined for three years which will end in August 2006. The interest is computed under two possible alternatives – a shekel track and a dollar track.

NOTE 13 – LONG-TERM LOANS (CONTD.)

C. Repayment schedule

	Consolidated	Company
	December 31, 2005	December 31, 2005
	NIS thousands	NIS thousands
2007	**355,844**	**34,522**
2008	**292,517**	**-**
2009	**304,440**	**-**
2010	**283,016**	**-**
2011 and thereafter	**916,143**	**-**
	2,151,960	**34,522**

D. Security

(1) Long-term loan agreements of the Company, aggregating NIS 565,924 thousand, include certain conditions upon the occurrence of which the lender may demand immediate repayment of the loans, including:

– A change (without the lender's consent) in the nature of the Company's business, which would have a materially adverse effect on its business, assets or financial condition.

– Non-repayment of a material amount of the loan that has fallen due, or violation of the undertakings or representations made by the Company.

– Abrogation or change of a provision of law that would prevent the Company's operations or the fulfillment of its undertakings.

– The Company ceases to manage its affairs or enters into receivership or bankruptcy proceedings, etc.

– Some or all of the lien-holders realize the liens on the Company's assets.

– A complete or material reduction of the Company's authority to administer its affairs as a result of the intervention of an authority or a change in the Company's tariffs that will have a material effect on the future receipts of the Company (in loans from foreign banks only).

– In respect of loans amounting to NIS 105,624 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company.

– In respect of the remaining balance of NIS 460,300 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company and of material subsidiaries, or failure to comply with ratio of net financial debt to earnings before interest, taxes, depreciation and amortization (EBITDA) of 3 : 1 for the Group.

The Company's position is that as at the balance sheet date, it is in compliance with these financial covenants.

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

NOTE 13 – LONG-TERM LOANS (CONTD.)

D. SECURITY (CONTD.)

(2) a. Bank loans and debentures of Pelephone are secured by an irrevocable undertaking in favor of the banks, whereby Pelephone created a negative pledge in favor of the banks. This undertaking includes, *inter alia*:

(1) that its debts will not exceed three times its shareholders' equity;
(2) that as long as its debts exceed its shareholders' equity by a ratio of 2, Pelephone will not distribute dividends and will not pay management fees to the shareholders;
(3) that its total debts will not exceed NIS 3.8 billion (linked to the known CPI of January 2002);
(4) that Pelephone will not encumber in any way, including by way of a floating lien or a fixed lien, of any kind or rank, any or all of its assets (as these may be from time to time), in favor of any third party, without obtaining the prior written consent of those who provided the credit.

As at the date of the financial statements, Pelephone is in compliance with its obligations to the banks, the balance of which as at the balance sheet date is NIS 1,353 million.

b. Under the general license for cellular services, Pelephone may not sell, lease or pledge any of its assets which are used for performance of the license without the consent of the Minister of Communications, except –

(1) Encumbrance of one of the assets of the license in favor of a bank duly operating in Israel, for the purpose of receipt of bank credit, provided that it has notified the Ministry of Communications of the encumbrance it intends to record, whereby the encumbrance agreement includes a clause guaranteeing that in no case, will an exercise of the rights by the bank harm the provision of services under the license in any way;
(2) Sale of items of equipment at the time of an upgrading process, including sale of equipment by the trade-in method.

c. Bezeq International provided a negative pledge in favor of banks, whereby it may not encumber its assets without the bank's consent. As at December 31, 2005, Bezeq International has no obligations towards banks.

d. BezeqCall Communications 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 63 million.

e. The terms of the bank loans which DBS received, the balance of which as at December 31, 2005 is NIS 1,325 million, impose limitations concerning the lien or sale of certain of DBS's assets, a limitation on receipt of credit from other banks (without the prior approval of the lending bank), a limitation relating to the distribution of a dividend, a limitation relating to repayment of shareholders' loans and a limitation on transactions with an interested party, including a requirement to meet financial criteria, as follows: minimum total income, minimum operating surplus (as defined in the financing agreement), minimum operating surplus after deduction of investment in set top boxes (as defined in the financing agreement), maximum churn rate, maximum financing needs (as defined in the financing agreement) and maximum supplier credit and bank debt coverage needs and debt balance (as defined in the financing agreement). The values for compliance with the financial criteria vary, and are measured once every quarter. Failure to meet the financial criteria entitles the banks to demand early repayment of the loans which DBS received. As at December 31, 2005, DBS is in compliance with those criteria (after it was granted a benefit in December 2005 in relation to the maximum supplier credit stipulation). IN view of the projections of the management of DBS concerning its business results for 2006, DBS will need to take steps to obtain the approval of the banks to update the financial stipulations in the financing agreement. DBS is also negotiating with the banks for resolving a dispute relating to insurance obligations prescribed in the financing agreement.

NOTE 13 – LONG-TERM LOANS (CONTD.)

E. Loan procurement expenses

Deferred expenses for raising loans amounted to NIS 9,601 thousand (2004 – NIS 10,855 thousand). The expenses are stated after deduction of accumulated amortization amounting to NIS 8,719 thousand (2004 – NIS 8,457 thousand).

NOTE 14 – DEBENTURES

A. Composition and terms

		Consolidated		Company	
		December 31 2005	December 31 2004	December 31 2005	December 31 2004
	Interest rate	NIS thousands	NIS thousands	NIS thousands	NIS thousands
CPI-linked debentures issued to the public Debentures Series 4 and 5 (1)	4.8 – 5.3	**1,721,604**	850,847	**3,821,674**	3,410,936
Debentures issued to the public: In euro (2)	6.5	**1,593,387**	1,717,622	**1,593,387**	1,717,622
Debentures issued: Unlinked (3)	Bank of Israel interest + 0.5	**36,423**	109,179	**36,423**	109,179
Debentures issued to financial institutions and others:					
CPI-linked	3.9 - 6.35	**2,049,073**	1,355,286	**942,191**	1,055,286
Euro-linked	LIBOR + 0.8	**29,736**	32,086	**29,736**	32,086
		2,078,809	1,387,372	**971,927**	1,087,372
		5,430,223	4,065,020	**6,423,411**	6,325,109
Less – current maturities		**527,167**	240,481	**410,827**	210,481
		4,903,056	3,824,539	**6,012,584**	6,114,628

(1) The outstanding balance of the debentures is NIS 3,586,967,000, of which NIS 1,636,967,000 par value were issued to the public.

a. (1) In a tender offer and public offering pursuant to a prospectus published on May 24, 2004, the Company issued 1,200,000,000 debentures (Series 4) of a par value of NIS 1 each, payable in four equal annual installments in each of the years 2008 through 2011. The interest set for these debentures is 4.8% per annum. Of these debentures, 400 million were allotted, prior to the prospectus, to Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav"), a wholly owned and controlled subsidiary of the Company.
In addition, on May 20, 2004 the Company issued a series of 600 million debentures (Series 5) of NIS 1 par value each, of which 50 million were allotted to institutional investors and the remainder to Bezeq Zahav. These debentures are repayable in 6 equal annual installments in each of the years 2011 through 2016. The interest rate set for these debentures is 5.3% per annum. The debentures were listed for trading under the aforementioned prospectus.

NOTE 14 – DEBENTURES (CONTD.)

A. COMPOSITION AND TERMS (CONTD.)

(2) During 2005 Bezeq Zahav sold NIS 400 million par value of the debentures (Series 4) which it had purchased from the Company. The proceeds from the sale in the amount of NIS 428,910 thousand, was transferred to the Company by Bezeq Zahav as repayment of a loan extended to it by the Company for purchase of the above debentures (Series 4). With the above sale of the debentures, Bezeq Zahav not longer holds any debentures (Series 4) of the Company, and all the debentures from this series, amounting to NIS 1,200,000,000 par value, are held by the public.

b. On December 9, 2004 the Company issued to Bezeq Zahav 1,500 million debentures (Series 5) of a par value of NIS 1 each. The debentures are registered in name, are repayable in six equal annual installments in each of the years 2011 to 2016, bear annual interest of 5.3% and are not secured by any lien.

The consideration in respect of the debentures was calculated at the market price of debentures from the same series at the close of trading on December 9, 2004, and is NIS 1,650 million.

The debentures were listed for trading on the stock exchange, and trading in them will be subject to blocking restrictions pursuant to the Securities Law and to a restriction which Bezeq Zahav undertook not to resell the debentures for any reason during the later of 12 months from the date of the allotment or until within three months from the date of sale of the State's holdings in the Company.

c. Bezeq Zahav financed the purchase of the above debentures by means of a loan granted to it by the Company for that purpose.

d. (1) On April 4, 2005 the Company completed a private placement of 286,967,000 debentures (Series 5) of a par value of NIS 1 each to institutional investors. The debentures are registered in name, are repayable in six equal annual installments in each of the years 2011 to 2016, bear annual interest of 5.3% and are not secured by any lien. The proceeds from the placement, NIS 315,663,700, were received on April 4, 2005. The purchase price in respect of NIS 1 par value of debentures (Series 5) was 110 points, reflecting an annual yield to redemption of approximately 4,46%.

(2) On August 17, 2005 Bezeq Zahav sold NIS 100 million par value of debentures (Series 5) of the Company. The consideration for this sale, NIS 110,950,000, was transferred to the Company as (partial) repayment of the loan extended to it by the Company for purchase of the above debentures (Series 5).

e. On February 27, 2005 Pelephone issued NIS 500 million of debentures in a private placement to institutional bodies at 4.4% interest. The debentures are repayable in twenty equal half-yearly payments commencing September 2005. On June 29, 2005 Pelephone issued NIS 333 million of debentures in a private placement to institutional bodies in consideration of their par value. The proceeds from the issue were received on July 3, 2005. The debentures are linked to the CPI, bear annual interest of 4.55% and will be repaid in twenty equal half-yearly payments commencing January 2006.

(2) The outstanding par value of the debentures held by the public is € 293,000,000.

(3) The outstanding par value of the debentures is NIS 36,443,333.

NOTE 14 – DEBENTURES (CONTD.)

B. Repayment schedule

	Consolidated	Company
	December 31, 2005	December 31, 2005
	NIS thousands	NIS thousands
2007	**1,728,439**	**1,612,099**
2008	**666,977**	**550,637**
2009	**626,938**	**510,598**
2010	**625,999**	**509,659**
2011 and thereafter	**1,254,703**	**2,829,591**
	4,903,056	**6,012,584**

C. Security

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

The lenders are entitled to demand the immediate repayment of the debentures in cases where the Company does not repay its loans or violates the terms of the debentures, if a significant attachment is imposed on its assets (and not removed within 60 days), if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to manage its business or if another lien-holder realizes the lien it has on the Company's assets.

In addition, some of the lenders, from whom the balance of loans as at December 31, 2005 is approximately NIS 343,698 thousand, may demand immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26%. For this reason, the balance in the financial statements is stated under short-term liabilities (see also Note 1I).

Furthermore, in respect of a balance of NIS 1,593,387 thousand of debentures listed on the Luxembourg bourse 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 (excluding an event deriving from a decrease in the State's holdings in the Company) and of its material subsidiaries as defined in the terms of the debentures (Pelephone is the only company meeting the definition of a material subsidiary in accordance with these debentures; it should be noted that DBS is not considered a material subsidiary as defined in the debentures), if the Company does not make the payments scheduled in respect of the debentures, if the Company or its material subsidiaries cease to manage their businesses or enter into receivership, liquidation proceedings and the like, and upon the occurrence of a number of additional events of non-compliance with the undertakings of the Company and its material subsidiaries, as set out therein.

Regarding the Company's application to the tax authorities for receipt of approval for exemption from the deduction of withholding tax from interest paid in respect of the above debentures, the Company reached an agreement with the assessment officer whereby it would be exempt from withholding tax from August 1, 2004 until the final repayment of the debentures. It was also agreed that where the ratio of debt to capital in the Company is greater than 1:1.5 debt to capital, the Company's financing expenses in the tax year would be adjusted for tax purposes but not by more than the amount of the financing expenses in respect of the debentures. This will be checked in the quarterly financial statements of the Company, and applied each quarter. In this regard, "debt" – any obligation bearing interest, linkage differentials or whose value changes as a result of changes in the interest or linkage differentials, except for an undertaking to the employees or former employees.
The Company believes that as at the balance sheet date, it is in compliance with all these conditions.

The Company has created a negative pledge in favor of the holders of the above debentures.

NOTE 14 – DEBENTURES (CONTD.)

D. ISSUANCE EXPENSES

The deferred expenses in respect of the issuance of the debentures amounted to NIS 20,475 thousand (2004 – NIS 39,266 thousand) and are stated net of accumulated amortization of NIS 11,427 thousand (2004 – NIS 29,520 thousand).

NOTE 15 – TRADE PAYABLES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Suppliers of goods and services	**1,397,367**	1,671,261	**540,459**	648,218
Current maturities of long-term supplier credit	**3,347**	4,308	**–**	–
	1,400,714	1,675,569	**540,459**	648,218
Including subsidiaries	**–**	–	**75,175**	99,409

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. COMPOSITION

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement (see D below)	**772,251**	1,190,447	**772,251**	1,190,447
Compensation for unutilized sick leave (see F below)	**54,865**	47,196	**54,865**	47,196
	827,116	1,237,643	**827,116**	1,237,643
Provision for severance pay (see B below)	**76,460**	76,629	**15,645**	13,186
Less – reserve in compensation fund	**38,271**	41,702	**–**	–
	38,189	34,927	**15,645**	13,186
	865,305	1,272,570	**842,761**	1,250,829
Stated as follows:				
In current liabilities	**567,878**	592,474	**567,878**	592,474
In long-term liabilities	**297,427**	680,096	**274,883**	658,355
	865,305	1,272,570	**842,761**	1,250,829

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

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 by the above liabilities. The accumulated amounts in the funds mentioned above 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 until January 31, 1985, are covered by a pension fund ("Makefet Fund") 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 to January 31,1985, is actually paid by the Company, and the amounts accumulated with the Makefet Fund with respect to this period are held in that 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 in the employee severance pay fund.

The liability of Group companies 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.

The severance pay liability included in the balance sheet represents the balance of the liability not covered by deposits and/or insurance policies as aforesaid, in accordance with existing labor agreements and in accordance with the wage components which the management of the companies believe entitle the employees to severance pay. In respect of this part of the liability, there is a reserve deposited in the Company's name in a recognized compensation fund. The reserves in compensation funds include linkage differentials and accrued interest, and are deposited in compensation funds in banks and an insurance company. Withdrawal from the funds is contingent upon fulfillment of the provisions of the Severance Pay Law.

Employees who transferred to the Company from government service ("transferred employees") and whose employment in the Company is ceased before reaching retirement age, are entitled, in certain conditions, if they so choose and under the provisions of the Civil Service Law (Retirees), 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. In recent years, most Company employees have retired under agreed early retirement plans, and therefore the chances of realization of the above liability are slight. Accordingly, no provision has been made in respect thereof in the financial statements, other than a provision for the early retirement plan described below.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

D. EARLY RETIREMENT PLANS

(1) In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement on early retirement (the "Retirement Agreement"). Under the Retirement Agreement, 1,770 additional employees, of whom up to 300 are not transferred employees, were to take early retirement between April 1, 2001 and December 31, 2006 (with the option of extending the final date of retirement for certain employees through December 31, 2008). Similarly, in accordance with the provisions of the agreement, the Company may terminate the employment of employees on the severance pay track in excess of the aforementioned quota. According to the agreement between the Company and workers' representatives, the funds raised by the Company in 2003, in the amount of approximately NIS 890 million, will be used to finance the costs of retirement of employees under the Retirement Agreement. Therefore, it was agreed that the funds raised would be held, managed and invested by the Company as part of its total monetary balances, and that shortly before the Government ceases to hold control of the Company, the Company will transfer the retirement funds to an external body which would manage and invest the retirement monies. As at the date of these financial statements, the Company and the workers' union had not reached agreement on implementing transfer of the retirement monies to an outside entity. The financing round was completed in 2003.

Under the retirement Agreement, 1,352 employees retired from the Company through December 31, 2005.

The Company's Management does not expect any significant costs arising as a result of employees who retire under the severance pay track (if they retire) under the Retirement Agreement, or under any other framework, and therefore no provision has been made in the financial statements.

In May 2003, the Knesset approved the Israeli Economic Recovery Plan (Legislative Amendments for Achieving Budgetary Targets and Economic Policy for the 2003 and 2004 Financial Years) Law, 5763-2003. This law includes, *inter alia*, an amendment to the Supervision of Insurance Business Law, 5741-1981, which relates to the old pension funds operating at a deficit, including the Makefet Fund. Under the amendment, the retirement terms of all members of these pension funds were made equal, in accordance with uniform articles which, amended by law, became valid on October 1, 2003, such that the rights of members of those pension funds who were a party to special pension agreements were harmed.

On March 18, 2004, an amendment to the Retirement Agreement was signed between the Company, the New General Workers' Trade Union and the workers' union, under which certain amendments to the present Retirement Agreement were agreed upon with the aim of clarifying the uncertainties arising out of the amendment of the Supervision of Insurance Business Law. *Inter alia*, it was agreed that by September 30, 2004, 400 employees would retire, and it was also agreed that the retirement conditions of all transferred employees who take a pension under the Retirement Agreement commencing September 2000, would remain in force despite the amendments to the Pension Law and that the Company would bear any additional costs that might be required.

On April 1, 2004, the Commissioner for Capital Markets, Insurance and Savings published a circular regarding "Employer-Financed Early Retirement in Old Pension Funds". According to the circular, the discount rate for capitalizing the cost of early pension was changed from 3.5% to 3% and the management fees were raised to 1.75%. As a result of these and additional updates, the Company recorded an additional provision of approximately NIS 105 million in its financial statements as at December 31, 2004.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

D. EARLY RETIREMENT PLANS (CONTD.)

(1) (contd.)

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

It is noted that all the approvals required for the agreement with Harel and the special collective agreement dated April 17, 2005, and its amendment to come into force, as signed between the Company and the workers' union and the Histadrut and regulating the early retirement of employees through Harel as substitute for the Makefet Fund, have been obtained.

As a result of the agreement described above and also subsequent to adjustments deriving from updated assessments of the pension liability the Company reduced the provision for early retirement in the financial statements for 2005 by approximately NIS 90 million.

(2) It is noted that before completion of transfer of the State's holdings in the Company to Ap.Sb.Ar, a document of principles was signed between Ap.Sb.Ar. and the workers union, regarding signing a future detailed agreement between the Company and the union, which includes reference to a change in the organizational structure of the Company involving the retirement and/or laying off of employees and employees' rights; capital reduction while maintaining the financial strength of the Company, and employee compensation. As at the date of publication of these financial statements, negotiations have commenced between the Company's Management and the union on these issues.

E. Under the collective agreements applicable to labor relations in the Company and pursuant to the agreements with Makefet ("the Fund"), Company employees who are transferred employees retain the option of retiring under one of two retirement tracks. The method of calculating the cost of early retirement of these employees is laid down in the provisions of several agreements and documents drawn up between the Company and Fund during the years 1990-1996, including a letter of understanding drawn up and signed by them 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, it determined the data on the basis of the assumption that these employees had chosen the track with the higher cost of purchase, irrespective of the track those employees had actually chosen. According to an actuarial opinion prepared for the Company, the difference 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 20, 2003, the Company filed another claim against the Fund for additional amounts of approximately NIS 80 million in respect of other components. The Fund submitted data on the previous retirees. On the basis of these data, together with the previous file, a revised actuarial opinion was prepared which quantified the total amount of the claim as at the date of its filing at approximately NIS 280 million. The Fund filed statements of defense in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

F. COMPENSATION FOR UNUTILIZED SICK LEAVE

The financial statements include a provision for compensation in respect of unutilized sick leave for all entitled employees, in accordance with the conditions laid down in the employment agreement, and based on past experience concerning the utilization and redemption of sick leave days at age 55.

NOTE 17 – OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties	**247,978**	**244,886**	**140,996**	**145,121**
Wages and salaries (1) (2)	**314,383**	397,666	**205,433**	286,360
Provision for vacation pay	**87,479**	113,144	**73,319**	73,370
Governmental agencies	**128,536**	102,229	**33,689**	15,635
Accrued interest	**146,431**	235,352	**173,137**	165,124
Payables in respect of derivatives	**77,400**	57,635	**75,657**	47,827
Other accrued expenses	**296,981**	166,086	**129,409**	103,519
Current maturities in respect of prepaid income	**38,298**	34,547	**19,533**	21,643
Provision for claims in respect of salary and pension components	**50,469**	50,595	**50,469**	50,595
	1,387,955	1,402,140	**901,642**	909,194
Including subsidiaries	**–**	–	**67,053**	76,308
(1) Including current maturities of a long-term loan from a pension fund	**–**	26,758	**–**	26,758

(2) Including a provision for a special benefit for employees in respect of the proportional period in the report year (9 months) in which the Company was controlled by the State.

NOTE 18 – OTHER LONG-TERM LIABILITIES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Prepaid income	**15,583**	25,750	**15,583**	20,937
Liabilities in respect of an onerous contract (1)	**9,135**	9,247	**–**	–
Liabilities in respect of derivatives	**–**	438	**–**	–
Checks payable	**3,711**	11,940	**–**	437
Customer deposits	**5,652**	–	**–**	–
	34,081	47,375	**15,583**	21,374

(1) In the course of its business and as part of the setting up of Bezeq International and receipt of assets from the Company, Bezeq International entered into agreements granting it rights to use transmission equipment (old-generation undersea cables) for periods ending between 2016 and 2024. Under those agreements, Bezeq International is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of those cables. The Management of Bezeq International estimates that the unavoidable costs for compliance with those agreements exceed the anticipated financial benefit that will accrue to it from use of the undersea cables. This assessment, together with the decision of Bezeq International's management not to operate the undersea cables, formed the basis for charging a provision in the financial statements. The balance of the provision as at December 31, 2005, which reflects the capitalized value as at that date of all the unavoidable costs that Bezeq International must pay the owners of the undersea cables until the end of the terms of the agreements is NIS 9,135 thousand (on December 31, 2004 – NIS 9,247 thousand).

NOTE 19 – CONTINGENT LIABILITIES

A. CLAIMS

Below are details of the status of contingent liabilities of the Company and investee companies as at December 31, 2005, in respect of which the maximum possible exposure is considerable.

(1) In September 1997 a claim was filed against the Company and the State in the Jerusalem Regional Labor Court. The claim was filed on behalf of 128 senior employees employed under personal employment contracts. The essence of the claim is the plaintiffs' allegation that since October 1, 1996, they have been entitled to a 33% salary increase, commensurate with the raise given at that time to Knesset members and to senior civil servants whose salaries are linked to those of Knesset members. The total amount of the claim in respect of salary differentials is approximately NIS 12 million. In addition, delay differentials are claimed in respect of these amounts. The Company contended that it pays the plaintiffs' salaries according to the directives of the Government Companies Authority. The State joined as a party to the proceeding and filed a final opinion written by the Attorney General, which supports the position of the Government Companies Authority that there is no obligation to grant the senior employees the salary increment demanded. In a hearing on January 27, 1998, the State's representative stated that the Attorney General had given his decision that the Government Companies Authority had no obligation to order a 33% raise in the salaries of the senior employees, and that the Government Companies Authority had exercised its discretion reasonably on this matter when it decided not to accede to the claim. The claim was dismissed, as was the appeal filed against its dismissal. On May 23, 2004, the plaintiffs filed a petition in the Supreme Court, requesting that the decision of the National Labor Court be annulled. On June 23, 2004, the Company, through its legal advisers, filed a preliminary response to the petition, seeking its dismissal *in limine*. A decision on these claims has not yet been made and a hearing was scheduled for March 22, 2005, in the Supreme Court. On May 2, 2005, the Supreme Court gave its ruling, dismissing the petition.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (contd.)

(2) a. In December 1998 the Antitrust Commissioner published notice that the Investigations Department of the Antitrust Authority ("the Authority") had completed an investigation it had carried out over the past year, regarding *prima facie* suspicion of restrictive agreements between Koor Industries, Telrad, Tadiran, the Company and a subsidiary company, BezeqCall Communications Ltd. ("BezeqCall Communications"), concerning the supply of large exchanges (Public Switching) and Network End Point ("NEP") exchanges.

In the field of Public Switching, the Authority's investigation found, according to the notice, suspected collaboration between Telrad and Tadiran against the Company, and suspected restrictive practices between the Company, Koor, Telrad and Tadiran, which include 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 from the two companies through tenders. It was suspected that these undertakings, or some of them, in the relevant circumstances, constitute violation of the provisions of the Antitrust Law. According to the Commissioner, 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 restricted itself and had the entire market not been blocked to other equipment suppliers by the aforementioned arrangement.

In the NEP field, the findings of the Authority's investigation gave *prima facie* indication of a series of restrictive arrangements and attempted offenses in the NEP field, between BezeqCall Communications, Telrad and Tadiran.

On March 3, 2002, the Company and certain persons who were serving as its officers during the relevant period, were summoned to a hearing by the Antitrust Authority. The summons (which relates to the investigation of the public switching issue only) stated that the Authority was considering committing the Company for trial on the basis of offenses against the Antitrust Law.

In 2004, the Authority gave notice that it does not intend to file indictments in connection with this affair. However, the Authority also notified the Company that it was considering issuing a determination against the Company, under Section 43 of the Antitrust Law, concerning the public switching field, and that the Company was invited to attend a hearing on the matter. In reply, the Company gave notice that it refuses to attend the hearing, for the same reasons it refused to attend the hearing in connection with the intention to file an indictment against it.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (contd.)

(2) a. (contd.)

Following dismissal of the Company's petition on March 2, 2005, to direct the Authority to hold a hearing for the Company, to submit security material to the Company for it to study and to refrain from issuing a determination under Section 43 of the Antitrust Law, discussions were held between the Company and the Authority in an attempt to arrive at an agreed order (which would also preclude issue of the determination), and resulted in agreement being reached between them on the wording of an agreed order which would be filed in the Antitrust Court for approval. The text of the order includes an undertaking by the Company to pay the State Treasury approximately NIS 2 million without admitting to violation of the Antitrust Law, and the Authority's confirmation that it will refrain from instituting any proceedings against the Company in connection with the public switching affair. The Authority recently published the text of the agreed order. The Company, based on its legal advisers, believes that an application for approval of the agreed order will be filed by the Authority, with the concurrence of the Company, in the near future, and that taking into consideration that the Antitrust Court approved an application similar to the agreed order which was filed in this affair by Telrad and Tadiran, it is probable that this application will also be approved by the Court.

b. On September 21, 2004, a claim and an application for approval as a class action were filed in the Jerusalem District Court against the Company and several other defendants (including Telrad and Tadiran) and against the State of Israel-Ministry of Communications as a formal defendant. The claim was filed by the plaintiff under the Antitrust Law,5748-1988, and Article 29 of the Civil Procedure Regulations, 5744-1984. According to the plaintiff, the defendants unlawfully formed a number of cartels which divided up the communications exchange market in Israel and set the prices of the exchanges, where the Company was party to those agreements as a customer of Telrad and Tadiran. It is alleged that these arrangements gave rise to unnecessary expenses for the Company, resulting in an unjustified rise in the Company's tariffs in a cumulative amount of NIS 1,750 million. Most of the claim is based on causes ostensibly found in the Antitrust Law for causes established in other laws, by means of an attempt to include the claim among the actions which can be filed by virtue of Article 29 of the Civil Procedures Regulations,5744-1984. On March 8, 2005, the Company filed its response to the application for approval of the claim as a class action, in which it also requested that the Court dismiss the application *in limine* and at least on its merits. In addition, on September 1, 2005, a decision was given in the A.S.T. ruling in the matter of the status and application of Article 29 for filing class actions, which limits, at least at this stage, the use of Article 29 as a tool for filing class actions.

In these circumstances, due to the complexity of the claim and the early stage of the proceeding, the case has not yet advanced to a stage where a realistic assessment can be made for the prospects of the claim itself.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(2) c. Applications by Company shareholders relating to the filing of claims against suppliers and/or officers:

In November 2000 an application was received from a Company shareholder, demanding that the Company take legal action against the abovementioned suppliers of communications equipment, and giving notice that in his estimation, the Company had suffered a loss of approximately NIS 392 million as a result of the cartel. In his application, the shareholder reserves the right to file a derivative claim pursuant to Section 194 of the Companies Law. The Company replied that it was monitoring developments in the matter, that it had requested the investigation material from the Authority and that it would formulate its position on the basis of the Authority's decision and any findings there might be. In November 2001 a similar application was made by another shareholder. The Company replied that it was still awaiting the decision of the Authority. On November 2, 2004, another similar application was made by a Company shareholder who believes that the Company should file an action in respect of losses caused by the suppliers. The Company replied that his application did not contain the factual and legal basis required under the Companies Law, and added that to the extent the Company explains, as part of the class action referred to in section b. above, or if information that comes to the Company shows that it has cause of action, it will be ready to institute proceedings to defend its rights.

In addition, on November 29, 2004, an application was received demanding that a claim be filed against whoever served in the Company as directors and/or as senior managers from the end of the 1980s to 2004 (inclusive), in which the officers would be required to compensate the Company in respect of all the excess payments made by the Company to its equipment suppliers and which, due to the omission of those officers, the Company is unable to claim from those equipment suppliers.

On January 30, 2005, the Company replied that it rejects everything stated and alleged in the demand, since the Company was not in a position which would enable it to formulate a reasoned and final position on the matter of the public switching and that it has no cause of action against any of its officers.

In the opinion of the Company's legal advisers, in these matters it is not certain that on the dates relevant to the contents of the demand there was no cause of claim against some of its officers.

(3) In March 1999 a claim was filed against the Company in the Jerusalem Regional Labor Court by a group of employees who had been employed as non-permanent workers at the Ministry of Communications and 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 transferred permanent employees, graduates of Bezeq College and retired Ministry of Communications employees. In the hearing of the Company's application for dismissal, the parties reached agreement regarding partial striking out 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. The Labor Court must now rule whether it approves the withdrawal of consent. In a preliminary hearing the parties agreed to split the hearing so that in the first stage the court would hear only the dispute on whether the plaintiffs have the status of "transferred employees". Based on the outcome of this stage, the plaintiffs will give notice of continuing the case proceedings. In the opinion of the Company the plaintiffs are not considered "transferred employees" and collective labor agreements differentiate between transferred employees and other employees regarding pension and other rights.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(3) (contd.)

On March 6, 2005, a partial decision was given, dismissing the plaintiffs' allegations as to their status as "transferred employees", and the Court's position was that the partial decision should be made final. The plaintiffs' lawyer was supposed to give notice of the plaintiffs' position on the matter. On August 11, 2005, when no such notice was received on behalf of the plaintiffs, a decision was given that the partial decision is a final decision, thereby dismissing the claim.

(4) Several claims are pending against the Company concerning the recognition of various salary components as pensionable components and the recognition of various components of the determining wage for severance pay as detailed below:

a. In September 2000, a claim was filed in the Jerusalem Regional Labor Court against the Company by 2,423 retired employees of the Company, who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are seeking declaratory relief from the Labor Court, which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are regular salary which should be considered as part of their determining wage for the purpose of calculating their pension and for the payments made to them upon retirement, and should be included in the calculation of hourly pay value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for pension should be calculated according to the last salary paid to each of them for the last month of work, and not according to the average staff grade which each of them held. The Company filed a preliminary application for the claim to be dismissed and/or stricken *in limine*. The preliminary allegations made in that application are dismissal for limitation, strike for absence of material details, strike for absence of financial quantification, and causal arguments relying on the retirement agreements.

On June 24, 2004, the Regional Court gave its decision, in which the claim was stricken *in limine*. The Court ruled that the plaintiffs were not a homogenous group in that each of them has different data relevant to his claim, that the claim cannot be conducted as if it were a class action, that it is a monetary claim which was not properly quantified, and it does not contain all the facts required for it to be quantified. The Court also determined that the pensioners' organization is not a workers' organization as referred to in Section 3 of the Collective Agreements Law, that it is not an action in a collective dispute and that the consent of the organization is not sufficient for filing a claim in the name of each of the 2,423 plaintiffs. On October 10, 2004, this decision was appealed in the National Labor Court. On September 6, 2005 .the National Labor Court allowed the appeal of the plaintiffs against striking the claim *in limine*, and determined that since the appellants had petitioned for a declaratory decision which tests entitlement to include various components in the determining salary for pension, a proceeding of a declaratory decision in this case is correct, since what is sought is a determination in principle. Accordingly, the National Court set aside the decision of the Regional Court and directed that the dismissal of the claim be cancelled.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(4) (contd.)

b. On February 24, 2002, a "notice of a party to a collective dispute" ("the Notice"), was received at the Company's offices, which was filed in the Jerusalem Regional Labor Court on February 21, 2002 by the New General Federation of Workers in the name of all Company employees. The applicant alleges that payments for grossing up of tax, the component of administrative on-call duty benefits and clothing allowances which were and are paid to Company employees, are regular pay which form part of the determining salary of every employee, including for the calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hourly pay value and that various payments and provisions should be made in respect thereof, including for pension purposes. On October 20, 2002, the Attorney General gave notice that he would be joining the claim, and he later submitted his position that the application in all its parts should be dismissed.

c. A group of employees filed a claim against the Company in the Tel Aviv-Jaffa Regional Labor Court concerning the inclusion of a number of components as part of the determining pay for pension. The Company and the group of employees participated in a mediation proceeding, which was terminated, and attempts to reach a settlement between the parties, which were conducted concurrently with the ongoing trial, were unsuccessful. Summations have been filed by the plaintiffs, and the Company must now file its summations. The financial statements include a provision which Management believes, based on its legal advisers, is appropriate.

d. A number of other, individual claims are pending against the Company, filed by employees and former employees and concerning recognition of various salary components as pensionable components and recognition of various components as part of the determining salary for severance pay.

The wide-ranging effect of these claims is most considerable, and the maximum exposure in respect of these claims could, under certain assumptions, reach an amount of approximately NIS 2.6 billion. Nevertheless, in view of two decisions in the matter of the administrative on-call duty component and in the matter of the grossing up of tax described in this Note below, the Company has revised the assessment, relying on its external legal advisers, and calculated that exposure of approximately NIS 2.2 billion (out of the maximum exposure) is unlikely to be utilized. Out of the balance of the exposure in the amount of NIS 392 million, in respect of component claims which the Company, relying on its external legal advisers, believes the risk cannot be assessed or in which the Company has good prospects for success, the Company did not include a provision in its financial statements, other than a provision of NIS 50 million in respect of administrative on-call duty benefits (according to the calculation formula determined in the decision on this matter) and in respect of a possible settlement in the claim described in Note 19A(4)c above.

Concerning the risk assessment of the claims described in this section –

On July 14, 2003, the National Labor Court gave its decision on an appeal in another claim which was filed by seven former employees of the Company, which recognized the component of administrative on-call duty benefits as a pension component, considering the factual circumstances in that case.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(4) (contd.)

On October 13, 2004, the National Labor Court gave its decision in the appeal of dismissal of a claim filed by a former employee of the Company, the main part of which was a claim for the inclusion of the administrative on-call duty benefits and a jubilee grant as part of the determining salary for making various payments, including for pension purposes. The Court determined in its ruling that the source of the right to administrative on-call duty benefits is contractual and that the parties to the agreement may determine the terms of granting the right, its scope and its limits, and therefore, full validity should be given to the limits set forth in the Company's procedure, whereby the payment for the administrative on-call duty benefit is not considered as salary in any way insofar as rights deriving from agreements are concerned. Nevertheless, the decision determined that the administrative on-call duty benefits should be included in the determining salary for the calculation of rights under law (Hours of Work and Rest Law and the Annual Vacation Law). In the opinion of the Company's external legal advisers, this decision appears to close the door on the claim that the component of administrative on-call duty benefits should be seen as salary in every respect. In view of the above and in accordance with the resolution of the Board of Directors of the Company of October 28, 2004, the Company has reduced the provision it made in its financial statements in respect of the component of administrative on-call duty benefits by approximately NIS 145 million.

On January 17, 2005, in a petition to which the Company is not a party, the Supreme Court ruled against a decision of the National Labor Court that the grossing up of tax component (in respect of the value of use of a vehicle and in respect of reimbursement of telephone expenses) should be recognized as part of the determining salary for pension purposes. The Supreme Court set aside the decision of the National Labor Court and determined that the grossing up of the tax component paid as aforesaid is not part of the determining salary for pension purposes, since that component is secondary to the salary increment in respect of which the tax is grossed up, and it should be treated in the same way as a salary increment. Since this petition refers to increments which are not part of the determining salary for pension purposes, the grossing up of tax component on the increments is also not part of the determining salary for pension purposes. Following this decision of the Supreme Court and in view of the opinion of the Company's external legal advisers that following the Supreme Court ruling there is a good chance that claims filed against the Company relating to the grossing up of tax component can be dismissed, and after examining the salary components which are grossed for tax in the Company, it appears that the risk to which the Company is exposed in relation to recognition of the grossing up of tax component as a pensionable component in pending claims against it has been reduced considerably, and accordingly, no provision has been made in the financial statements. In view of the above, the provision of approximately NIS 62 million for the grossing up of tax component which was recorded in the books, has been cancelled.

(5) On September 7, 2000, an action and an application for approval as a class action were filed against the Company in the Tel Aviv – Jaffa District Court, based on Article 29 of the Civil Proceedings Regulations, 5744-1984 ("Article 29"). The amount of the claim is estimated at approximately NIS 110 million. According to the plaintiff, the Company unlawfully collected "collection fees" from its subscribers for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiffs' debt. According to the plaintiff, Article 2 of the Telecommunications Regulations (Arrearage interest and collection fees), 5747-1987 ("the Collection Regulations") authorizes the Company to collect collection expenses for a bill in arrears only if the collection action against the consumer has been initiated, and therefore the Company exceeded its authority. In addition, the plaintiff alleges that charging collection fees before taking any action is an administrative offense, fraud, under Section 56 of the Torts Ordinance (New Version), false representation, negligence, harm to the proprietary right, violation of legislated duty, unjust enrichment, and fulfillment of a contract in bad faith. There are two main reliefs requested by the plaintiff – declaratory, in which the Court is requested to declare that the collection of "collection expenses" by the Company in the circumstances described in the claim was unlawful and that the Company may not continue to collect such expenses in the future, and an "operative – financial" relief, for reimbursement of said amounts.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(5) (contd.)

On January 7, 2001, the Company filed its response to the application for approval of the claim as a class action, to which it attached an economic opinion of an auditor. In its response the Company argued that Article 29 does not constitute legal grounds for filing class actions and therefore the application for approval should be dismissed *in limine*. Alternatively, the Company argued that the claim does not meet the criteria of Article 29 for filing a class action. The Company also alleged in its response that it charges the collection expenses only from subscribers who have caused it to incur expenses due to arrears in payment, that the plaintiff's interpretation of the provisions of the Collection Regulations are groundless, and that it acted lawfully. On February 8, 2001, the plaintiff filed his reply to the Company's response.

On October 18, 2001, an additional class action was filed in the Tel Aviv-Jaffa District Court on exactly the same matter – unlawful charging of collection fees on Company bills not paid on time, before the Company had started any collection action. The plaintiff alleges that this action constitutes exploitation of the consumer's difficulties, in contravention of the Consumer Protection Law, 5741-1981 ("the Consumer Protection Law"), as well as unjust enrichment. The amount of the class action is estimated by the plaintiff at about NIS 21 million. On December 16, 2001, the court approved a stay, requested by the Company, until after a decision is given on the application for approval as a class action in the first claim described in this sub-section, in view of the similarity of the causes of action in the two cases.

On February 20, 2003, the District Court approved the first action as a class action in the name of whoever was charged collection fees by the Company despite having paid the relevant bill before the Company commenced collection actions as explained in the statement of claim, from March 7, 1997 to the date of filing the claim. In its decision, the court determined that the Company's authority to collect collection expenses depends on the initiation of means of collection involving costs, and that the Company had not presented proof that retrieving the data of payment arrears, before any action is taken against them, involves costs. In addition, the court determined that Article 29, on which the application for approval relies, is suitable grounds for a class action. On March 17, 2003. the District Court suspended the proceedings in the claim pending a decision on the application for leave to appeal which would be filed by the Company. On March 20, 2003, the Company filed an application in the Supreme Court for leave to appeal the decision to allow the action as a class action. In its application, the Company claimed, *inter alia*, that that the District Court's interpretation of the Collection Regulations is erroneous and disregards their language and purpose, and that even were its interpretation correct, the plaintiff would still have no cause against the Company since the Company collects the collection expenses by virtue of the Collection Regulations only from subscribers whose arrears require additional handling, which the Company would not have required had the payment been made on time.

The Company further alleged that the District Court erred when it determined that no proof was presented of the Company bearing expenses in relation to a bill that is not promptly paid before the elapse of 14 days' arrears, since an affidavit of the Company was presented which described the expenses it incurs due to the fact of arrears, as well as an economic opinion on the same matter, which the court had disregarded in its decision.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(5) (contd.)

On April 2, 2003, a precedent-setting ruling was given by the Supreme Court (in another case, to which the Company is not a party), stating that a class action cannot be filed by virtue of Article 29 where no specific arrangement is made in principal legislation for filing such action ("the A.S.T. Ruling"). It should be noted that an application for an additional hearing of this Supreme Court ruling was filed (and allowed). Based on the above, the court ruled that the response to the Company's application for leave to appeal in the matter of the first action described in this sub-section, would be postponed pending a decision in the additional hearing in the other case. On September 1, 2005, a decision was given in the additional hearing on the A.S.T. Ruling ("the Additional Hearing"), whereby class actions cannot be filed under Article 29. On September 14, 2005, the Supreme Court requested the position of the parties on resumption of the proceedings in the application for leave to appeal, in light of the decision in the Additional Hearing. The Company submitted its position to the court that, in light of the decision in the Additional hearing, the application for leave to appeal should be allowed. The plaintiff stated that that the hearing of the application should continue be suspended pending completion of the process of legislation of the Class Action Law. The hearing in the case was scheduled for 27 September, 2006. In view of the Court's determination in the matter of Article 29 and the absence of reference to evidence in the case, as well as the A.S.T. Ruling, the Company, relying on its legal advisers, believes that there is a reasonable chance that the application for leave to appeal (and the appeal itself) will be allowed. Nevertheless, the Company, relaying on its legal advisers, is unable, at this stage, to assess whether and how the proposed class action law currently going through legislative phases, will affect the proceedings in the case.

(6) On September 28, 2000, three plaintiffs filed a claim in the Tel Aviv-Jaffa District Court, together with an application for approval as a class action, against the Company, Bezeq International and the other international call operators. The plaintiffs estimated the total value of the claim in millions of shekels per year.

According to the plaintiffs, commencing October 20, 1998, the Company unlawfully collected 17% VAT for some collect calls from abroad received by its subscribers in Israel (where according to the plaintiffs, the Company serves, in this matter, as a "collection conduit" for the international call operator to which the payment is eventually due), in contravention of the VAT law and its regulations and in violation of a legislated duty, in a way which breaches existing contractual commitments and with bad faith conduct in fulfilling those contracts and with negligent conduct. The plaintiffs also make allegations against the international call operators concerning collection of VAT for calls made abroad by means of a telephone card. According to the plaintiffs, the total damages sustained by the class in respect of the unlawful collection of VAT for all the calls made from abroad to Israel in the relevant period (from October 20, 1998), amount to millions of shekels per year.

The plaintiffs applied mainly for two reliefs: declaratory, stating that each of the defendants violated its duties under the agreement between it and a member of the group which contracted with it, and monetary, for restitution of the aforesaid amounts (compensation for the loss sustained by the members of the group whom the plaintiffs wish to represent, in the aforementioned amounts). The defendants filed responses and Bezeq International filed an application to dismiss *in limine* the application for approval as a class action. On June 18, 2001, the Attorney General gave notice that he would join the proceeding. On January 6, 2002, the Court decided that the Director of VAT should be added as another defendant in the action and in the application for its approval as a class action, and it dismissed the application of Bezeq International for dismissal *in limine*. In a hearing on February 28, 2002, the plaintiff's lawyer explained that the plaintiffs were not suing the international call companies for independent relief but for the same reimbursement of VAT that the Director of VAT will repay to them if the Court allows the claim. The plaintiff's lawyer also proposed that the international call companies be seen as formal defendants. In view of the A.S.T Ruling, the Court decided, on August 25, 2003, to strike the application for approval as a class action and as a result, also the action itself.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(6) (contd.)

On October 13, 2003, the plaintiff filed an appeal against this decision in the Supreme Court. On April 18, 2004, the Supreme Court decided to stay the proceedings in the case pending a decision of the Supreme Court in the Additional Hearing in the matter of A.S.T. On September 1, 2005 (see also Note 19A(5) above), the appellants filed their position that they should be allowed a stay of proceedings until the enactment of a new class action law or alternatively, they should be allowed to amend their claim. The Company gave notice that it opposes a stay of the proceeding in view of the A.S.T. Ruling, and that in any case since the Company is a formal defendant in the case, it should be stricken from the proceeding. For this reason, the Company made no provisions in this matter in the financial statements. Bezeq International, in the response it filed in the Court, stated that based on the decision of the District Court in the case and on the decision in the A.S.T. case, there was no alternative but to dismiss the appeal. The legal advisers of Bezeq International estimate, based on the above, that Bezeq International will not be affected by the outcome of the hearing, and accordingly, Bezeq International also made no provision in its financial statements in respect of this matter.

(7) In September 2001, an application was filed in the Tel Aviv-Jaffa District Court for approval of a class action against the Company. The plaintiffs allege that in view of certain amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Company subscriber who called a Pelephone subscriber in off-peak hours during the period between October 2000 and December 31, 2000, was lower than the amount actually collected. The applicants estimate the amount of the claim, as at the date of filing the application for approval of a class action, at about NIS 44 million. The Company filed a response to the application for approval, in which it alleged mainly that it simply acts as a non-discretionary collection contractor and that the conditions required for approval of the claim as a class action have not been met. On May 12, 2002, the Company's request to conjoin Pelephone as a party to the proceeding was allowed. On August 29, 2002, Pelephone filed a response to the application for approval as a class action, to which it attached confirmation from the Ministry of Communications that the plaintiffs' interpretation does not reflect the intention of the promulgator of the Regulations. The parties filed their summations in the application for approval of the class action. On January 14, 2005, the Court gave its decision denying the application for approval. No appeal against this decision was filed, and the proceeding has ended.

(8) a. In March 2003 a claim was filed in the Tel Aviv-Jaffa District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the 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 located near the homes of the plaintiffs. It is also alleged that as a result, the plaintiffs were subjected to prohibited radiation from the broadcasting station causing bodily harm, which in the most part, had 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.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) a. (contd.)

The Company filed a statement of defense to which it attached expert opinions in occupational medicine and non-ionizing radiation safety, which state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the alleged cancer of the plaintiffs. The plaintiffs filed a response in which they argue against the Company's experts and their opinions. In the opinion of the Company, relying on its external legal advisers, whose opinion is based on the expert opinions mentioned above, the chances of the claim being dismissed are greater than the chances that the claim against the Company will be allowed. Accordingly, no provision has been included in the financial statements in respect of this claim.

It should be noted that following an application for dismissal *in limine* filed by the Company, a partial decision was given in favor of the Company, denying the claim of five plaintiffs who died before the Company commenced operation of the station.

The Company is reserving its arguments against the other defendants, the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the station was operated by the Company for and on behalf of the other defendants, in accordance with the directives and operational requirements of the other defendants or any of them, and that the Company acted in accordance with the provisions of any law and with the directives of the various authorities, including those which were responsible for the broadcasting activity from the station.

b. On June 13, 2004, another claim was filed in the Tel Aviv-Jaffa District Court by 25 plaintiffs from Moshav Porath and Moshav Ein Vered, including 11 heirs of the estates of deceased persons, against the Company, the Broadcasting Authority and the State of Israel, for compensation in respect of bodily harm (18 of the plaintiffs are suing the Company, the Broadcasting Authority and the State, and 7 plaintiffs are suing only the Broadcasting Authority and the State).

The additional 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 located near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to prohibited radiation from the broadcasting station causing bodily harm, which had ended in the death of some of the plaintiffs.

The amount of the compensation demanded in the additional claim is not estimated (although the claim is in the jurisdiction of the District Court, i.e. more than NIS 2.5 million), and the compensation is based on financial and non-financial damages items which are listed in respect of each plaintiff, together with punitive compensation. The claim also states that the plaintiffs will petition to split the reliefs so that they will reserve the right to sue later for other financial damages which are not bodily harm allegedly caused, and that this refers to damage to crops, loss of value of land, deterrence of potential investors and the like. According to the plaintiffs, these damages are "in excess of millions of shekels", but have not yet been calculated. The Company filed a statement of defense on October 31, 2004.

At this stage, the external legal advisers of the Company are still unable to assess the chances of the Company's defense against the claim. Nevertheless, since the claim is similar in essence to the first claim mentioned above, they expect (subject to the aforesaid) that the chances that this claim will be dismissed are greater than the chances of it being allowed, and accordingly, no provisions has been included in the financial statements in respect of these claims.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) (contd.)

c. On May 9, 2005, the Company received a claim for damages amounting to NIS 46 million which was filed by 14 plaintiffs who were and/or are residents of the moshavim Porath, Ein Vered, Ein Sarid and of the settlement of Kadima, against the Company, the Broadcasting Authority and the State of Israel. According to the plaintiffs, the negligence and/or failures of the defendants in operating the Hillel broadcasting station, which is situated near the above locations, and which for many decades has allowed uncontrolled and hazardous exposure to radiation from the Hillel broadcasting station and from installations connected with it, have caused them (or their heirs) bodily harm and property damage of various kinds. As described in the above Note, the opinions of experts in occupational medicine and in non-ionizing radiation safety, filed by the Company as part of its defense in the two claims, state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the cancer allegedly suffered by the plaintiffs in those claims. In relation to these claims, the Company, relying on its external legal advisers (whose opinion is supported by the aforementioned expert opinions), believes that the chances of the claims being dismissed are greater than the chances of their being allowed. Accordingly, no provision has been made in the financial statements in respect of this claim.

   The plaintiffs in the three claims described above have filed an application for consolidation of their hearing.

d. On May 23, 2005, the Company received a claim for damages in respect of property damage and financial loss amounting to approximately NIS 141 million, which were allegedly sustained by 53 plaintiffs who were and/or are residents of Moshav Porath. The claim was filed in the Tel Aviv-Jaffa District Court against the Company, the Broadcasting Authority and the State of Israel. According to the plaintiffs, the negligence and/or failures of the defendants in operating the Hillel broadcasting station, which is situated near the moshav, were the direct cause of irreversible damage to agricultural fields owned by moshav residents, harm to the livelihood of the moshav and enormous financial losses, due, *inter alia*, to the effects of operation of the Hillel broadcasting station and the electromagnetic fields radiating from it towards the agricultural land of the plaintiffs, which the plaintiffs allege damaged their crops and prevented them from making proper use of their agricultural land. In addition, an application was filed to split the reliefs so as to enable future claims for damages. On September 1, 2005, the plaintiffs filed an application to amend the statement of claim, in which they wished to delete 23 plaintiffs and to reduce the amount of the claim of the remaining 30 plaintiffs, so that the amount of compensation sued for in the statement of claim would be approximately NIS 35 million.

   Furthermore, at this stage a partial court fee has been paid and 6 of the plaintiffs have filed an amended application for full or partial exemption from payment of the fee. The court has not yet given its decision on these applications. The statement of defense on behalf of the Company and the other defendants has not yet been filed. The Company, relying on its external legal advisers, cannot assess at this early stage the chances of the outcome of the claim against the Company, and accordingly has not included a provision in respect of this claim in the financial statements.

   Regarding all of the above claims, the Company has defense arguments against the other defendants – the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the Company operated the station for and on behalf of those other defendants in accordance with their directives and operational requirements, and that the Company acted in accordance with the directives of the various authorities, including those responsible for the broadcasting activities from the Hillel station.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) d. (contd.)

Furthermore, the Company also has allegations against insurers related to the cases, where investigation of the insurance cover for the events which are the subject of the claims against the insurance companies has not yet been completed.

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

(9) In January 2002 a claim for payment of monetary compensation of approximately NIS 57 million and for writs of mandamus were filed in the Tel Aviv-Jaffa District Court by an international communications operator against the Company and Bezeq International. The claim makes allegations concerning the process of customer allocation 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 allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the coordinated listing and removing them from the customer allocation process, and in respect of losses it sustained 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 imposed 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. On April 22, 2002, the Company filed a statement of defense, in which it denied the allegations of the plaintiff. In the statement of defense the Company claimed, *inter alia*, that postponement of the date for completing the allocation process derived, among other things, from objective failures and difficulties. The Company also alleged that in the subscriber survey its role was purely technical, and involved nothing more than collating the data and preparing a file of those who participated. The Company relied, for this purpose, on data conveyed to it by the three international operators, and was extremely careful in processing the data and even on its own initiative, beyond the call of duty, identified errors that had occurred in them (insofar as these were apparently reasonable to discover, by means of the systems at its disposal).

In addition, the Company filed a third party notice against the Ministry of Communications in the full amount of the claim. In the notice the Company alleges, *inter alia*, (as in the statement of defense) that in all its actions relating to the allocation process, the Company acted as the agent and long arm of the Ministry of Communications and under its instruction, that the Ministry of Communications devised, planned and supervised the allocation process, directed it and dictated the manner of its implementation and the timetables for each stage of its implementation, and to the extent that it was flawed in any way, the Ministry of Communications is exclusively responsible.

Bezeq International also filed a statement of defense and a third party notice.

On July 3, 2002, the plaintiff filed its reply. On October 14, 2002, the Ministry of Communications filed a statement of defense to the third party notice filed against it by the Company and Bezeq International. The case has been transferred for mediation. The Company, relying on its external legal advisers, is unable, at this stage, to estimate the outcome of the mediation proceeding. If it ends without a result and the claim is returned to the court, the Company believes, relying on its legal advisers, that its defense arguments against the claim have a reasonable chance of being allowed. Accordingly, no provision has been made in the financial statements in respect of this claim.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(9) (contd.)

The legal advisers of Bezeq International estimate, regarding the cause relating to postponement of application of the customer allocation process and relating to another cause which concerns the fact that in the pubic telephone system, Bezeq International appears first, Bezeq International has reasonable defense arguments, and regarding the cause concerning the unlawful inclusion of customers in the main file (its share out of the total claim being approximately NIS 29 million), Bezeq International estimates that the risk is reasonable but it is unlikely that it will be ordered to pay any part of that amount. However, at this early stage of the proceeding – before the start of the evidentiary hearings which will examine the evidence on which the plaintiff's damages are based, and before the plaintiff's damages have been examined by experts on behalf of Bezeq International, the legal advisers of Bezeq International are unable to estimate the rate of the risk. Accordingly, Bezeq International decided not to include a provision in respect of this claim in the financial statements.

(10) In January 2002 the Company received a letter of demand from a supplier, alleging that an order issued by the Company to the supplier for a total sum of approximately NIS 31 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. About a year ago the supplier sent the Company a letter to which it attached a draft statement of claim for approximately 2 million euro and the Company's reply rejected the supplier's allegations and repeated its own allegations. In the opinion of the Company, relying on the legal advisers who are handling the demand on its behalf, the chances of the Company's defense, should a claim to be filed against it in this matter, cannot be assessed, and therefore no provision has been included in the financial statements in respect of this claim.

(11) In February 2002 a claim and application for recognition as a class action were filed against the Company in the Tel Aviv-Jaffa 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 about NIS 15 million as at the date of filing the claim. Summations have been filed in the matter of the application for recognition as a class action and the case is awaiting a decision on that application. On February 23, 2004, the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) (Amendment of the 5759-1999, 5760-2000 and 5761-2001 Regulations), 5764-2004 were published, in which the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) were amended for the years 1999-2001. In the opinion of the legal advisers who are handling the claim for the Company, following the above amendment, there are no longer grounds for the claim and the application for recognition as a class action, and accordingly, no provision has been made in the financial statements in respect of this claim.

(12) On July 25, 2002, the Company received a claim for monetary and declaratory relief together with an application for recognition as a class action by virtue of both Article 29 of the Civil Proceedings Regulations and the Antitrust Law 1988 – 5748 (“the Antitrust Law”), which had been filed in the Tel Aviv - Jaffa District Court against the Company. The plaintiffs, who contend that they are Company subscribers or use its services, allege that the Company unlawfully collects interest on arrears, as defined in a directive concerning Accountant General's interest rates, in respect of arrears in payment for services provided by other communications providers, which are included in the bill which the Company issues to its subscribers. The plaintiffs allege that the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(12) (contd.)

They further allege that the Company does not transfer to the other communications providers the full amount of interest on arrears it collects, and that by collecting the additional arrearage interest, the Company enriched itself unlawfully at their expense and perpetrated an administrative offense against them. The plaintiffs are seeking declaratory relief including, for the Company's abuse of its monopolistic status, and that the Company be directed to reimburse the interest on arrears that it allegedly 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.

On February 11, 2003, the Company filed its response to the application. Its arguments are that since it is the one which bears the costs of collecting the bill from the subscribers, there can be no dispute that it is entitled to interest for arrears in payment of the bills both legally by virtue of the Adjudication of Interest and Linkage Law and by virtue of the licenses of the other communications providers, that according to a practical interpretation of the interest regulations it is entitled to collect the additional arrearage interest at the rate prescribed in those regulations. In addition, the Company argued that the basic assumption of the plaintiffs, that the arrearage interest under the interest regulations is necessarily higher than the arrearage interest under the licenses of the communications providers and/or under the Adjudication of Interest and Linkage Law, is unfounded and incorrect. In this context the Company showed that in calculating the damages, the plaintiffs have disregarded several benefits that the Company grants its subscribers, as a result of which some of the plaintiffs suffered no damages and some suffered damages that were much lower than alleged in the claim, and in any case the plaintiffs in the class action suffered no damage and therefore cannot serve as appropriate plaintiffs in a class action, that Article 29 cannot serve as legal grounds for filing a class action, and that the filing of the action is tainted with serious delay which is sufficient for its dismissal.

Following the A.S.T. Ruling, the plaintiffs filed an agreed claim in January 2004 and an amended application for approval from which the parts relating to Article 29 and causes of action the source of which was not the Antitrust Law, had been stricken. The Company filed its amended response on May 3, 2004. On June 6, 2005, the District Court gave its decision dismissing the plaintiffs' claim and their application for its approval as a class action, and ordering them to pay costs. On September 18, 2005, the plaintiffs filed an appeal against the decision in the Supreme Court. The appeal is scheduled for November 1, 2006. The Company, relying on its legal advisers, is unable to assess the chances of the appeal at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

(13) On December 22, 2002, a financial claim for grant of a declaratory order and injunction, together with an application for recognition as a class action, were filed in the Tel Aviv-Jaffa District Court against the Company. The plaintiffs, who contend that they are subscribers of cellular communications providers, allege that the Company is misleading the consumer public regarding calls to 1-800 or 1-700 numbers, into thinking that such numbers are toll-free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies for air-time for those calls. According to the plaintiffs, in so doing, the Company is perpetrating torts according to the Consumer Protection Law (deception of the consumers, including deception in advertising, exploitation of the distress of consumers and refraining from disclosure of essential information to consumers), and all the members of the group represented in the action (all the consumers who called 1-800 or 1-700 from a cellular telephone during the seven years prior to the date of filing the claim) 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 temporary 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.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(13) (contd.)

On March 27, 2003, the Company filed its response to the application for approval, in which it alleged, *inter alia*, that no transaction was made between it and the plaintiffs, that the advertisements did not make representations towards the plaintiffs and that all the representations of the Company were correct. In addition, the Company contended that the claim does not meet even one of the conditions required under the Consumer Protection Law for its approval as a class action.

The case is in preliminary proceedings. In the opinion of the Company, relying on its external legal advisers, the chances and implications of the claim cannot be estimated at this stage, and therefore no provision has been made in the financial statements in respect of this claim.

(14) 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 were filed against the Company in the Tel Aviv-Jaffa District Court. 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, allegedly, 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 each year to every private internet user, since the connection of a number of tenants in a condominium on one telephone line using such splitters would considerably reduce the fees paid to the Company by each consumer. The pretexts for the claim as they appear in the statement of claim, are cited by virtue of the Antitrust Law, the Torts Ordinance and the Unjust Enrichment Law and not by case law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law. The amount of the claim is 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 to 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. The stage of evidentiary hearings has ended and the case is scheduled for written summations. The main points of the Company's arguments are that there is no basis in law for obligating it to connect a number of users on one "broadband" and that the service and the tariff collected by the Company for it were approved by the Ministry of Communications.

On February 5, 2006 the Court decided to dismiss the claim, and determined that the plaintiff has no personal grounds for the claim, that he failed to show how he was misled and that he had not proved that the price collected by the Company is not a fair price. The plaintiff filed an application for the court to reconsider the decision, which was given without the summations of the plaintiff. The Company filed a response in the court, in which it argued that there is no legal or other basis for the plaintiff's application.

(15) The Makefet Fund ("the Fund") received a directive from the Capital Markets Division at the Ministry of Finance to fulfill the undertakings it had made in connection with the change in the retirement tracks of about 600 Company retirees, contingent upon the Company paying the Fund NIS 50 million. The Company notified the Fund that it is demanding the continued implementation of the agreement that enabled transfer from one retirement track to another at no additional cost to the Company, since the Fund had undertaken not to impose any additional cost on the Company. Subsequently, the Fund stopped allowing Company retirees to transfer from one track to another and also ceased complete or partial performance of the retirement agreement with regard to pensions paid in respect of April 2002. On January 11, 2004, a claim was filed in the Tel Aviv-Jaffa Regional Labor Court by 66 retirees who had retired under the retirement agreement of November 1997, alleging that they had elected to receive their pensions under Track B since the personal agreement signed with them under that track embodied a promise of amendment of the wage that determines their pensions in accordance with the "Yellow Note" agreement (i.e. additional payment of up to NIS 650 per employee).

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(15) (contd.)

According to the plaintiffs, that promise had not been kept, and therefore a collective agreement was signed on April 2, 2001, which was intended to enable employees to transfer from Track B to Track A. The plaintiffs contend that the April 2001 agreement was applied to only about 70 employees of the 600 or so who wished to exercise their right under it. The claim is consequently for enforcement of the April 2001 agreement. The claim, which was filed initially by 66 retirees, was broadened when, with the approval of the court, other retirees were added to bring the total to 264 retirees. After a preliminary hearing on December 5, 2004, the Company and the Fund filed applications for dismissal of the claim, and alternatively, for its quantification. On June 6, 2005, the court decided not to dismiss the claim *in limine* and not to strike the retirees' organization as plaintiff, but it directed that the sections in the claim concerning demands for payment be stricken (as long as a fee had not been quantified or paid for them), so that in fact, the claim remained declaratory only. An application similar to two earlier applications was filed in the court, for joining another group of employees to this claim. This application is to add another 34 employees. If it is allowed, the total number of employees named in the claim will be 299. Principal evidence affidavits were filed on behalf of the plaintiffs, as well as an application to add another 20 retirees. In the opinion of the Management of the Company, relying on its external legal advisers, the Company is not at risk of actual legal exposure in respect of the claim, and accordingly, no provision has been made in respect thereof in the financial statements.

(16) At the beginning of July 2004 an action for declaratory relief against Makefet ("the Fund"), the State of Israel and the Company, was filed in the Tel Aviv Regional Labor Court by the Organization of Bezeq Retirees and six of its members, alleging that the defendants breached agreements for binding arrangements that were made upon the transfer of the employees from the civil service to the Company. According to the plaintiffs, the uniform code under the Economic Recovery of Israel Law should not be applied to them as retirees, and alternatively, the defendants or any of them must compensate them for application of the uniform code. The Company filed an application for dismissal of the claim *in limine*, citing as its reasons, *inter alia*, that the claim is not quantified, and that in the amendment to the retirement agreement from March 18, 2004, the Company undertook that the rights of employees who retired from the Company commencing from the date of application of the uniform code, would not be harmed. The plaintiffs responded to the application, and the Company is awaiting the decision of the court. In the opinion of the external legal advisers of the Company, there are weighty preliminary arguments for dismissal of the action, and there is only a low risk that the action will actually impose a financial cost on the Company. Accordingly, no provision in respect of this claim is included in the financial statements.

(17) During 2004, various claims were filed in the Regional Labor Courts in Tel Aviv-Jaffa and Be'er Sheva, against the Company and/or Makefet ("the Fund"), by a number of employees who retired from the Company with a disability pension due to their medical condition. Against a background of the pension reforms, these employees were called for a repeat medical examination and were notified of a reduction to their pension, initially of 50%. In their claim, the employees are demanding payment of a full disability pension. A procedural agreement was drafted between the parties, in which the applications for temporary reliefs have been consolidated into the main case, and pending a decision in the main case, the Fund will pay advances to supplement the pension to its full rate and the Company will pay the Fund compensation for insurance of half of the salary. If the claim against the Fund is allowed, this compensation will be returned to the Company. On June 20, 2005, the Supervision of Insurance Business Law was amended so that for a retiree whose disability was determined before October 2003 and who has been disabled for at least five years, or who reached retirement age prior to the decision to reduce his disability, the reduction decision will be cancelled. Following this amendment, the claims of those retirees who meet these criteria became superfluous and were stricken.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(17) (contd.)

The proceeding in one claim to which the amendment of the law does not apply, will go forward. In the opinion of the Company, relying on its external legal advisers, this claim has a reasonable chance of being allowed against the Fund and dismissed against the Company, and therefore no provision has been included in the financial statements.

(18) On October 19, 2004, a claim together with an application for its recognition as a class action was filed in the Tel Aviv-Jaffa District Court. The statement of claim alleges that the Company adds VAT to the arrearage interest it collects from its subscribers in respect of arrears in payment, thereby generating over-collection, in contravention of the law, since the arrearage interest of the Accountant General at the Ministry of Finance, which the Company is entitled to collect, includes the VAT component. The claim is grounded, *inter alia*, in the Antitrust Law, 5748-1988 and the Consumer Protection Law, 5741-1981. The amount of the claim against the Company is estimated by the plaintiffs at approximately NIS 87 million (if it is ruled that the ground for the action is only the Consumer Protection Law, the amount of the claim is estimated by the plaintiffs at about NIS 56 million). A decision was given on May 3, 2005, stating that the Attorney General's position is required on the question of whether he intends to intervene in the proceeding, and to explain his position on whether Accountant General's interest includes a VAT component or not. On September 15, 2005, the Attorney General filed his position, which is according to existing law, Accountant General's arrearage interest does not include the addition of VAT. The court directed the plaintiffs to file their position on the position of the Attorney General and to say whether they intend to continue conducting the claim. On December 21, 2005, the District Court gave its decision to strike the class action. It should be noted that the decision to strike the claim came in the wake of an agreed notice filed by the parties, stating that in view of the detailed response of the Company to the application for recognition of the claim as a class action, and in view of the position of the Attorney General, the plaintiff wished to withdraw from the proceeding and it was stricken.

(19) On February 10, 2005, the Company received a claim and an application for its approval as a class action which were filed in the Haifa District Court. The statement of claim alleges that the Company's charges for internet access in the "WOW Extra" and "WOW" campaigns in the summer of 2004 and in its calculations, constituted deception, fraud, unjust enrichment and overcharging. The plaintiff also alleges that the acts and/or failures of the defendant constitute a criminal offense under the Consumer Protection Law, 5741-1981, and a tortious offense. In addition, the plaintiff requests discovery of facts. The grounds for the claim are by virtue of the Consumer Protection Law, and the preliminary estimated amount of the class action is NIS 96 million. From an investigation carried out by the Company, it transpires that the plaintiff was not overcharged and that for official-technical reasons the charge was split into a charge and a credit. Following the Company's response to the application, the plaintiff applied to strike his claim, and subsequently, on June 8, 2005, with the consent of the parties, the Haifa District Court decided to strike the claim.

(20) In the matter of the dispute between the Company and the Ministry of Communications regarding payment of royalties in respect of interconnect revenues from cellular subscribers and Company subscribers in the period between April 1999 and the end of 2000, on July 25, 2005, the Company received a letter from the Director General of the Ministry of Communications requiring that the Company pay the above disputed royalties debt, which amounts to approximately NIS 17 million. The Company replied to the Ministry of Communications that it is adhering to its legal position, namely, that in respect of the relevant period the Company was not required to pay royalties to the State for interconnection of calls from cellular subscribers to Company subscribers, and that the Ministry gave no reasons for its decision and did not relate to the contentions and data presented recently by the Company to professional personnel at the Ministry. The Company also requested an urgent meeting to discuss the matter with the Director General of the Ministry of Communications, and to postpone the demand for payment until after the aforementioned discussion.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(20) (Contd.)

On February 19, 2006, the reply of the Ministry of Communications was sent to the Company, stating that the Ministry sees no justification for further discussions on the question, and requesting that the Company transfer the payment of the royalties to the Ministry without further delay.

The legal advisers of the Company are unable, at this stage, to assess the outcome of the dispute. Nevertheless, the Company believes that its outcome will not have material consequences for the financial results of the Company's operations or for its financial condition.

(21) On August 15, 2005, the Company received a claim and application for its approval as a class action under the Antitrust Law, 5748-1988 and the Consumer Protection Law, 5741-1981, concerning the Company's method of billing for calls made using the Company's phone card – BezeqCard.
The plaintiff alleges that the pulse on which the Company bases the cost of calls made with a BezeqCard is based on a whole minute rather than seconds, as prescribed in law.
The amount of the class action is estimated by the plaintiff at approximately NIS 38 million (a claim in respect of the past seven years, based on the plaintiff's allegation of advertisements about the number of BezeqCard-holders, the number of minutes of the call made using a BezeqCard and the plaintiff's own calculations). On January 1, 2006, the Company filed an application to strike the action *in limine* , as well as a response and opposition to the application for recognition of the claim as a class action. On February 22, 2006, the Company received the decision of the court, stating that in the absence of a response to the Company's application to strike and dismiss the claim *in limine*, the application for recognition as a class action had been struck out *in limine*.

(22) On December 25, 2005, a claim was filed against the Company in the Tel Aviv-Jaffa District Court, together with an application for recognition as a class action, under the Consumer Protection Law, 5741-1981. The claim alleges, *inter alia*, that the Company collected, unlawfully and while misleading its subscribers, payments for surfing the internet with WOW's high-speed service ("the Service"), even though it allegedly did not provide the Service in certain areas at the requested surfing speed and even though it is allegedly technically unable to provide the Service in those areas at that speed. The plaintiffs estimate the amount of the class action at approximately NIS 100 million for all subscribers, where they allege that this loss has two sources: surplus payment collected by the Company from its subscribers for the Service, and an additional payment made by every subscriber to his internet service provider on the assumption that he is indeed surfing at high speed. Based on the above, the plaintiffs are requesting that the court order the restitution of the monies which they contend were collected unlawfully from subscribers, and an order to adjust the payment of the "subscriber fees" from now on for all subscribers. In addition, the plaintiffs are petitioning, *inter alia*, for orders obliging the Company to inform its subscribers of the non-feasibility of providing the Service, to refrain from advertising and marketing the Service in a way which seems to show that the Service will be provided to whoever pays for it, to look into the technical feasibility of the Service before making a commitment with the customer, to end collection of the subscriber fees from subscribers to whom the Service cannot be provided at the stated speed, and to refrain from making agreements with consumers in cases where the Company is technically unable to provide the declared surfing speed. The Company has been given an extension until March 1, 2006, to file its response.

At this early stage of the claim, the Company is still studying the case and drafting its response, and is unable, based on its legal advisers, to estimate the chances of the outcome of the claim. Accordingly, no provision is included in the financial statements in respect of this claim.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(23) In November 1997 a claim was filed in the Tel Aviv-Jaffa District Court, together with an application to recognize the claim as a class action, against the Company, Bezeq International, the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner had determined that Bezeq International had abused 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 registered as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. On June 19, 2001, the District Court decided to deny 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*. The parties filed their summations. In a hearing in the Supreme Court on July 15, 2003, the Supreme Court explained that the District Court had erred procedurally, since it should have decided only on the application to join another plaintiff to the class action and not on the question of denial of the application for approval of the claim as a class action. Accordingly, the appeal was allowed. The case was returned to the District Court and instead of a hearing, the plaintiff's summations were filed on May 16, 2004, and on January 2, 2005, Bezeq International filed its summations on the question of approval of the claim as a class action and on the question of establishment of the plaintiffs' personal cause of action. On November 22, 2005, the District Court dismissed the application for approval of the claim as a class action, adopting the ruling of the court in the earlier decision to dismiss the application, and added that the application should also be dismissed due to the fact that the applicant had no personal cause of action. On January 15, 2006 the applicant filed notice of appeal in the Supreme Court. The legal advisers of Bezeq International believe that Bezeq International has a reasonable chance of the applicant's appeal being in the Supreme Court will be dismissed, which will bring the proceeding to an end. Accordingly, Bezeq International decided not to include a provision in respect of this claim in the financial statements.

(24) On September 16, 2001, a revised statement of claim and an application for recognition as a class action were filed against Bezeq International and the State of Israel. The plaintiff alleges that the tariffs for international telecommunication services during the period from May 10, 1996 to July 8, 1997, were exorbitant and unreasonable, and abused the status of Bezeq International as a monopoly, against a backdrop of falling prices as the international calls market was opening up to competition. On February 18, 2002, Bezeq International filed its response in the court, in which it rejected the allegations of the plaintiff and alleged that the conditions for allowing the claim as a class action had not been established. The Court allowed the request of the applicant to study the financial statements of Bezeq International for the relevant period and the minutes of the meetings of its board of directors from the same period. On December 25, 2003, the court allowed the application by virtue of the Antitrust Law and not on the basis of a cause arising from the Unjust Enrichment Law, and approved the claim as a class action. On January 14, 2004, the daily press included an item about the decision to approve the claim as a class action under Chapter F of the Antitrust Law. On January 15, 2004, an application was filed in the District Court for a stay of implementation of the decision. On February 2, 2004, the plaintiff filed its reply to the application, requesting its dismissal *in limine.* On the same date, the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law. At the request of the State and Bezeq International, in February 2004 the District Court agreed to delay implementation of its decision on approval of the claim as a class action pending the decision of the Supreme Court on the application for leave to appeal filed by Bezeq International (see below).

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(24) (contd.)

Following applications for leave to appeal filed by the State and Bezeq International in the Supreme Court on this matter, the Supreme Court determined, on March 7, 2004, that their applications must be answered, and accordingly, on May 9, 2004 the plaintiff filed its reply to the applications of Bezeq International and the State for leave to appeal. The hearing of the class action and the two applications for leave to appeal were consolidated into one case, the parties filed their summations, and the Court scheduled a hearing to complete the arguments orally on April 4, 2006.

The Company believes, based on the assessment of Bezeq International and its legal advisers, that if the action is eventually approved also by the Supreme Court as a class action and if it is allowed, the amount of the action is liable to reach hundreds of millions of shekels. However, the legal advisers of Bezeq International estimate that Bezeq International has good arguments against the decision of the District Court, and that there is a good change that Bezeq International's application for leave to appeal will be allowed and that the decision of the District Court will be set aside. Accordingly, Bezeq International decided not to include a provision in respect of this claim in the financial statements.

(25) On March 3, 2003, a claim was filed against Bezeq International by a systems vendor for approximately NIS 18.5 million. According to the vendor, Bezeq International unlawfully canceled an agreement to supply and install a customer care and billing system, and it is suing for enforcement of the agreement with Bezeq International 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 it sustained as a result of breach of the contract. On May 26, 2003, Bezeq International filed a statement of defense and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was canceled because the vendor violated the undertakings it made in the contract. On September 14, 2003, the vendor filed a reply to the counter-claim, in which it denied the allegations of Bezeq International. At the request of the vendor on January 20, 2004, that a date for the pre-trial hearing be set, the Court recommended that the parties use the time until the pre-trial hearing for a mediation proceeding. The parties conducted settlement negotiations, and there is agreement in principle which needs to be formalized. It was agreed that the principles would be formalized in the mediation proceeding before an agreed mediator. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the outcome of the claim or the mediation proceeding, but clearly, the amount of the settlement at which the parties intend to arrive is not material, and accordingly, the management of Bezeq International decided not to include a provision in the financial statements.

(26) In December 2000 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone by the State of Israel, for royalties allegedly payable for the period from January 1994 to February 1996. The amount claimed is estimated at approximately NIS 260 million (including principal, linkage differentials and interest).

In the opinion of Pelephone's management, relying on the opinion of its external legal advisers who are handling the claim, Pelephone has a good defense against the claim, the amount of which is apparently highly exaggerated. Pelephone's financial statements include a provision which the management believes is appropriate, and will suffice if indeed Pelephone is required to pay any amount in the claim / mediation proceeding.

On March 11, 2001, Pelephone filed a statement of defense and a statement of counter-claim relating to the State's claim for payment of royalties for the period January 1, 1994 to February 7, 1996. In its counter-claim, Pelephone claims reimbursement of approximately NIS 66 million (principal, interest and linkage up to March 1, 2001) in respect of an advance it paid to the State as a goodwill gesture in order to arrive at a settlement arrangement in 1996, a payment which was made contingent upon the State not suing Pelephone for reason of royalties.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(26) (contd.)

Before a hearing was held, the parties reached an agreement to transfer the matter to a mediation proceeding, which commenced in 2002 and during which an outside examiner was appointed to check the revenue components on which royalties are payable for the period of the claim and which affect the amount of the original claim. The results of that examination were submitted in September 2004, and found that the maximum amount of royalties on the revenues of Pelephone from January 1, 1994 to February 7, 1996 is only approximately NIS 118 million (before interest and linkage), of which approximately NIS 23 million relate to the period January – October 1994. The sum of NIS 46 million (before interest and linkage differentials) was paid as aforesaid in 1996 out of a desire to reach a settlement. The mediation proceeding has ended. The parties have reached agreement in principle concerning the statement of claim, but no agreement has yet been reached regarding the final text.

On February 16, 2004, the Company provided an undertaking to Pelephone, as approved by the Board of Directors on February 12, 2004, that if the mediation proceeding fails, the Company will pay Pelephone any sum it is ordered to pay to the State, if charged in a peremptory decision in respect of royalties for revenues from the provision of cellular services during the period from January 1, 1994 to October 10, 1994. According to the Company, it paid the State for that period under the settlement agreement between it and the State dated November 29, 1995. The undertaking to indemnify is subject to the presentation of the Company's arguments in the proceeding and the consent of Pelephone for the Company to join the action as a third party should the Company request to do so. The Company estimates that the risk of it being ordered to pay is low, and accordingly, no provision has been made in its financial statements.

(27) In July 2001 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone. The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of a patent of the plaintiff's company. Among the reliefs claimed are that Pelephone be directed to cease and desist from infringing the patent, be ordered to submit a report on the number of cards, revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in compensation. The Registrar of Patents recently gave his decision on the matter of cancellation of the patent, determining that the patent is not worthy of registration. The date for filing an appeal against the Registrar of Patents decision has already elapsed.

(28) In September 2001 a claim was filed in the Ramallah District Court by the General Palestinian Public Communications Co. Ltd. ("Paltel"), against Pelephone and another company.

The plaintiff alleges that its license grants it, *inter alia*, the full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and cellular, for the supply of fixed and cellular communications services for an extended period, part of which being granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its requests 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, 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.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(28) (contd.)

As at the date of signing these financial statements, the process of transferring the claim through the Attorney General has ceased and the alternative process of delivery effected by registered mail has been returned through the Ministry of Justice, and therefore this claim is not counted among the claims currently pending against Pelephone. It should also be noted that Pelephone does not recognize the jurisdiction of the court in Ramallah.

Pelephone learned that the Ramallah Court may have given a decision on the aforementioned claim. According to the Emergency Order (Judea, Samaria and the Gaza Strip – Jurisdiction in offenses and legal aid) (Territories of the Palestinian Authority – Legal aid in civil matters), 5759-1999, enforcement of decisions given by a court of the Palestinian Authority may only be executed if approved by the Commissioner for Legal Aid at the Ministry of Justice. Pelephone considers that such a ruling – if made – was made without jurisdiction, contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations Law (Judea, Samaria and Gaza Strip – Jurisdiction in offenses and legal aid) 5727-1967. If an attempt is made to submit this ruling for the approval of the Commissioner or to enforce it in any way, Pelephone will act to prevent such approval and/or enforcement of the ruling and/or proceedings for execution or to cancel them for the reasons set out above, which formed the basis of the Commissioner's decision to prevent the claim being served on Pelephone in the first place, and additionally due to the fact that the very hearing of the claim in the Ramallah Court without the process having been served in accordance with the Order and the Agreement, constitutes a breach of the Agreement and harm to the sovereignty of the State of Israel, and that any ruling handed down in such a claim has no force. Accordingly, no provision in respect of this claim has been included in the financial statements.

(29) In November 2002 an application was filed for leave to appeal the decision of the Tel Aviv-Jaffa District Court from October 1, 2002, to dismiss the application of the applicants for approval of their claim against Pelephone as a class action. The statement of claim was based on the applicants' allegation that throughout the years when Pelephone was a monopoly in the cellular telephone market, it abused that 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 total the amount of the claim (NIS 12.3 billion). On February 2, 2003, Pelephone responded to the application for leave to appeal. In the opinion of Pelephone and its legal advisers, Pelephone has good defense arguments, although the chances of the appeal cannot be assessed at this stage, and accordingly, no provision has been made in the financial statements in respect of this claim.

(30) In December 2002 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone and against another cellular company, together with an application for its approval as a class action, in the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone.

The claim relates to amounts collected by Pelephone and another cellular company for incoming calls from May 5, 1996 to October 2, 2000. The applicants, through their lawyers, 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 other cellular operator 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 the incoming call service is 25 agorot per minute, and not as collected in the past by Pelephone and the other cellular company or as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(30) (contd.)

b. Pelephone and the other cellular company violated obligations legislated under the authority of the Telecommunications Law, their licenses and the duty of good faith which require a reasonable price for a telecommunications service for which no price is set.

In July 2003 Pelephone filed its response to the application. Pelephone and its legal advisers believe that Pelephone has a good defense, but are nevertheless 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.

(31) In April 2003 an application was filed in the Tel Aviv-Jaffa District Court for approval of a class action in a total amount of approximately NIS 90 million against all the cellular companies. 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, coordinated, exaggerated, unreasonable and unfair tariff. The period to which the claim relates is from March-June 2002 through the date of filing the claim. Pelephone believes, relying on its legal advisers, that it has good arguments for defense against the claim, however at this stage, its chances cannot be assessed. Accordingly, no provision has been made in the financial statements in respect of this claim.

(32) On May 13, 2004, a petition was filed in the High Court of Justice by the municipalities and local planning and building committees in Herzliya and Ramat Hasharon against the Government of Israel, the National Planning and Building Council, the Minister of Health, the Interior Ministry, the head of the Noise and Radiation Abatement Department at the Ministry of the Environment, the Attorney General, the Future Generations Commissioner and the cellular companies, among them Pelephone. The petition attacks the provisions of the National Outline Plan for Small Communications Installations, Part A (NOP 36), its legality and the manner of its implementation in the field. The petition was heard on July 5, 2004, at which time the High Court of Justice ruled to postpone the hearing to a later date and to rule on continuing the proceedings in the light of a supplementary notice to be submitted by the State Attorney's office within three to four months. During 2005, the petitioner filed an application to withdraw the petition and the petition was struck out.

(33) In August 2005 a claim was filed against the Government of Israel, the National Council, the Ministry of the Interior, the head of the Noise and Radiation Abatement Division (at the Ministry of the Environment), the cellular companies, including Pelephone, and a company named Elidav – Building & Investments Co. Ltd. (the owner of a house in Ramat Hasharon on the roof of which cellular antennae were installed). The claim concerns the liability for claims under Section 197 of the Planning and Construction Law for the issue of building permits for cellular antennae. The central allegation in the claim, as far as the cellular companies are concerned, is that in the proceedings for approval of National Outline Plan 36A, the cellular companies undertook to indemnify the local committees in respect of compensation those committees would be ordered to pay in claims under the aforementioned Section 197, and that the National Outline Plan was approved on the basis of that undertaking. According to the plaintiffs, the undertaking is tantamount to "a contract in favor of a third party" in their favor and in favor of the other local committees.
The plaintiffs also allege that the Government and the National Council were negligent in that they did not anchor that undertaking in the National Outline Plan, and once it transpired – after approval of the Plan – that the cellular companies were unwilling to indemnify the local committees, the Government and the National Council should have cancelled or suspended the Plan and should also have cancelled the franchises of the cellular companies.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(33) (contd.)

The plaintiffs are petitioning for a large number of reliefs (about 20), all declaratory. The principal reliefs are to declare that the cellular companies and the other defendants must pay the compensation ruled against the local committees in claims under the aforementioned Section 197. In the opinion of Pelephone, relying on its legal advisers, the chances of the claim are poor, and accordingly, a provision is not included in respect of this claim in the financial statements.

(34) In October 2005 Pelephone received notice of the filing of an application to add Pelephone to the proceeding of an appeal filed by the owners of rights in land adjoining a cellular communications site operated by Pelephone and others in Ramat Gan. The appeal was filed against a decision of the local committee in Ramat Gan to reject a claim submitted to it in respect of impairment of value by virtue of Section 197 of the Planning and Construction Law, by the owners of those rights. The amount of the claim is approximately NIS 100 million. The notice also stated that the local committee was making the application since it believes that Pelephone is liable for any damage caused as a result of the communications installation, and is one of those who must indemnify it for any damages it incurs as a result of the claim/appeal being allowed. A decision on joining Pelephone has not yet been made
The proceeding is being studied by Pelephone, which intends to oppose it in its entirety. Pelephone believes, relying on its legal advisers, that at this stage of the proceeding there is no exposure for Pelephone. No decision has been given on the application as yet.

(35) On February 12, 2006, a claim together with an application for its recognition as a class action was filed against Pelephone, concerning payments collected by Pelephone for transferring calls from Bezeq's 144 service to the requested destination (call transfer). The plaintiff alleges that Pelephone unlawfully collected 53 agorot for each call transfer. The total amount of the claim (which relates to the three years prior to the date of its filing) is estimated by the plaintiff at NIS 33.5 million.

Pelephone is studying the claim and is unable and/or the Company is unable, at this stage, to assess its chances. It is noted even before examining the claim itself, that from its examination of the sums of money relevant to the action, Pelephone believes that even if the claim is allowed in its full amount, its financial exposure is not material.

(36) On December 3, 2002, an application was filed in the Tel Aviv-Jaffa District Court for recognition of a claim as a class action against DBS, 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 in the approval issued by the Council for its broadcasting while stripping Channel 5 of its content, in contravention of the aforementioned approval. The applicants, who wish to sue DBS for deception, violation of fiduciary duty and good faith under a contracted agreement, fundamental breach of the contract between DBS and its customers and unjust enrichment, estimated the amount of the claim at approximately NIS 126 million up to the date of its filing and an additional amount of approximately NIS 10.5 million for each month from the date of filing the claim until the date on which the decision is handed down. On July 25, the court allowed the application of DBS to stay the proceedings, pending the decision in the application for approval which was filed on the same matter against the cable companies.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(36) (contd.)

On December 13, 2005, the Consumer Protection Law was amended in a way that enables class actions to be filed in connection with circumstances which came into being after the date of making a commitment in a transaction, and it was determined that the amend would apply also to claims filed before the application of the law, provided that a final decision had not yet been given. On January 9, 2006, a decision was given on an appeal in the matter of the cable companies setting aside the decision of the District Court to deny the application against them. On January 29, 2006, an application was filed to amend the application for approval, in view of the amendment to the provisions of the Consumer Protection Law , as well as an application for direction for the matter of further stay of the proceedings pending a new decision on the application filed against the cable companies.

The legal advisers of DBS believe that it is difficult, at this stage, to estimate the chances of the claim, and accordingly, no provision has been included in respect of this claim in the financial statements.

(37) On February 21, 2005, an application was filed in the Tel Aviv-Jaffa District Court against DBS, concerning payment the plaintiff makes to cover the electricity consumption of installations used to receive DBS's broadcasts. Together with the claim, an application was filed in the court for its approval as a class action, since it concerns thousands of condominiums in which DBS's equipment is installed and which pay for the consumption of electricity of those installations.

According to the plaintiff, about 200,000 households pay a monthly charge of NIS 1.4, from which he concludes that since the start of its operation (which the plaintiff contends is 6 years), DBS should be ordered to pay approximately NIS 20 million. On April 28, 2005, the parties filed an agreed application to strike the action and an application to approve it as a class action without an order to pay costs. On May 1, 2005, the claim and the application for approval were stricken without an order to pay costs.

(38) In 2001 the Ministry of Communications issued administrative directives which regulate how a subscriber switches from the services of the cable companies to DBS and vice versa, and the use of infrastructures in the subscriber's home. The directives also prescribe a duty to pay monthly usage fees for infrastructure owned by the other multi-channel television service provider. Since the administrative directives were issued, DBS and the cable companies have submitted mutual complaints of violation of the directives by the other party, and voluminous correspondence has been exchanged between DBS and the Ministry of Communications on the matter. On August 15, 2005, the Ministry of Communications notified DBS and the cable companies that in view of their numerous violations of the administrative directives, it had re-examined the matter and was now considering their cancellation, *inter alia*, in view of the mechanism for purchasing the wiring prescribed in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120.

On November 2, 2005, DBS submitted its position to the Ministry of Communications, stating that the administrative directives should remain in place, while canceling the early notice prescribed in them, which requires that notice be given to a party whose subscribers disconnect from its services. DBS also contended that the provisions of the law granting ownership of infrastructure to the multi-channel television provider that installs it in the homes of its subscribers. At the very least, contended DBS, if that directive remains in place, its proper interpretation should not grant the cable companies ownership of the wiring it installed in private houses. DBS also stated that the amount prescribed in the law as the consideration to be paid for purchasing the wiring (NIS 120) is baseless and that if the directive is retained, the amount should be considerably reduced.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(39) On December 29, 2005, an application was filed in the Tel Aviv-Jaffa District Court for approval of a claim against DBS as a class action. The reliefs applied for are as follows:

a. Monetary compensation for every customer who entered into an agreement with DBS by telephone and not in writing (leaving the amount to the discretion of the court. In the plaintiff's personal claim, he requests NIS 20,000 in compensation).

b. Monetary compensation in the amount allowed against him, for whoever actually paid more than the amount agreed upon with him by telephone by representatives of DBS's service.

c. A declaratory order to DBS determining that from now on, whoever enters into an agreement with it by telephone will receive the arrangement in writing within 21 days.

In the opinion of the legal advisers of DBS, it is difficult, at this stage, to assess the chances of the claim, and accordingly, no provision has been included for this claim in the financial statements.

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

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

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

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

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

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

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(40) a. (contd.)

On June 30, 2005, DBS, filed a statement of defense in the court, in which it denies the allegations made by HOT in the statement of claim. No date has been scheduled as yet for hearing the claim. On July 12, 2005, HOT filed an application to split reliefs, so as to enable it to file a financial claim against DBS in a separate claim. On September 18, 2005, DBS filed its response in an application to dismiss HOT's application. No decision has been given on the application. DBS believes, relying on its legal advisers and noting the fact no financial claim has yet been filed, the fact that no decision has yet been given on the application to split reliefs and the novelty and complexity of the legal questions arising in the claim, that at this stage the chances of the outcome of the claim cannot be estimated.

b. On May 31, 2005, three employees of Bezeq International were called in for questioning as part of the police investigation of the industrial espionage by computer (a Trojan horse program). After being questioned, the employees were released under restriction. Up to the date of publication of these financial statements, no action has been taken against Bezeq International and/or its employees which relates to the aforementioned investigation.

c. In November 2005 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone and against Modi'in Ezrachi, for an order to report, together with an application to split reliefs. The grounds for the claim revolved around allegations that Pelephone had ostensibly solicited business information about the plaintiff's business and this was supplied by Modi'in Ezrachi by violating a number of provisions of the law and as part of a Trojan horse affair. A statement of defense had not yet been filed. In the opinion of Pelephone, relying on its legal advisers, the action in its present format and the reliefs included in it have little chance of success, and therefore no provision has been made in respect of this claim in the financial statements.

It should be noted that a number of senior employees of the Company were called in for questioning by the police immediately after publication of the affair, regarding confidential documents of the Company which were found on the premises of competing entities and to assess the extent of the harm which the Company could expect as a result. The Company examined the matter and took immediate action to minimize as far as possible the risk of the removal of information from the Company.

(41) In 1995 the Company, together with others and by means of a joint company, competed for tenders issued by the Government of India for the establishment of a basic communications system in India. Letters of intent and draft franchise agreements for development of the basic telephone system in four regions, which were won by the joint company in which the Company has a stake, were sent to the joint company, which did not sign them since, *inter alia*, it found that the drafts did not correspond to the terms of the tender. When submitting its bid in the tender, the joint company provided the Ministry of Communications in India with bank guarantees, in which the Company's share is 273 million rupees (approximately NIS 26 million). The Indian Ministry of Communications demanded foreclosure of the guarantees at the end of June 1996. On September 19, 1997, the court in India 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 the decision preventing the foreclosure. During 2003 the proceeding was struck out for "inaction" and an application was filed to revive it. The appeal is scheduled for May 21, 2006. The Company requested that the Indian Ministry of Communications release the guarantees it was holding (the subject of the appeal) and return them to the Company. A reply to the request has not yet been received. The Indian lawyer who is handling the case on behalf of the Company believes that since the proceeding is still in its preliminary stages, its outcome cannot reasonably be foreseen with any accuracy. Accordingly, the financial statements do not include a provision for this case. It should be noted that the Company currently has no operations in India.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(42) For possible demand for early repayment of bank loans, see Notes 13D and 14C.

(43) Miscellaneous claims - Various claims are pending against the Company and the Group Companies arising from the normal course of business. It is the opinion of the companies' Managements that the latent risk in each of these claims will not cause material financial losses beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without the addition of interest) in terms of shekels of December 31, 2005.

B. COMMITMENTS

(1) Lease and Rental Contract Commitments

Forecast contractual rent for the coming five years computed according to the rent in effect on December 31, as follows:

	Consolidated	Company
For the year ended December 31	**NIS thousands**	**NIS thousands**
2006	**218,648**	**62,967**
2007	**184,535**	**61,943**
2008	**137,621**	**56,529**
2009	**75,363**	**21,453**
2010 and thereafter	**173,135**	**98,865**
	789,302	**301,757**

(2) As at December 31, 2005, DBS is committed to agreements to purchase broadcasting rights which amount to approximately NIS 139 million.

(3) DBS entered into an agreement to lease space segments of the Amos 1 satellite. The agreement commenced on April 14, 1999 and ends on the earlier of June 30, 2009 or the end of the life of the satellite. In addition, DBS entered into an agreement on May 16, 2001, to lease space segments on the Amos 2 satellite. The lease period will end on the earlier of twelve years after the date of the satellite's launch or at the end of the satellite's life. The satellite was launched in April 2004. The contractual annual lease fees during the next five years as stated in the aforementioned agreements, amount to NIS 621 million.

(4) Under the license and the rules set by the Cable and Satellite Broadcasts Council, in 2006 and 2007 DBS will be required to invest not less than 8% of its revenues from subscriber fees in locally produced content broadcasts.

(5) As at December 31, 2005, DBS is signatory to a number of agreement for acquiring purchased channels. In the year ended December 31, 2005, the expenses in respect of consumption of purchased channels amounted to approximately NIS 173 million.

(6) In winning a tender for frequencies, Pelephone committed to paying license fees in the amount of NIS 225 million to the Ministry of Communications in six installments through 2006 (see Note 8D2).

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

B. COMMITMENTS (CONTD.)

On March 16, 2004, Pelephone accepted the proposal of the Ministries of Communications and Finance concerning a reduction of NIS 33 million from the original payment stipulated in the frequency band tender, against –

a. payment of the remainder of the balance of the license fee in the amount of approximately NIS 99 million, during 2004; and
b. return of the aforementioned frequencies to the State, in order that that Pelephone will not have to pay frequency fees from 2003 onwards. In addition and concurrently, Pelephone was granted a right to a future allocation of these frequencies, at which time Pelephone would complete payment of the reduced amount, plus the frequency fees in respect of the relevant period, and all plus linkage differentials and interest as is customary

Between March and August 2004 Pelephone paid the balance of the license fees – approximately NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Ministry of Communications, advising that according to an amended calculation made by the Ministries of Finance and Communications, the amount that Pelephone will be required to pay at the time of allocation of the frequencies in the future, is NIS 51 million rather than NIS 33 million as agreed in March 2004. Pelephone has not submitted its position to the Ministries.

As at the date of publication of these financial statements Pelephone, based on an assessment of its technological and business requirements, has not changed its assessment regarding the need to utilize the future rights to frequencies.

(7) In May 2004 Pelephone signed an agreement for upgrading sites with EVDO technology. The contract value is approximately $44 million, and the upgrade will be carried out during 2004-2007. In March 2005 Pelephone signed an agreement with the same supplier for additional sites, in order to increase the coverage and capacity of Network 1X. The contract value is approximately $20 million.

(8) In January 2005 Pelephone won a tender issued by the Accountant General at the Ministry of Finance ("the AG"), to provide cellular services to the various government ministries for a period of three years, commencing April 2005. The tender includes an option for the AG to extend the agreement for a further three years. Under the agreement, Pelephone supplied cellular subscriber equipment to about 30,000 subscribers. The costs of acquiring the subscribers in the AG transaction, approximately NIS 30 million in respect of the supply of subscriber equipment, was charged to the statement of operations in 2005.

(9) In February 2004 Bezeq International entered into an agreement with Mediterranean Nautilus Limited ("Med Nautilus") for acquisition of an irrevocable right of use of undersea cable capacity. In addition, the agreement grants Bezeq International options for an additional purchase of an irrevocable right of use of undersea cable capacity from Med Nautilus. Some of the options were exercised during 2004, and the others will be exercised over a period of one year commencing June 2006.

(10) For commitments to purchase fixed assets, see Note 9E.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

C. SECURITIES, LIENS AND GUARANTEES

(1) The Company has provided guarantees to third parties in the amount of approximately NIS 2,652 thousand.

(2) In May 2003, the Company, upon the demand of the Ministry of Communications, provided a bank guarantee in the amount of $10 million in connection with its general license for performing telecommunications operations and providing telecommunications services. On June 22, 2005, the Company received a letter from the Director General of the Ministry of Communications, containing notice of the Ministry's decision to call in NIS 10 million out of the $10 million bank guarantee provided by the Company as aforesaid. According to the Director General's letter, the decision to foreclose was made in light of the fact that the Company made a commitment to the institutional investors who extended loans to DBS, in which the Company holds 49.8% of the share capital, which contravened the directives of the Minister of Communications.

It should be noted that since the decision of the Minister of Communications to impose limitations and conditions on the transfer of funds by the Company to DBS, both DBS and the Company have acted, irrespective of their legal position concerning the authority of the Minister of Communications to intervene in the matter of the financing of DBS by shareholders and other financing bodies, to comply with the conditions and limitations imposed by the Minister and by the Antitrust Commissioner, concurrently with legal proceedings which they instituted in the High Court of Justice and in the Antitrust Court (see Note 8 above). The Company's position is that there is neither legal nor any other basis for calling in part of the guarantee of which the Director General gave notice, and therefore no provision was included in the financial statements. An appeal against the decision was submitted to the Minister of Communications, and implementation of the foreclosure has been frozen pending a decision on the appeal. As noted in Note 8E above, the petitions of the Company and DBS against the Minister of Communications in the High Court of Justice were heard on October 11, 2005, but the Court has not yet handed down its ruling.

(3) The Company provided a guarantee amounting to up to NIS 70 million to banks in connection with credit granted to subsidiaries.

(4) Regarding guarantees provided by the Company with regard to its investments in India, see Note 19A(41).

(5) The Company provided a guarantee of approximately NIS 10 million for DBS, in respect of a bank guarantee of approximately NIS 33 million that DBS provided in favor of the State of Israel. The guarantee is valid until December 31, 2010.

(6) In February 2002, upon the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of NIS 10.6 million for fulfillment of all the terms of the license to provide international telecommunications services. In December 2004, again at the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of approximately NIS 320,000 for fulfillment of the terms of a special license granted to Bezeq International for a VOB service marketing trial. As at the balance sheet date, Bezeq International provided additional bank guarantees in a total amount of approximately NIS 2.3 million.

(7) BezeqCall Communications provided a guarantee of approximately NIS 4 million for third parties

(8) Pelephone provided a guarantee to third parties of approximately NIS 78 million, of which approximately NIS 46 million to the Ministry of Communications in connection with the tender for third generation frequencies for cellular telephones.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

C. SECURITIES, LIENS AND GUARANTEES

(9) To secure its obligations, DBS provided documentary credit and guarantees amounting to approximately NIS 54 million (including a bank guarantee of NIS 33 million in favor of the State of Israel).

(10) Regarding three loan agreements signed between DBS and various institutional bodies in March-April 2005, for a total amount of NIS 50 million with an option to extend additional loans for a total amount of NIS 50 million as described in Note 8E above, the Company undertook that if (all or part) of the loans are not repaid on time, or if certain other conditions exist (if an final injunction is given by a court of law or if a valid decision is made to liquidate DBS, if a receiver is appointed for DBS and/or on all or a material part of its assets, in any case where the guarantee provided to the Banks is called in or realized, if the Company sells all its holdings in DBS, and in respect of a loan to one institutional body – if control of the Company is transferred from the State to another and as long as six months have not elapsed from the date of actual transfer of control to the date of the lender's notice), the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differentials) and an amount computed according to a predetermined formula which takes into account the value of DBS at that time.

(11) Regarding another guarantee provided in connection with the Company's investments in DBS, see Note 8E.

(12) Regarding securities, liens and stipulations given by the Company and investee companies in connection with loan covenants, see Notes 13D and 14C.

(13) Regarding loans which the lenders may call for immediate repayment, see Note 1F.

NOTE 20 – SHAREHOLDERS' EQUITY

A. SHARE CAPITAL

	Registered		Issued and fully paid up	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	No. of shares	No. of shares	No. of shares	No. of shares
Ordinary shares of NIS 1 par value each	**2,625,000,000**	2,625,000,000	**2,605,045,611**	2,605,045,611

B. On June 1, 2004 the State of Israel offered, pursuant to a prospectus of the Company of May 24, 2004, 156,000,000 ordinary shares of NIS 1 par value each of the Company (approximately 5.99% of the Company's issued capital). In the public offering, 70,671,100 ordinary shares of NIS 1 par value each were sold (approximately 2.71% of the Company's issued capital) at a price of NIS 4.921 per share, and the State's holdings in the Company as at December 31, 2004 were approximately 46.38%. Following the closing of the sale of 30% of the State's shares in the Company to Ap.Sb.Ar. (see also Note 1F above), on October 11, 2005 the State's holdings in the Company decreased to 16.38%.

C. On January 27, 2003, the Special General Meeting of the Company approved the recommendation of the Board of Directors of January 2, 2003, for the distribution of a cash dividend to holders of Company shares recorded in the Register of Shareholders at the end of the business day on February 5, 2003. The ex-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 a dividend of 7.8784 agorot per share.

D. On the matter of a dividend of NIS 1,200 million announced after the balance sheet date, see Note 1H.

NOTE 21 – REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Traffic	**1,436,615**	1,567,631	1,990,649
Fixed fees	**2,559,559**	2,501,250	2,289,868
	3,996,174	4,068,881	4,280,517
Cellular telephone	**3,643,795**	2,699,876	1,989,970
International communications and internet services	**775,532**	771,290	683,037
Multi-channel television	**1,171,318**	529,838	-
Installation, sale of equipment to subscribers, and other	**1,246,947**	914,838	665,717
	10,833,766	8,984,723	7,619,241
Other revenues	**264,920**	285,081	362,027
	11,098,686	9,269,804	7,981,268

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Fixed–line communications			
Traffic	**1,460,076**	1,590,671	2,006,567
Fixed fees	**2,404,970**	2,354,700	2,184,650
Total revenues from fixed-line communications	**3,865,046**	3,945,371	4,191,217
Cellular telephone	**370,706**	414,740	428,149
International communications	**109,207**	126,856	134,212
Installation, sale of equipment to subscribers, and other	**167,904**	266,980	224,443
	4,512,863	4,753,947	4,978,021
Other revenues	**210,871**	205,744	252,540
	4,723,734	4,959,691	5,230,561

NOTE 22 – OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses –			
Operational	**1,794,458**	1,578,426	1,648,413
General and administrative	**684,290**	549,869	304,465
Total salaries and incidentals	**2,478,748**	2,128,295	1,952,878
General expenses	**1,209,169**	996,323	733,412
Materials and spare parts	**1,016,735**	643,013	597,676
Consumption of content from satellite services	**419,309**	200,469	-
Cellular telephone expenses	**991,066**	700,890	480,536
Building maintenance	**366,630**	352,430	352,405
Services and maintenance by sub-contractors	**422,416**	341,999	250,220
International communications expenses	**277,210**	228,936	159,478
Motor vehicle maintenance expenses	**181,385**	144,630	118,050
Collection fees	**49,196**	39,357	36,160
	7,411,864	5,776,342	4,680,815
Less – wages charged to investment in fixed assets (1)	**218,396**	211,252	195,515
	7,193,468	5,565,090	4,485,300

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses			
Operational	**1,140,482**	1,122,381	1,206,623
General and administrative	**288,804**	271,310	241,206
Total salaries and incidentals	**1,429,286**	1,393,691	1,447,829
General expenses	**298,767**	341,977	342,492
Materials and spare parts	**97,294**	114,443	93,601
Building maintenance	**320,700**	315,074	322,099
Services and maintenance by sub–contractors	**195,820**	205,192	207,843
International communications expenses	**30,033**	27,105	10,685
Motor vehicle maintenance expenses	**128,961**	111,359	101,597
Collection fees	**36,735**	36,904	35,916
	2,537,596	2,545,745	2,562,062
Less – wages charged to investment in fixed assets (1)	**191,145**	198,297	195,515
	2,346,451	2,347,448	2,366,547

(1) Commencing February 2003, following the establishment of a new reporting system in the Company which allows precise measurement of the direct costs of employees in the Engineering Division and the Information Technology Division, the Company capitalized an additional sum for self-constructed fixed assets. The additional amount for the period ended December 31, 2005 is approximately NIS 42 million (2004 – NIS 50 million).

NOTE 23 – FINANCING EXPENSES, NET

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Expenses in respect of long-term liabilities			
Debentures	**(245,184)**	(319,522)	(395,393)
Loans	**(405,735)**	(121,329)	(21,015)
	(650,919)	(440,851)	(416,408)
Income in respect of deposits and investments	**218,200**	195,243	249,677
Expenses in respect of derivatives	**(116,852)**	(12,250)	(806)
Short-term bank credit	**(6,012)**	(2,699)	(33,470)
Other income, net	**138,274**	43,028	43,485
	(417,309)	(217,529)	(157,522)

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Expenses in respect of long-term liabilities			
Debentures	**(166,604)**	(315,175)	(395,393)
Loans	**(76,163)**	(20,774)	43,618
	(242,767)	(335,949)	(351,775)
Income in respect of deposits and investments	**199,557**	194,761	248,629
Income (expenses) in respect of derivatives	**(129,469)**	3,834	21,024
Other income, net	**91,782**	44,138	19,750
	(80,897)	(93,216)	(62,372)

Financing income (expenses) for 2005 include exchange rate differences amounting to approximately NIS 85,562 thousand and 53,620 thousand in the Company and Consolidated, respectively.

NOTE 24 – OTHER INCOME (EXPENSES), NET

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Provision for claims for salary and pension components (1)	**–**	207,000	(195,000)
Provision for employee severance benefits upon early retirement (2)	**83,000**	(105,000)	(419,016)
Write-off and impairment of fixed assets (3)	**(830)**	–	(327,295)
Provision for impairment and other liabilities in respect of investments in other companies	**(5,868)**	(26,000)	(42,908)
Indemnity for settlement agreement	**14,483**	–	–
Amortization of goodwill	**(93,112)**	(35,135)	(1,032)
Capital gain from sale of operation (4)	**103,869**	35,033	–
Capital gains, net	**5,715**	7,338	1,634
Other	**2,129**	(3,556)	439
	109,386	79,680	(983,178)

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Provision for claims for salary and pension components (1)	**–**	207,000	(195,000)
Provision for employee severance benefits upon early retirement (2)	**83,000**	(105,000)	(419,016)
Write-off and impairment of fixed assets (3)	**–**	–	(198,686)
Provision for impairment and other liabilities in respect of investments in other companies	**(5,868)**	(26,000)	(36,110)
Indemnity for settlement agreement	**14,483**	–	–
Capital gain from sale of operation (4)	**103,869**	35,033	–
Capital gains, net	**5,385**	5,674	1,570
Other	**143**	(6,803)	294
	201,012	109,904	(846,948)

(1) See Note 19A(4).
(2) See Note 16D.
(3) See Note 9F, 9G and 9H.
(4) See Note 9C.

NOTE 25 – EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		**Adjusted for the effects of inflation in shekels of December 2003**
	NIS thousands	**NIS thousands**	**NIS thousands**
Primary and diluted earnings (loss) before cumulative effect of the change in accounting method	**575,858**	620,825	(437,836)
Primary and diluted net earnings (loss) for the year	**590,858**	620,825	(437,836)
Weighted number of shares in primary earnings and diluted earnings	**2,605,046**	2,605,046	2,444,891

NOTE 26 – BUSINESS SEGMENTS

The Company operates in various segments of the communications sector, with each company in the Group operating in a separate business segment.

Each company provides services in the segment in which it operates by means of the fixed assets and the infrastructure it owns. The infrastructure of each company is used for providing its services only. Each of the companies in the Group is exposed to different risks and yield opportunities, primarily in relation to the technology and competition in the sector in which it operates.

Each company in the Bezeq Group is a separable component, since each company's business is the provision of service or group of related services, and each company is exposed to different risks and yield opportunities from those of other components.
Based on the above, the business segments of the Bezeq Group are as follows:

- "Bezeq", The Israel Telecommunication Corp. Ltd.– Domestic fixed-line communications.
- Pelephone Communications Ltd. – Cellular telephone.
- Bezeq International Ltd. – International communications and internet services.
- D.B.S. Satellite Services (1998) Ltd. – Multi-channel television.

The other companies of the Group are presented in other sections.

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments

Consolidated

	For the year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	4,457,189	4,413,421	795,176	1,200,865	232,035	-	11,098,686
Inter-segment revenues	266,545	14,854	21,488	20,997	104,511	(428,395)	-
Total revenues	4,723,734	4,428,275	816,664	1,221,862	336,546	(428,395)	11,098,686
Segment results	851,273	466,165	97,978	(99,535)	1,197	-	1,317,078
Financing expenses							(417,309)
Earnings after financing expenses							899,769
Other income, net							109,386
Earnings before income tax							1,009,155
Income tax							(429,594)
Earnings after income tax							579,561
Equity in losses of affiliated companies							(12,645)
Minority share in losses of a consolidated company							8,942
Earnings before cumulative effect of the change in accounting method							575,858
Cumulative effect as at the beginning of the year of the change in accounting method							15,000
Net earnings							590,858

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Identified assets	8,217,243	4,834,849	683,068	1,348,813	254,166	(185,581)	15,152,558
Investment by equity method							75,467
General assets							5,437,847
Total consolidated assets							20,665,872
Segment liabilities	1,263,755	718,903	227,859	584,368	128,827	(209,331)	2,714,381
General liabilities							9,893,631
Total consolidated liabilities							12,608,012
Capital investments	787,790	586,447	39,475	247,713	17,452		
Depreciation and amortization	1,390,435	625,393	91,435	298,658	20,729		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2004						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	4,736,756	2,966,486	797,735	529,838	238,989	-	9,269,804
Inter-segment revenues	222,935	8,493	18,704	12,304	80,387	(342,823)	-
Total revenues	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Segment results	971,016	379,328	118,223	(85,381)	8,362	-	1,391,548
Financing expenses							(217,529)
Earnings after financing expenses							1,174,019
Other income, net							79,680
Earnings before income tax							1,253,699
Income tax							(497,485)
Earnings after income tax							756,214
Equity in losses of affiliated companies				(126,630)	(8,143)		(134,773)
Minority share in earnings of a consolidated company							(616)
Net earnings							620,825
Identified assets	8,589,680	4,775,659	598,090	1,364,941	235,240	(206,476)	15,357,134
Investment by equity method							70,308
General assets							4,744,539
Total consolidated assets							20,171,981

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2004						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Segment liabilities	1,412,990	858,943	233,113	595,229	133,360	(200,811)	3,032,824
General liabilities							9,673,390
Total consolidated liabilities							12,706,214
Capital investments	850,005	588,002	116,938	160,134	173,353		
Depreciation and amortization	1,502,354	418,925	117,316	162,029	18,978		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2003					
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
		Adjusted for the effects of inflation in shekels of December 2003				
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,023,754	2,021,807	689,378	246,329	–	7,981,268
Inter-segment revenues	206,807	5,568	13,958	40,236	(266,569)	–
Total revenues	5,230,561	2,027,375	703,336	286,565	(266,569)	7,981,268
Segment results	906,619	96,013	90,001	72	644	1,093,349
Financing expenses						(157,522)
Earnings after financing expenses						935,827
Other expenses, net						(983,178)
Loss before income tax						(47,351)
Income tax						(48,013)
Loss after income tax						(95,364)
Equity in losses of affiliated companies	(2,280)			(341,054)		(343,334)
Minority share in losses of a consolidated company						862
Net loss						(437,836)
Identified assets	9,903,468	2,258,000	527,565	213,574	(106,196)	12,796,411
Investment by equity method						240,667
General assets						3,051,686
Total consolidated assets						16,088,764
Segment liabilities	1,609,316	500,091	270,031	126,516	(102,649)	2,403,305
General liabilities						6,840,517
Total consolidated liabilities						9,243,822
Capital investments	815,382	524,644	114,456	201,670		
Depreciation and amortization	1,776,279	394,203	99,868	7,498		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

B. Distribution of the Group's Revenues

The table below provides additional information about the distribution of revenue in the Group according to customer use. The costs relating to this revenue cannot be allocated since expenses relating directly to them are impossible to identify, nor can they be allocated on a reasonable basis.

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		**Adjusted for the effects of inflation in shekels of December 2003**
	NIS millions	**NIS millions**	**NIS millions**
Telephony – domestic calls, fixed fees and installations	**3,105**	3,329	3,549
Cellular telephone	**4,532**	3,128	2,199
Multi-channel television services to subscribers	**1,171**	530	-
Internet	**867**	773	643
International communications	**564**	599	562
Transmission services and data communication	**584**	608	648
Fixed line infrastructure and maintenance works	**221**	230	298
Others	**55**	73	82
Total	**11,099**	9,270	7,981

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. The Company and its subsidiaries provide a range of communication services, such as telephony, access, information and data communication, transmission, satellite and video, various infrastructure services, international communications and internet, multi-channel television, cellular and NET services and so on ("the Services").

The entities to which the Company and its subsidiaries provide the Services include interested parties in the Company, among them Ap.Sb.Ar., which holds 30% of the Company's shares, the State of Israel, which holds approximately 16.38% of the Company's shares, and the Zeevi Holdings Group, which holds approximately 17.75% of the Company's shares through a receiver appointed for those shares on behalf of certain banks.

In view of the above, as far as interested parties who are not the State of Israel are concerned, the Services with which the Company and its subsidiaries provide them are negligible transactions and accordingly, pursuant to Article 64(3)(d)(1) of the Securities Regulations (Preparing annual financial statements), 5753-1993 ("the Regulations"), they are not described in these reports.

As far as the State of Israel is concerned as an interested party in the Company – prior to amendment of the Securities Regulations (Preparing annual financial statements) (Amendment), 5765-2005, since a description of transactions relating to the regular provision of the Services would involve numerous difficulties (it concerns the provision of a range of services to the State and its numerous branches, including government ministries, state corporations, government authorities and companies), the Company was granted an exemption from describing the transactions. Now, in view of the amendment of the Regulations, a general description will be given of typical transactions and their scope, in accordance with Article 64(3)(d)(2) of the Regulations:

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

A. (CONTD.)

(1) The Services are defined above.

(2) The consideration in respect of most of the transactions made by the Company with State authorities is paid according to the tariffs prescribed in regulations. The remainder of transactions made by the Company with State authorities (for which the consideration is not paid according to the tariffs prescribed in regulations), such as services for which no tariff is prescribed in the regulations, specially ordered work, work as a contractor, excavation works and the installation and maintenance of offices, as well as transactions made by the Company's subsidiaries with State authorities - all these are transactions in the normal course of their business at market prices, where each individual transaction or Service of itself is not material for the Company.

(3) The transactions with government ministries for the group and for the report period are:
Royalties expenses NIS 257,445 thousand, frequencies NIS 30,762 thousand, revenues from telephony services (mainly) NIS 385,171 thousand. Debit/credit balances in respect of these services: trade receivables NIS 91,727 thousand, trade payables NIS 49,936 thousand, current liabilities NIS 183,163 thousand.

Arrangements which to not comply with these conditions are disclosed in the Company's reports.

B. In July 2002 the Company reached an agreement with the Ministry of Defense on behalf of the State of Israel, for the provision of telecommunications services by the Company.

The main points of the agreement, which was approved when the Company was controlled by the State by all of the Company’s authorized bodies, including the General Meeting of the shareholders, as required under the Companies Law for a transaction with a controlling interest, are as follows:

(1) The Company will provide telecommunications services to the IDF at a special discounted rate 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 took 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 at least 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 at the end of the agreement term will remain with the Ministry of Defense and ownership of infrastructures outside the IDF bases 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 an immaterial amount).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

B. (CONTD.)

On May 8, 2005, a new commercial agreement was signed between the Company and the Ministry of Defense in the name of the State of Israel, for the provision of communication services by the Company. The agreement had been approved earlier by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and requires the approval of the general meeting of the shareholders of the Company (by a special majority), in accordance with the Securities regulations (Transaction between a company and its controlling shareholder), 5761-2001. On June 2, 2005 and at the request of the Company, the General Meeting of the Company resolved to remove this subject from its agenda, in view of a query made by the Ministry of Communications and the State's subsequent request to postpone the discussion. The Ministry of Communications query contended, *inter alia*, that the agreement was for giving discounts which seemingly contravenes the provisions of the law and the general license of the Company. The Ministry requested the Company's comments for clarification of the matter. The Company submitted its comments to the Ministry, stating that it was a new framework agreement to replace the previous one, under which the Company had also given the IDF discounts of various percentages. The Company pointed out that its license allows it to enter into a special agreement with the Ministry of Defense for providing the IDF with telecommunication services, which would include any conditions agreed upon by the parties, including discounts, as was the case in the previous framework agreement. The Ministry of Communications has not yet completed its investigation of this matter.

In addition, the Company received a query from the Antitrust Commissioner which noted that the above agreement appeared to contravene the provisions of the Antitrust Law. The Company submitted its comments to the Commissioner. As at the date of approval of the financial statements, the Company intends, together with the Ministry of Defense, to look into alternatives to the agreement. The financial statements include a liability of NIS 19 million, which constitutes the difference in tariffs under the agreement from July 2002 and the agreement from May 8, 2005.

On December 16, 2003, the Company filed a claim in the Tel Aviv District Court against the Ministry of Defense for payment of approximately NIS 57 million in connection with a dispute in the matter of a discount of 18% deducted by the Ministry, as referred to in item (3) above, and on March 16, 2004 the State filed a statement of defense. On May 17, 2004 the Company filed its response. As proposed by the Court, the parties agreed to refer the case to a mediation proceeding, but eventually decided to try to resolve their differences out of court. In April 2005 a settlement agreement was signed, which was approved by the Audit Committee of the Board of Directors and by the Board of Directors. On June 2, 2005, the General Meeting of the shareholders of the Company approved the agreement, as required by the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. In June 2005 the settlement agreement was approved by the Court and validated as a judgment.

Below are the main points of the settlement agreement:

(1) In clearance of a financial claim in the amount of approximately NIS 37.4 million (principal) plus interest in an estimated amount of NIS 20 million, filed by the Company against the State in the matter of the deduction of discounts of 18% on various charges included under the "Miscellaneous" item in the telephone bills of the IDF, the Ministry of Defense will pay the Company a global sum of NIS 28.5 million (including VAT insofar as applicable), in three equal payments of NIS 9.5 million each, which will be paid by the following dates: June 30, 2005, January 31, 2006, June 30, 2006.

(2) Arrears in any one of the payments will entail payment of Accountant General's arrearage interest by the Ministry of Defense.

(3) Subject to the above, neither party shall have any allegation and/or demand and/or claim against the other in this matter.

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

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

C. On March 1, 2006, the Audit Committee of the Board of Directors and the Board of Directors approved the Company's commitment in a management agreement with a company owned and controlled by the shareholders of Ap.Sb.Ar. ("the Management Company"), whereby the Management Company will provide the Company with management and consultation services for managing the business of the Bezeq Group. The consideration in respect of these services, according to the agreement, will be approximately $1.2 million plus VAT. The term of the agreement is from October 11, 2005 to December 31, 2008, unless one of the parties gives the other three months notice of its wish to terminate it. The agreement requires the approval of the General Meeting (see also Section E below).

D. **TRANSACTIONS WITH INVESTEE COMPANIES (COMPANY)**

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Consolidated companies			
Revenues –			
Interconnect and access fees	**160,050**	48,320	38,515
Services, royalties and commissions	**95,131**	92,688	52,940
Rent and usage fees for buildings and equipment	**11,364**	4,034	541
Interest	**117,186**	70,458	12,298
Expenses –			
Purchase of services	**61,261**	46,221	47,092
Proportionally consolidated company			
Revenues –			
Interconnect and access fees	**–**	37,533	58,458
Services, royalties and commissions	**–**	103,790	41,425
Rent and usage fees for buildings and equipment	**–**	10,341	6,818
Interest	**–**	1,240	–
Expenses –			
Purchase of services	**–**	3,901	2,481
Interest	**–**	–	551
Affiliated companies			
Revenues –			
Services, royalties and commissions	**–**	8,063	2,812

For balances with investee companies, see the relevant notes.

For loans to investee companies and the terms of those loans, see Note 8 and Note 14A(1).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effect of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Total cost of compensation of the CEO and the Chairman of the Board *	7,893	1,574	1,678
Number of employees	3	2	3
Compensation of members of the Board of Directors who are not Company employees**	1,643	1,663	1,695
Number of directors receiving compensation***	8	13	16
Management fees to a company that is a controlling shareholder****	1,250	–	–

* The cost in respect of 2005 includes salary and grants in respect of the period when the CEO of the Company was CEO of Pelephone, as well as salary and grants for the outgoing CEO and salary and retirement pay to the Chairman of the Board. The salary includes options which were distributed according to the stock options plan – see Note 1G. The cost for 2003 includes retirement pay to the outgoing CEO.

** Compensation for directors in a proportionally consolidated company is stated at the proportional share of the Company (50%) for the period in which that company was proportionally consolidated.

*** From the date of transfer of control of the Company to Ap.Sb.Ar., the directors serving on the Board of Directors of the Company (except for the external directors) do not receive compensation from the Company.

**** A provision of NIS 1,250 thousand for payment of management fees to Ap.Sb.Ar – see Section C above.

(1) On December 3, 2003, the General Meeting of the shareholders of the Company approved a commitment to indemnify 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 by virtue of that agreement. The commitment was limited to NIS 890,000 thousand (the amount of the capital raising), linked to the CPI published after the capital was raised in accordance with the framework agreement.

(2) On May 13, 2004, the General Meeting of shareholders of the Company approved an undertaking to officers on the subject of indemnification and insurance, as follows:

a. An undertaking by the Company regarding the extension of a loan to officers to finance reasonable litigation expenses in legal proceedings, and an undertaking by the Company to acquire an insurance policy for officers at a reasonable cost.

b. Grant of notes of indemnity in advance to officers of the Company on the following matters:

1. The claim of a shareholder holding 15% or more of the share capital of the Company. The total extent of the indemnity will not exceed $150 million plus $30 million for legal expenses (a claim of this kind was excluded in the officers insurance policy of the Company).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

2. In everything related to a prospectus for an offer for sale of securities of the Company by the State of Israel and an issuance by the Company, which was published at the end of May 2004. The total amount of the indemnity (including in respect of commitments to indemnify in advance which were given until publication of the prospectus and in respect of commitments to indemnify in advance which will be given, if given, prior to the transfer of control in the Company by the State) shall not exceed 25% of the shareholders' equity of the Company (according to its 2003 financial statements), linked to the CPI of November 2003).

(3) On April 20, 2004, the Board of Directors of the Company resolved that the Company would indemnify the employees of the Group who took part in preparation of the prospectus to be published in May 2004, who are not officers of the Company, in respect of financial liability that would be imposed upon them and in respect of reasonable litigation expenses that they might face, with respect to the prospectus, similar in form to the indemnity given to officers.

(4) The Company has an officers' insurance policy. The insurance ceiling is $150 million per occurrence and for the period (12 months), plus up to $30 million for legal expenses in Israel.

During 2005 the Company purchased officers' liability insurance policies, and commitments were made to indemnify directors and officers as follows:

a. On April 6, 2005, the General Meeting of the shareholders approved an undertaking by the Company to indemnify in respect of a financial liability that will be imposed upon Company officers and in respect of reasonable litigation expenses they will incur, in everything connected, directly or indirectly, with the process of sale of the State's holdings in the Company.
The undertaking to indemnify will be made to officers who were serving and/or were appointed and/or will be appointed in the Company commencing from the start of the Company's preparations for the sale process until the date of completion the sale proceeding.

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

b. On May 16, 2005, the General Meeting of the shareholders approved the insurance and indemnification of the Company's officers as follows:

(1) Approval of exercise of an option to purchase a run-off policy for the liability of officers in the Company, on the terms of the current policy, with the following changes:

a. For a period of seven years from the date of closing transfer of the State's shares in the Company, which are being sold in accordance with decision of the Ministerial Committee on Privatization dated July 19, 2004 ("the Date of Closing the Sale").

b. The total amount of the insurance cover shall not exceed $150 million, plus $30 million in respect of legal expenses in Israel only.

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

c. Limits of liability:

(1) Cover for the first three years at a limit of liability of $150 million, plus $30 million in respect of legal expenses in Israel only.
(2) Cover for an additional three years at a limit of liability of $75 million, plus $15 million in respect of legal expenses in Israel only.
(3) Cover for the seventh year at a limit of liability of $25 million, plus $5 million in respect of legal expenses in Israel only.

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

d. The premium for the entire period of insurance is $3 million (in a single advance payment).

(2) Approval for making a commitment in advance to indemnify an officer in the Company who were serving in the Company at the time of making the commitment to indemnify which applies on the Date of Closing the Sale or who served during the seven years prior to that date, for a financial liability imposed upon him in each of the events listed in the document of indemnity and in the terms set out there, in which the officer acted in good faith and had reasonable grounds to assume that the action is in the best interests of the Company. The undertaking to indemnify shall not apply for an event for which an insurer has recognized liability under an insurance policy; however, if due to an indemnifiable event the officer was ordered to pay an amount exceeding the amount paid to him by the insurer, the Company will indemnify him in the amount of the difference, and subject to the amount of the indemnity for all the Company's officers not exceeding $150 million plus $30 million in respect of legal expenses in Israel only per claim and for each insurance year in the period of insurance. Upon the closing of the transaction for the sale of the State's shares to Ap.Sb.Ar. (October 11, 2005), this undertaking came into force.

These resolutions were approved and came into force on the Date of Closing the Sale (October 11, 2005).

c. On August 3, 2005 the Special General Meeting of the shareholders approved the extension of the term of an officers' insurance policy, including a run-off option, for a period of up to four months at a cost of $112,500 per month, commencing July 31, 2005 (the date of expiration of the previous policy). With the closing of the sale of the State's shares top Ap.Sb.Ar. (October 11, 2005), the run-off option was exercised as described in Section (2)a. above and that policy expired.

d. On November 24, 2005 the General Meeting of the shareholders approved:

(1) The purchase of a policy for insurance of the liability of Company officers for a period of one year commencing October 11, 2005 with a limit of liability of $150 million per claim and for the entire insurance year. In addition, $30 million per claim and for all the claims for the insurance period in respect of legal expenses in Israeli only. A limit of liability for subsidiaries – $50 million (as part of the aforesaid limit of liability). Annual premium – $675,000 + 1.5% stamp duty (it is noted that the scope of the insurance cover is identical to the insurance of officers which was in place until now at the Company, whereas the annual premium is considerably lower than that paid in the past, due to the existence of the concurrent run-off insurance).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

(2) A "framework transaction" for the Company's commitment in the normal course of business in future insurance policies (after expiration of the current policy, as referred to in section a. above), to cover the liability of directors and officers, as may be from time to time, including directors and officers who are or are likely to be seen as controlling shareholders in the Company, and all by way of a "framework transaction" as defined in the Companies Regulations (Benefits in transactions with interested parties), 5760-2000, at an annual premium of $675,000 plus a sum in the amount of 20% of that premium in respect of the insurance cover existing today (and described above), as well as $30 million per claim and total claims for the period of insurance in respect of legal expenses in Israel only. The limit of liability for subsidiaries is $50 million (as part of he limit of liability referred to above). If insurance cover is purchased in an amount differing from the amount of insurance cover today, the option to increase the premium is up to a ceiling of 20% more than the premium for the current policy ($675,000). In other words, the maximum premium (after the increase) will not exceed $810,000.

F. Regarding guarantees to related parties, see Note 19C.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

A. DERIVATIVES

The Group is exposed to credit and currency risks during the normal course of its business, and uses derivatives to minimize its exposure to these risks.

The Group has an excess of monetary liabilities over monetary assets in or linked to foreign currency in the amount of approximately NIS 2,520 million, of which the excess of current liabilities over current assets is approximately NIS 952 million. The excess of current liabilities is covered by forward exchange contracts, as described in section C below. The Group has revenues in foreign currency from international telecommunications.

As at December 31, 2005, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 4,383 million, of which the excess of current assets over current liabilities was approximately NIS 272 million. As stated in Note 1E, most of the Company's tariffs are subject to government regulation and are revised annually in accordance with the increase in the CPI, net of an efficiency factor.

The Company has limited commitments in derivatives, which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2005 – see section C below.

B. CREDIT RISK

As at December 31, 2005, 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 bonds and in debentures of companies traded on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

The Group's revenues derive mainly from providing services to customers in Israel. Management reviews customer debts on a current basis and the financial statements include specific provisions which, in Management's opinion, adequately reflect the loss inherent in doubtful debts. The exposure to credit risk in connection with customers is limited, considering their large number.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD,)

C. CURRENCY RISK

The Company and the consolidated companies manage their exposure to currency risk deriving from fluctuations in foreign currency exchange rates in respect of assets, liabilities and cash flows denominated in foreign currency. The Group acts to minimize the currency exposure by forward transactions in foreign currency and by purchasing currency options. Hereunder the details of the derivatives of the Company and consolidated companies as at December 31, 2005:

Consolidated

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**	Dollar	Shekel	September 2006	361	362	-	-
	Euro	Shekel	December 2006	1,557	1,646	(69)	(70)
	CPI-linked Shekel	Shekel	December 2010	1,237	1,279	–	2

(2) Forward currency transactions - non-hedging transactions

	Purchased currency	Currency payable	Last repayment date	Fair value	Scope of commitment
				NIS millions	
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**	Dollar	Shekel	May 2006	(2)	129

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD.)

C. CURRENCY RISK (CONTD.)

Company

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Forward transactions at predetermined currency exchange rate -	Dollar	Shekel	September 2006	288	290	(2)	2
	Euro	Shekel	December 2006	1,557	1,646	(69)	(70)
	CPI-linked Shekel	Shekel	December 2010	1,237	1,279	-	2

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD.)

D. INTEREST RISK

The Company takes loans at variable interest rates, and therefore its financial results (financing expenses) are exposed to the risk of changing interest rates. The Company also has loans at fixed interest rates which are exposed to possible changes in their fair value.

E. FAIR VALUE OF FINANCIAL INSTRUMENTS

The book value of 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.

Hereunder the differences between the amount recorded in the books and the estimated fair value:

	December 31, 2005	
	Book value	Fair value
	NIS thousands	NIS thousands
Debentures:		
Issued to the public	1,721,604	1,763,531
CPI-linked	2,049,073	2,252,803
Euro-linked	1,593,387	1,733,622
Unlinked, issued to others	36,423	36,564
Euro-linked, issued to others	29,736	30,381
CPI-linked loans	1,928,222	1,987,961
Unlinked loans	692,305	693,602
Foreign currency loans	563,867	569,483

The fair value of the liabilities presented above is based on the present value of the cash flows related to those liabilities.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2005

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	**100,345**	**3,074**	**3**	**-**	**2,055,351**	**2,158,773**
Short-term investments*	**277,581**	**24,350**	**-**	**1,376,203**	**720,391**	**2,398,525**
Trade receivables	**31,444**	**-**	**-**	**8,871**	**2,073,197**	**2,113,512**
Other receivables and debit balances	**3,407**	**-**	**-**	**14,855**	**19,922**	**38,184**
Investee companies	**-**	**-**	**-**	**5,514**	**-**	**5,514**
Investments, long-term deposits and debit balances						
	68,147	**32,679**	**-**	**94,286**	**605,544**	**800,656**
	480,924	**60,103**	**3**	**1,499,729**	**5,474,405**	**7,515,164**
Liabilities						
Short-term bank credit	**-**	**-**	**-**	**-**	**75,191**	**75,191**
Current maturities of long-term liabilities						
Trade payables	**759,495**	**-**	**-**	**899,595**	**130,660**	**1,789,750**
Other current liabilities	**488,894**	**14,785**	**1,058**	**-**	**895,977**	**1,400,714**
Long-term loans	**15,972**	**112,053**	**-**	**228,008**	**995,236**	**1,351,269**
Other long-term debentures	**34,522**	**-**	**-**	**1,469,350**	**648,088**	**2,151,960**
Employee severance benefits	**-**	**1,623,122**	**-**	**3,279,934**	**-**	**4,903,056**
Other long-term liabilities						
	-	**-**	**-**	**-**	**865,305**	**865,305**
	1,707	**-**	**9,135**	**5,649**	**2,004**	**18,495**
	1,300,590	**1,749,960**	**10,193**	**5,882,536**	**3,612,461**	**12,555,740**

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	**7,524**	**3,074**	**3**	**-**	**1,668,643**	**1,679,244**
Short-term investments*	**251,073**	**24,350**	**-**	**1,256,217**	**514,261**	**2,045,901**
Trade receivables	**10,062**	**-**	**-**	**-**	**886,353**	**896,415**
Other receivables and debit balances	**3,189**	**-**	**-**	**276,546**	**7,215**	**286,950**
Investee companies	**-**	**-**	**-**	**2,100,070**	**-**	**2,100,070**
Investments, long-term deposits and debit balances	**64,442**	**32,679**	**-**	**79,344**	**193,041**	**369,506**
	336,290	**60,103**	**3**	**3,712,177**	**3,269,513**	**7,378,086**
Liabilities						
Current maturities of long-term liabilities	**529,345**	**-**	**-**	**376,461**	**36,423**	**942,229**
Trade payables	**23,619**	**14,785**	**1,058**	**-**	**500,997**	**540,459**
Other current liabilities	**8,007**	**112,053**	**-**	**128,579**	**633,470**	**882,109**
Long-term loans	**34,522**	**-**	**-**	**-**	**-**	**34,522**
Other long-term debentures	**-**	**1,623,122**	**-**	**4,389,462**	**-**	**6,012,584**
Employee severance benefits	**-**	**-**	**-**	**-**	**842,761**	**842,761**
	595,493	**1,749,960**	**1,058**	**4,894,502**	**2,013,651**	**9,254,664**

* Including mutual fund participation certificates of approximately NIS 162 million and NIS 135 million Consolidated and in the Company, respectively..
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2004

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	30,373	1,301	–	–	1,425,433	1,457,107
Short-term investments*	171,029	24,757	–	476,622	*615,401	1,287,809
Trade receivables	33,296	–	–	–	2,081,774	2,115,070
Other receivables and debit balances	519	75,982	–	8,038	8,173	92,712
Investee companies	–	–	–	16,414	(12,330)	4,084
Investments, long-term deposits and debit balances	69,048	35,261	–	256,986	478,397	839,692
	304,265	137,301	–	758,060	4,596,848	5,796,474
Liabilities						
Short-term bank credit	–	–	–	–	88,102	88,102
Current maturities of long-term liabilities	604,548	–	–	868,063	72,786	1,545,397
Trade payables	572,048	52,795	1,182	–	1,049,544	1,675,569
Other current liabilities	66,401	44,829	–	169,147	1,087,216	1,367,593
Long-term loans	743,130	–	–	1,425,268	692,536	2,860,934
Other long-term debentures	–	1,749,709	–	2,038,438	36,392	3,824,539
Employee severance benefits	–	–	–	–	1,272,570	1,272,570
Other long-term liabilities	9,247	–	–	437	11,941	21,625
	1,995,374	1,847,333	1,182	4,501,353	4,311,087	12,656,329

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	4,262	1,301	–	–	1,322,168	1,327,731
Short-term investments*	171,029	24,757	–	476,622	*613,512	1,285,920
Trade receivables	11,724	–	–	–	959,042	970,766
Other receivables and debit balances	286	75,982	–	103,215	9,697	189,180
Investee companies	–	–	–	2,560,089	–	2,560,089
Investments, long-term deposits and debit balances	60,312	35,261	–	229,614	203,196	528,383
	247,613	137,301	–	3,369,540	3,107,615	6,862,069
Liabilities						
Current maturities of long-term liabilities	469,572	–	–	141,701	72,786	684,059
Trade payables	1,590	52,795	1,182	–	592,651	648,218
Other current liabilities	48,622	44,829	–	145,829	648,271	887,551
Long-term loans	527,730	–	–	2,004	–	529,734
Other long-term debentures	–	1,749,708	–	4,328,527	36,393	6,114,628
Employee severance benefits	–	–	–	–	1,250,829	1,250,829
Other long-term liabilities	–	–	–	437	–	437
	1,047,514	1,847,332	1,182	4,618,498	2,600,930	10,115,456

* Including mutual fund participation certificates of approximately NIS 113 million consolidated and in the Company.
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

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NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

A. ACCOUNTING PRINCIPLES USED FOR STATING DATA IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

1. These financial statements were prepared on the historical cost basis.
2. These financial statements include the data of the Company alone, without presentation of consolidated statements, as required under accepted accounting principles.
3. The Company's investments in investee companies are stated on the basis of their historical cost.

B. BALANCE SHEETS

	December 31 2005	December 31 2004
	NIS thousands	NIS thousands
Assets		
Current assets	**5,065,790**	3,954,529
Materials and spare parts	**88,881**	130,922
Investments, long-term deposits and debit balances	**400,423**	569,800
Investment in investee companies	**5,835,689**	6,379,360
Fixed assets	**4,539,216**	4,899,478
Other assets	**572,250**	631,477
	16,502,249	16,565,566
Liabilities		
Current	**2,952,208**	2,833,945
Long-term	**6,337,572**	7,324,091
	9,289,780	10,158,036
Shareholders' equity	**7,212,469**	6,407,530
	16,502,249	16,565,566

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

B. Statements of Operations

	For the year ended December 31		
	2005	**2004**	**2003**
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues from telecommunications services	**4,723,734**	4,959,691	5,285,062
Costs and expenses			
Operating and general expenses	**2,346,451**	2,347,448	2,397,800
Depreciation	**1,140,953**	1,178,829	1,334,060
Royalties to the Government of Israel	**135,575**	145,318	182,181
	3,622,979	3,671,595	3,914,041
Operating income	**1,100,755**	1,288,096	1,371,021
Financing expenses, net	**(80,897)**	(93,216)	(45,667)
Earnings after financing expenses	**1,019,858**	1,194,880	1,325,354
Other income (expenses), net	**201,802**	112,836	(806,725)
Earnings before income tax	**1,221,660**	1,307,716	518,629
Income tax	**(349,449)**	(573,572)	(195,754)
Net earnings (loss) after income tax	**872,211**	734,144	322,875
Equity in earnings (losses) of investee companies	**(68,507)**	26,023	(285,464)
Net earnings (loss)	**803,704**	760,167	37,411

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

C. Statement of Changes in Shareholders' Equity

	Share capital	Capital reserves	Dividend proposed after the balance sheet date	Retained earnings (loss)	Total
	NIS Thousands				
Balance as at January 1, 2003	2,411,658	3,432,994	190,000	(1,115,568)	4,919,084
Changes in 2003					
Net earnings	–	–	–	37,411	37,411
Dividend paid	–	–	(190,000)	–	(190,000)
Allotment of shares	193,388	687,480	–	–	880,868
Balance as at December 31, 2003	2,605,046	4,120,474	–	(1,078,157)	5,647,363
Changes in 2004					
Net earnings	–	–	–	760,167	760,167
Balance as at December 31, 2004	2,605,046	4,120,474	–	(317,990)	6,407,530
Changes in 2005 –					
Net earnings	**–**	**–**	**–**	**803,704**	**803,704**
State's payment in respect of Company privatization	**–**	**1,235**	**–**	**–**	**1,235**
Dividend proposed for payment	**–**	**–**	**1,200,000**	**(1,200,000)**	**–**
Balance as at December 31, 2005	**2,605,046**	**4,121,709**	**1,200,000**	**(714,286)**	**7,212,469**

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD.

1. PELEPHONE COMMUNICATIONS LTD.

A. BALANCE SHEET

	December 31 2005	December 31 2004
	Reported amounts	Reported amounts
	NIS thousands	NIS thousands
Current assets	**1,881,982**	1,413,049
Long-term trade receivables	**338,281**	278,778
Investment in investee companies	**3,565**	4,084
Deferred income taxes	**19,799**	106,503
Fixed assets	**3,009,219**	3,093,675
Other assets, net	**337,787**	334,028
	5,590,633	5,230,117
Current liabilities	**1,558,012**	1,794,413
Long-term liabilities	**1,666,193**	1,305,674
Shareholders' equity	**2,366,428**	2,130,030
	5,590,633	5,230,117

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from Pelephone services, sales and services	**4,428,277**	4,412,344	4,054,749
Cost of Pelephone services, sales and services	**3,415,885**	3,258,877*	3,239,830*
Gross profit	**1,012,392**	1,153,467	814,919
Sales and marketing expenses	**432,808**	470,409*	471,828*
General and administrative expenses	**107,218**	123,934*	133,201*
	540,026	594,343	605,029
Operating profit	**472,366**	559,124	209,890
Financing expenses, net	**(115,264)**	(99,597)	(143,786)
Other income (expenses), net	**1,136**	3,645	(167)
Earnings (loss) before income tax	**358,238**	463,172	65,937
Income tax	**(113,333)**	(153,400)	(24,273)
Earnings (loss) after income tax	**244,905**	309,772	41,664
Company's equity in losses of investee companies	**(8,507)**	(9,080)	(6,224)
Net earnings (loss)	**236,398**	300,692	35,440

* Reclassified

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. D.B.S. Satellite Services (1998) Ltd.

A. Balance sheet

	December 31 2005	December 31 2004
	Reported amounts	Reported amounts
	NIS thousands	NIS thousands
Current assets	**154,567**	124,393
Broadcasting rights, net	**154,500**	140,496
Fixed assets, net	**1,047,994**	1,102,066
	1,357,061	1,366,955
Current liabilities	**613,379**	595,229
Long-term liabilities	**1,419,257**	1,299,138
Loans from shareholders	**2,893,024**	2,661,540
Capital deficit	**(3,568,599)**	(3,188,952)
	1,357,061	1,366,955

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS Satellite Services (1998) Ltd. (contd.)

B. Statements of Operations

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from DBS services	**1,221,863**	1,027,992	842,374
DBS operating expenses	**1,089,835**	1,013,403	1,012,159
Gross profit (loss)	**132,028**	14,589	(169,785)
Sales and marketing expenses	**140,665**	133,511	109,859
General and administrative expenses	**77,055**	72,240	84,691
	217,720	205,751	194,550
Operating loss	**(85,692)**	(191,162)	(364,335)
Financing expenses, net	**(241,335)**	(171,522)	(179,608)
Other expenses, net	**(830)**	(3,200)	(11,201)
Net loss	**(327,857)**	(365,884)	(555,144)

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. BALANCE SHEET

	December 31 2005	December 31 2004
	Reported amounts	Reported amounts
	NIS thousands	NIS thousands
Current assets	**366,078**	223,302*
Long-term investments and debit balances	**28,702**	26,684*
Fixed assets	**305,826**	355,439
Other assets	**23,625**	18,106
	724,231	623,531
Current liabilities	**401,126**	239,133
Long-term liabilities	**14,835**	181,982
Shareholders' equity	**308,270**	202,416
	724,231	623,531

* Reclassified

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from international telecommunication services	**816,664**	816,439	703,336
Operating expenses	**530,806**	506,779*	434,658*
Gross profit	**285,858**	309,660	268,678
Marketing, general and administrative expenses	**193,297**	191,437*	184,707*
Operating income	**92,561**	118,223	83,971
Financing income (expenses), net	**(3,361)**	(4,301)	(21,830)
Earnings after financing	**89,200**	113,922	62,141
Other income (expenses), net	**1,377**	4,656	(128,580)
Earnings (loss) before income tax	**90,577**	118,578	(66,439)
Tax benefit (income tax)	**15,226**	822	(3,489)
Earnings (loss) after income tax	**105,803**	119,400	(69,928)
Company's equity in earnings (losses) of an affiliate	**4,583**	1,440	(619)
Net earnings (loss)	**110,386**	120,840	(70,547)

* Reclassified

Appendix A – List of Group Companies

	Percentage control and ownership as at	
	December 31 2005	**December 31 2004**
	%	**%**
Consolidated Companies		
Bezeq International Ltd.	**100**	100
DBS Satellite Services (1998) Ltd. (1)	**49.8**	49.8
Pelephone Communications Ltd. (2)	**100**	100
GoNext Ltd. (3)	**100**	100
Bezeq Zahav (Holdings) Ltd.(4)	**100**	100
BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.) (5)	**100**	100
BezeqCall Ltd. (5)	**100**	100
Bezeq On Line Ltd. (6)	**100**	100
GoldNet Communication Services – registered partnership (7)	**74.9**	74.9
B-One General Partnership (8)	**100**	100
Proportionally Consolidated Company		
Aspire Partnership (18)	**49**	–
Affiliated Companies		
Stage One Venture Capital Fund (Israel) L.P. (an Israeli Limited Partnership) (hereinafter – the Fund) (9)	**100**	100
Stage One Capital Investments L.P. (an Israeli Limited Partnership) (hereinafter – SOCI) (9)	**27**	27
The International Company for Undersea Cables Ltd. (ISCC) (10)	**-**	50
Aphrodite B.V. Amsterdam (11)	**-**	67
Infogate Online Ltd. (12)	**2.47**	8.12
Walla! Communications Ltd.(13)	**42.85**	44.97
Adanet for Business Group Ltd.(14)	**50**	50
Companies that are not investees		
Ambez Ltd. (formerly Comfinet Ltd.)	**17**	17
Xpert Integrated Systems Ltd. (15)	**-**	16
Personeta Inc.	**0.3**	0.6
Exent Ltd.	**3.14**	3.5
Atrica Inc.	**0.31**	0.34
Num4net (16)	**3.82**	4.45
Nexus Telocation Systems Ltd (17)	**4.03**	6
Venture Capital Funds that are not affiliated		
Eurofund 2000 L.P	**15.15**	14.4

(1) See Note 8E.

(2) See Note 8D.

(3) On March 16, 2000, Pelephone signed an agreement for the establishment of GoNext Ltd. (hereinafter – GoNext). The principal operations of GoNext are the set-up and operation of the portal with a link to cellular mediation. On December 29, 2004, Pelephone and GoNext agreed that Pelephone would waive and pardon the balance of its right in GoNext, in the amount of NIS 64,970 thousand, less a current debt balance between the two companies. As a result of this waiver, a capital gain was generated at GoNext, enabling GoNext, for the first time, to allocate the surplus cost created at the time of purchase of half of the shares in GoNext in 2002, to a deferred tax asset. At the beginning of 2005, operations of GoNext were terminated.

(4) Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav") is wholly owned and controlled by the Company. Bezeq Zahav was established in September 1995 and commenced operations in May 2004. Bezeq Zahav holds debentures which were issued by the Company (see Note 14A(1)).

(5) Commencing July 1, 1997, the operations of the two companies were consolidated and BezeqCall Ltd. ceased its operations.

(6) The company was founded in December 2000 and commenced operations in 2001. The company provides Call Center Outsourcing services.

Appendix A – List of Group Companies (Contd.)

(7) In 2002, following exercise of the Put option with AT&T, the Company's holding in the partnership increased to 54%. In March 2003, Malam Systems Ltd. ("Malam") notified the Company of exercise of a Put option it had towards the Company, to sell 20.9% of its holdings in the partnership. In May 2003, on receipt of the required approvals for changing the holdings in the partnership and on payment of consideration of approximately NIS 6.4 million by the Company, the Company's holdings in the partnership increased to 74.9%, while the holdings of Malam in the partnership decreased to 25.1%, accordingly.

(8) In May 2003, Pelephone, Bezeq International and BezeqCall Communications established the general partnership B-ONE ("the Partnership"), the purpose of which is to market total communications services to the customers of those companies. The Partnership will help increase the sales of the products and services of the parties to the agreement and be a main interface point with customers who purchase products and services through it but which will be supplied directly by each of the partners. In October 2005 Pelephone decided, together with the other partners, to terminate the joint operation. It was decided that the Partnership would continue to provide the billing services and that its customers would be transferred gradually to receipt of service from each of the parties. Upon termination if the operation, it was decided that the companies involved would waive the entire amount and/or a right that had accumulated or would accumulate by the actual date of termination of the operation. With the waiver of the other partners of their part iin the Partnership, Pelephone's part increased in the results of the Partnership to 100%.

(9) The Fund is a venture capital fund, all of whose management rights are held by SOCI, and the Company has rights in profits only. SOCI's management is implemented by an investments committee in which the Company has no control. As the Company does not control SOCI (nor its management of the Fund), the investments are accounted for by the equity method. The Company undertook to invest the sum of $20 million in the Fund, of which approximately $17 million was invested by the end of 2005.

(10) ISCC – The Company maintained an undersea cable that it had laid. The Company's equity in the costs of the equipment and its maintenance is charged to fixed assets and to maintenance expenses. In February 1997, use of the undersea cable was halted. In January 1999, the Board of Directors resolved on the voluntary liquidation commencing March 31, 1999. The liquidation of the company was completed during 2005.

(11) With the sale of Aphrodite's investment in Emitel and transfer of the profit as a dividend to the Company, Aphrodite ceased its operations and was sold. The shares were transferred in February 2005.

(12) Infogate develops and provides ASP concept computer communication services in which computers in a broadband network are connected to a central server and receive various services from that server. In January and November 2005, additional dilutions decreased the Company's holding in Infogate to 2.47%.

(13) See Note 8F.

(14) See Note 8G.

(15) In 2001, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration for 16.26% of the capital of that company, as well as options which would enable it to increase its holdings to 19.53%. Xpert is involved in the construction and provision of integration services in the communications field (primarily in the field of IP) and data security. On July 11, 2005 the Company sold all its holdings (16.3%) in Xpert. The Company's share of the proceeds from the sale amounts to approximately $2.8 million. The payments will be made in installments, the last of which should be received in January 2007.

(16) Num4net develops technology for providing interconnect services for information.

(17) Commencing July 2004, Pelephone holds shares and options of Nexus Telocation Systems Ltd. ("Nexus"), which is traded on Nasdaq in the U.S.A. Pelephone holds these shares and options as a permanent long-term investment , and has no material influence in Nexus.

(18) Aspire Partnership – in the reporting period, BezeqCall Communications set up a general partnership, together with TeleAll Connect Center Ltd. ("TeleAll") in the fields of Voice and Data.
TeleAll is a company which operates in the field of integration of contact center systems. The operations of the new partnership are based on the activity of the department which operated at TeleAll under the name of Aspire Advanced Solutions ("Aspire"), which acquired extensive experience in CTI integration, the development of dedicated software for the contact centers and IP-T related activities. In particular, Aspire acquired extensive and unique experience in the field of integration of the contact center products of Nortel, one of the core suppliers of BezeqCall Communications. The commitment received the approval of BezeqCall Communications' general meeting and the approval of the General Director of the Antitrust Authority.