# “BEZEQ” THE ISRAEL TELECOMMUNICATION CORP. LIMITED

## CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

## JUNE 30, 2007

### (UNAUDITED)

The information contained in these financial statements constitutes a translation of the financial statements published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only.

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

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter "Company") as at June 30, 2007, as well as the condensed interim consolidated statement of income, the condensed statement of recognised income and expense and the condensed interim consolidated statement of cash flows for the six and three-month periods then ended.

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

Reports of other auditors were furnished to us which relate to the review of the condensed interim financial statements of subsidiaries, whose assets as at June 30, 2007, constitute approximately 7% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 11% and 12% of the total revenues included in the condensed interim consolidated statement of income for the six and three-month periods then ended, respectively. Furthermore, reports of other auditors were furnished to us which relate to investments in associates in which the Company's investments amount to approximately NIS 33 million as at June 30, 2007, and the Company’s share in the losses in respect thereof amount to approximately NIS 1,644 thousand and NIS 1,171 thousand for the six and three-month period then ended, respectively.

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

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

KPMG

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

1. The continuing opening of the communications sector to competition and the effects of regulation on the Group's financial position and operating results, as described in Note 1.

2. Contingent claims made against the Group of which the exposure cannot yet be assessed or calculated, and other contingencies as described in Notes 8B and 8C.

3. The financial position of a subsidiary. As mentioned in Note 7A, in accordance with the 2007 annual budget, the continuation of the activity of the subsidiary is contingent on arranging sources of finance required by the subsidiary in the forthcoming year. In the opinion of the management of the subsidiary, the receipts from the debentures issued by the subsidiary in July 2007 facilitate the arrangement of the sources of finance required for the coming years.

Additionally, we draw attention to Note 14L to the Group financial statements regarding the adjustment by way of restatement of the financial statements as at June 30, 2006, in order to retroactively reflect the depreciation of property, plant and equipment and the related tax effects thereon, in respect of the presentation of receipts from interconnect to the cellular networks and in respect of a reduction of lease payments of land from the Israel Lands Administration as described in the aforementioned note. These aforementioned corrections were implemented on the data presented in the Note of restatement to IFRSs in order to properly reflect the financial position of the Group in the transition to IFRSs in accordance with generally accepted accounting principles in Israel.

Somekh Chaikin
Certified Public Accountants (Isr.)

August 13, 2007

## Condensed Consolidated Interim Balance Sheets as at

| | June 30, 2007 (Unaudited) NIS thousands | June 30, 2006 (Unaudited) NIS thousands | December 31, 2006 (Audited) NIS thousands |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | **2,063,408** | 1,256,603 | 2,631,790 |
| Trade receivables | **2,161,238** | 2,079,960 | 2,111,451 |
| Other receivables | **230,984** | 165,257 | 250,657 |
| Inventory | **228,844** | 231,115 | 204,669 |
| Broadcasting rights | **205,327** | 188,986 | 169,017 |
| Investments and loans, including derivatives | **1,007,495** | 2,478,899 | 960,561 |
| Current tax assets | **11,886** | 11,147 | 11,105 |
| **Total current assets** | **5,909,182** | 6,411,967 | 6,339,250 |
| Trade and other receivables | **452,413** | 368,690 | 417,144 |
| Investments and loans, including derivatives | **279,271** | 458,662 | 342,175 |
| Property, plant and equipment | **6,210,952** | 6,833,535 | 6,492,362 |
| Intangible assets | **2,540,921** | 2,571,682 | 2,554,242 |
| Deferred and other expenses | **362,862** | 389,075 | 373,749 |
| Investments in associates accounted by the equity method | **33,231** | 24,890 | 32,122 |
| Deferred tax assets | **788,750** | 990,123 | 993,616 |
| **Total non-current assets** | **10,668,400** | 11,636,657 | 11,205,410 |
| **Total assets** | **16,577,582** | 18,048,624 | 17,544,660 |

## Condensed Consolidated Interim Balance Sheets as at

| | June 30, 2007 | June 30, 2006 | December 31, 2006 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| **Liabilities** | | | |
| Loans and credit | **4,187,307** | 2,873,564 | 3,637,347 |
| Trade payables | **1,332,783** | 1,324,091 | 1,393,568 |
| Other payables, including derivatives | **856,971** | 881,132 | 802,747 |
| Current tax liabilities | **70,206** | 55,516 | 121,704 |
| Deferred income | **37,142** | 38,306 | 57,879 |
| Provisions | **331,806** | 255,040 | 288,851 |
| Employee benefits | **758,716** | 617,889 | 906,203 |
| Proposed dividend | **-** | - | 300,000 |
| **Total current liabilities** | **7,574,931** | 6,045,538 | 7,508,299 |
| Debentures | **3,350,062** | 4,918,177 | 3,169,441 |
| Obligations to banks | **391,914** | 595,399 | 480,830 |
| Loans from others | **125,772** | 114,791 | 169,182 |
| Loans provided by the minority in a subsidiary | **598,785** | 541,482 | 564,250 |
| Employee benefits | **328,766** | 336,076 | 373,036 |
| Deferred income and others | **28,394** | 25,989 | 37,020 |
| Provisions | **54,140** | 51,722 | 51,857 |
| **Total non-current liabilities** | **4,877,833** | 6,583,636 | 4,845,616 |
| **Total liabilities** | **12,452,764** | 12,629,174 | 12,353,915 |
| **Shareholders' Equity** | | | |
| Share capital | **6,132,636** | 6,309,133 | 6,309,133 |
| Share premium | **-** | 1,623,423 | 1,623,423 |
| Reserves | **680,506** | 387,539 | 671,820 |
| Deficit | **(2,089,539)** | (2,359,163) | (2,849,381) |
| **Total equity attributable to shareholders of the Company** | **4,723,603** | 5,960,932 | 5,754,995 |
| **Minority equity in capital deficit of a consolidated company** | **(598,785)** | (541,482) | (564,250) |
| **Total shareholders' equity** | **4,124,818** | 5,419,450 | 5,190,745 |
| **Total shareholders' equity and liabilities** | **16,577,582** | 18,048,624 | 17,544,660 |

| **Dov Weissglas** | **Avi Gabbay** | **Ran Oz** |
|---|---|---|
| Chairman of the Board | Acting CEO | Deputy CEO and CFO |

Date of approval of the financial statements: August 13, 2007.

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

## Condensed Consolidated Interim Statements of Income

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues (Note 10)** | **6,141,354** | 6,030,989 | **3,052,675** | 3,018,890 | 12,231,830 |
| **Costs and expenses** | | | | | |
| Depreciation and amortisation | **877,332** | 931,630 | **436,133** | 471,550 | 1,864,035 |
| Salary | **1,159,671** | 1,139,105 | **584,274** | 571,891 | 2,586,437 |
| Operating and general expenses (Note 11) | **2,832,382** | 2,857,520 | **1,409,612** | 1,401,086 | 5,966,616 |
| Other operating expenses (income), net | **44,430** | 70,573 | **52,106** | 58,563 | 249,540 |
| | **4,913,815** | 4,998,828 | **2,482,125** | 2,503,090 | 10,666,628 |
| Operating income | **1,227,539** | 1,032,161 | **570,550** | 515,800 | 1,565,202 |
| **Financing costs** | | | | | |
| Financing expenses | **320,916** | 427,123 | **158,529** | 181,037 | 694,393 |
| Financing income | **(189,736)** | (235,182) | **(85,217)** | (71,078) | (356,425) |
| Net financing expenses | **131,180** | 191,941 | **73,312** | 109,959 | 337,968 |
| Profit after financing expenses | **1,096,359** | 840,220 | **497,238** | 405,841 | 1,227,234 |
| **Equity in profits of investees accounted by the equity method** | **1,644** | 4,013 | **1,171** | 2,422 | 11,184 |
| Profits before income tax | **1,098,003** | 844,233 | **498,409** | 408,263 | 1,238,418 |
| **Income tax** | **372,696** | 277,627 | **158,169** | 139,719 | 488,393 |
| Profit for the period | **725,307** | 566,606 | **340,240** | 268,544 | 750,025 |
| **Attributable to:** | | | | | |
| The shareholders of the Company | **759,842** | 602,808 | **361,092** | 288,706 | 808,995 |
| Minority in a consolidated company | **(34,535)** | (36,202) | **(20,852)** | (20,162) | (58,970) |
| Profit for the period | **725,307** | 566,606 | **340,240** | 268,544 | 750,025 |
| **Earnings per share** | | | | | |
| Basic and diluted earnings per share (in NIS) | 0.29 | 0.23 | 0.14 | 0.11 | 0.31 |

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

## Condensed Consolidated Interim Statements of Recognised Income and Expense

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Net change in fair value of financial assets classified as available for sale | **4,613** | 1,887 | **3,641** | (987) | (1,464) |
| Net change in fair value of financial assets classified as available for sale transferred to profit and loss | **-** | (5,218) | **-** | (27,069) | (5,218) |
| Actuarial gains from a defined benefit plan (1) | **-** | - | **-** | - | 3,427 |
| Taxes in respect of income and expenses attributable directly to equity | **(1,677)** | 933 | **(1,400)** | 9,989 | 2,227 |
| **Income and expenses attributable directly to equity** | **2,936** | (2,398) | **2,241** | (18,067) | (1,028) |
| **Profit for the period** | **725,307** | 566,606 | **340,240** | 268,544 | 750,025 |
| **Total recognised income and expense for the period** | **728,243** | 564,208 | **342,481** | 250,477 | 748,997 |
| **Attributable to:** | | | | | |
| The shareholders' of the Company | **762,778** | 600,410 | **363,333** | 270,639 | 807,967 |
| Minority in a consolidated company | **(34,535)** | (36,202) | **(20,852)** | (20,162) | (58,970) |
| **Total recognised income and expense for the period** | **728,243** | 564,208 | **342,481** | 250,477 | 748,997 |

(1) The Group does not recalculate its actuarial provisions in each interim reporting period, unless there are significant changes in the benefit plan or fundamental changes in market terms during the interim period. As a result, there are no actuarial earnings or losses in the reporting period.

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

## Condensed Consolidated Interim Statements of Cash Flows

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Cash flows from operating activities** | | | | | |
| Net earnings for the period | **725,307** | 566,606 | **340,240** | 268,544 | 750,025 |
| Adjustments: | | | | | |
| Depreciation | **740,797** | 807,746 | **364,688** | 393,834 | 1,591,054 |
| Amortisation of intangible assets | **125,983** | 111,831 | **66,221** | 71,686 | 247,557 |
| Amortisation of deferred and other charges | **10,552** | 12,053 | **5,224** | 6,030 | 25,424 |
| Gain from decrease in holdings in associates | **346** | (584) | **28** | (61) | (595) |
| Net financing costs | **187,916** | 239,754 | **176,059** | 178,563 | 440,429 |
| Equity in earnings of associates accounted by the equity method | **(1,644)** | (4,013) | **(1,171)** | (2,422) | (11,184) |
| Net capital (gain) loss | **(5,461)** | (7,974) | **11,382** | 2,591 | (159,017) |
| Share-based payment transactions | **-** | - | **-** | - | 286,506 |
| Payments to a former senior officer | **5,750** | - | **5,750** | - | - |
| Income tax expenses | **372,696** | 277,627 | **158,169** | 139,719 | 488,393 |
| Change in inventory | **(25,587)** | 1,631 | **22,076** | (8,584) | 23,014 |
| Change in trade receivables | **(108,644)** | 27,245 | **(95,685)** | (11,004) | 109,100 |
| Change in other receivables | **(25,626)** | (9,327) | **26,630** | 23,252 | (107,854) |
| Change in trade payables | **17,382** | 18,349 | **(38,093)** | (32,284) | (56,778) |
| Change in suppliers | **(129,177)** | (127,296) | **(161,830)** | 32,214 | (79,046) |
| Change in provisions | **45,238** | (5,408) | **29,889** | (26,797) | 27,327 |
| Change in broadcasting rights | **(36,310)** | (34,486) | **(4,841)** | (15,385) | (14,517) |
| Change in employee benefits | **(191,757)** | (160,111) | **(106,851)** | (137,088) | 168,758 |
| Change in deferred and other income | **(8,626)** | 478 | **(46,476)** | 1,661 | 11,509 |
| | **1,699,135** | 1,714,121 | **751,409** | 884,469 | 3,740,105 |
| Interest received | **70,073** | 127,307 | **27,005** | 33,178 | 220,078 |
| Dividend received | **3,084** | 26,010 | **3,084** | 26,010 | 26,010 |
| Income tax paid | **(224,390)** | (143,286) | **(86,502)** | (75,228) | (277,573) |
| **Net cash from operating activities** | **1,547,902** | 1,724,152 | **694,996** | 868,429 | 3,708,620 |
| **Cash flows from investing activities** | | | | | |
| Investment in intangible assets | **(92,128)** | (82,003) | **(42,629)** | (58,163) | (209,733) |
| Proceeds from sale of property, plant and equipment | **116,395** | 12,905 | **97,084** | 4,847 | 47,804 |
| Proceeds from realisation of deferred expenses | **4,213** | 272 | **-** | - | - |
| Current investments, net | **7,375** | (92,669) | **(108,441)** | (45,243) | 1,491,439 |
| Purchase of property, plant and equipment | **(410,326)** | (511,255) | **(232,833)** | (209,410) | (953,226) |
| Investment in deferred expenses and others | **(2,615)** | (5,365) | **(1,790)** | (3,324) | - |
| Proceeds from sale of investments and long-term loans | **33,380** | 11,888 | **25,510** | 7,624 | 62,729 |
| Purchase of investments and long-term loans | **-** | (12,328) | **-** | (2,821) | (19,723)* |
| Purchase of a subsidiary | **(12,468)** | - | **-** | - | - |
| **Net cash from (used for) investment activities** | **(356,174)** | (678,555) | **(263,099)** | (306,490) | 419,290 |

* Reclassified

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

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

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Cash flows from financing activities** | | | | | |
| Receipt of loans | **50,000** | - | **50,000** | - | 50,000 |
| Issue of debentures | **756,813** | - | **756,813** | - | - |
| Repayment of debentures | **(96,874)** | (179,056) | **(15,241)** | (30,088) | (280,350) |
| Repayment of loans | **(148,663)** | (387,263) | **(79,646)** | (226,182) | (1,268,656) |
| Short-term credit, net | **(22,769)** | 55,578 | **9,254** | 9,262 | 43,146 |
| Dividends paid | **(2,099,920)** | (1,200,000) | **-** | (1,200,000) | (1,600,000) |
| Interest paid | **(198,571)** | (236,348) | **(123,198)** | (147,013) | (601,752) |
| **Net cash from (used for) financing activities** | **(1,759,984)** | (1,947,089) | **597,982** | (1,594,021) | (3,657,612) |
| **Net increase (decrease) in cash and cash equivalents** | **(568,256)** | (901,492) | **1,029,879** | (1,032,082) | 470,298 |
| Cash and cash equivalents at the beginning of the period | **2,631,790** | 2,158,773 | **1,032,988** | 2,290,704 | 2,158,773 |
| Effect of fluctuations in the rate of exchange on cash balances | **(126)** | (678) | **541** | (2,019) | 2,719 |
| **Cash and cash equivalents at the end of the period** | **2,063,408** | 1,256,603 | **2,063,408** | 1,256,603 | 2,631,790 |

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

## Appendix to Condensed Consolidated Interim Statements of Cash Flows

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Appendix of activities not affecting cash flows** | | | | | |
| Purchase of property, plant and equipment, and intangible assets | **199,549** | 120,140 | **199,549** | 120,140 | 141,518 |
| Sale of property, plant and equipment on credit | **74,506** | 13,996 | **74,506** | 13,996 | 161,800 |

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

## NOTE 1 – REPORTING ENTITY

**A.** Bezeq – The Israel Telecommunication Corp. Ltd. ("the Company") is a company domiciled in Israel whose shares are traded on the Tel Aviv Stock Exchange. The official address of the Company is 132 Menachem Begin Road, Tel Aviv. The consolidated financial statements of the Company comprise those of the Company and its subsidiaries (jointly referred to as the "Group"), and the Group's interests in affiliated companies. The Group is a principal provider of communications services in Israel (see Note 13 – Segment Reporting).

**B.** On October 11, 2005, control in the Company was transferred from the State to Ap.Sb.Ar. Holdings Ltd. and the Company ceased to be a government company. The Company was declared a monopoly in the main areas in which it operates. An appeal filed by the Company was pending in the Antitrust Court against the non-revocation of its monopoly status in the basic telephony field; however, at the suggestion of the court (in view of the time elapsed since it was filed), the Company consented to withdraw the appeal and is considering its continued handling of the matter. All the segments of operation of the Group are subject to competition. The activities of the Group are, in general, subject to government regulation and control. It is expected that the said regulation and control, as well as the intensifying competition including implementation of the number portability program, together with all the changes in the communications market, will have an adverse effect on the business results of the Group, an effect that the Group is unable to estimate.

## NOTE 2 – BASIS OF PRESENTATION

**A.** The interim consolidated financial statements were prepared in accordance with the International Financial Reporting Standards ("IFRS"), as required for the preparation of interim financial statements in accordance with standard IAS 34 – Interim Financial Reporting, and in accordance with Section 4 of the Securities (Periodic and immediate reports) Regulations, 5730-1970.

**B.** These reports should be reviewed in the context of the annual financial statements of the Company and its subsidiaries as at December 31, 2006 and the year then ended, and their accompanying notes ("the annual financial statements"). The Group states in the notes to the interim financial statements only the material changes that have occurred from the date of the most recent annual financial statements until the date of these interim financial statements.

## NOTE 3 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

The significant accounting policies applied in these financial statements are consistent with those applied in the annual financial statements for the year ended December 31, 2006.

**A. Initial application of accounting standards**

Commencing January 1, 2007, the Group applies several standards and interpretations of the international accounting standards that have come into effect, as follows:

(1) IFRIC 7 – "Applying the Restatement Approach under IAS 29 - Financial Reporting in Hyperinflationary Economies", that relates to the application of IAS 29 when an economy becomes hyperinflationary for the first time, and in particular the accounting treatment of deferred tax.

(2) IFRIC 8 – "Scope of IFRS 2 - Share-based Payment", that relates to the accounting treatment of share-based payment transactions in which some or all of the goods or services received cannot be specifically identified.

(3) IFRIC 9 – "Reassessment of Embedded Derivatives", that determines that reassessment with regard to the need to separate an embedded derivative from a host contract will arise only when changes occur in the contract.

## NOTE 3 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### A. Initial application of accounting standards (contd.)

(4) IFRIC 11 – “Group and Treasury Share Transactions” is an interpretation dealing with the application of “IFRS 2 - Share-based Payment”, in share-based payment transactions related to the equity instruments of the Group.

(5) IFRIC 10 – “Interim Financial Reporting and Impairment”, prohibits the cancellation of an impairment loss that was recognised in a prior interim period in respect of goodwill, investment in an equity instrument or a monetary asset stated on a cost basis. IFRIC 10 applies to the financial statements of the Group for the year 2007.

The application of the new standards has no effect on the Group’s results of operations and its financial position.

### B. New standards during the period not yet adopted

(1) IFRIC 12 – “Segment Reporting Arrangements”. This interpretation relates to the accounting treatment of operators from the private sector that provide public assets and infrastructure services. IFRIC 12 distinguishes between two types of arrangements for service concessions. In one, the operator receives a financial asset, an unconditional contractual right to receive cash or other financial assets from the government in exchange for the construction or upgrading of a public asset. In the other, the operator receives an intangible asset and the right to collect payment in return for the use of the public asset it is constructing or upgrading. The right to collect payment from users is not an unconditional right to receive cash, since the amounts depend on the scope of use the public will make of the service. The interpretation will apply to annual periods commencing on January 1, 2008 or thereafter, and early adoption is permitted. The adoption of IFRIC 12 is not expected to effect the financial statements of the Group.

(2) In June 2007 the IFRIC published Interpretation 13 (“the Interpretation”) – “Customer Loyalty Programmes”. The Interpretation addresses the accounting treatment of companies that grant benefits in frame of Customer Loyalty Programmes (e.g. “points” or “Frequent Flyer”) upon the purchase of goods or services. IFRIC 13 determines how companies should account for their obligation to provide in the future free or discounted goods or services (benefits) to customers that are expected to utilize the benefits. The Interpretation will apply to annual periods commencing on July 1, 2008 or thereafter. The adoption of IFRIC 13 is not expected to significantly effect the financial statements of the Group.

(3) In July 2007 the IFRIC published Interpretation 14 (“the Interpretation”) - “IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction”. The Interpretation addresses three issues: a) when are amortizations in future funding requirements or returns considered “available” in the context of IAS 19 – “Employee Benefits”. b) How does a minimum funding requirement affect the availability of reductions in future contributions. C) when does a minimum funding requirement create a liability. The interpretation will apply to annual periods commencing on January 1, 2008 or thereafter. The adoption of IFRIC 14 is not expected to significantly effect the financial statements of the Group.

(4) IFRS 8 – “Segment Reporting” sets how a company should report on segment operations in its annual financial statements, and addresses selected details pertaining to segments in interim reports. In addition, the standard addresses the required disclosure about products and services, geographic regions and major customers. The standard sets that the identification of segments will be based on reporting to the management that is used to make operational decisions. The standard will apply to annual periods commencing on January 1, 2009 or thereafter. The standard permits early adoption, and requires amendment of comparative numbers on adoption of the standard. The adoption of IFRS 8 is not expected to significantly effect the financial statements of the Group.

## NOTE 3 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### B. New standards during the period not yet adopted (contd.)

(5) In March 2007 an amendment to IAS 23 – "Borrowing Costs" was published. The amendment removes the option of immediately recognising in the income statements all borrowing costs if specific borrowing costs were generated from the purchase, set-up or production of a qualifying asset. The amendment to the standard requires that such costs will be capitalised as part of the cost of such assets. The rest of the borrowing costs will be recorded in the income statement on their generation. The standard will be in effect beginning with the 2009 reports, and is not expected to have a significant effect on the financial statements of the Group.

## NOTE 4 – ESTIMATES

The preparation of interim financial statements requires Management to make judgments and use estimates, assessments and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expenses. Actual results may differ from these estimates.
The significant estimations applied in these interim statements do not differ significantly from those applied to the annual financial statements.

## NOTE 5 – RATES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES

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

| | Consumer Price Index | Rate of exchange of the US dollar | Rate of exchange of the euro |
|---|---|---|---|
| | % | % | % |
| For the six month period ended on: | | | |
| June 30, 2007 | **0.97** | **0.57** | **2.68** |
| June 30, 2006 | 1.55 | (3.54) | 3.62 |
| For the three month period ended on: | | | |
| June 30, 2007 | **1.21** | **2.26** | **3.23** |
| June 30, 2006 | 0.96 | (4.82) | (0.33) |
| For the year ended December 31, 2006 | (0.10) | (8.21) | 2.16 |

## NOTE 6 – PROPERTY, PLANT AND EQUIPMENT

During the reporting period, the Group companies initiated examination of the useful lives of their property, plant and equipment in order to determine whether significant circumstances exist that justify changing the estimated useful lives of the same.

The findings of the examination to date indicate that due to the Company's intention to replace switches in its fixed-line network, it is necessary to shorten the useful lives of these switches. As a result of the aforesaid, depreciation expenses will increase in 2007 by approximately NIS 18 million, in 2008 by approximately NIS 18 million and in 2009 by approximately NIS 14 million, net before tax.

The findings of the examination also revealed that there are assets whose useful lives might exceed the present estimate, but at this stage a new estimate cannot be established. The companies will continue to examine whether the circumstances that support this assessment are significant, also considering the clarification of the Securities Authority that its decision regarding extension of the depreciation period of property, plant and equipment should also be implemented by corporations that report in accordance with IFRS, unless the Authority shall publish otherwise.

## NOTE 7 – GROUP ENTITIES

### A. D.B.S. Satellite Services (1998) Ltd.

Since commencing its operations, DBS has accumulated considerable losses. Its losses in 2006 amounted to approximately NIS 320 million and the loss in the six-month and three-month periods ended June 30, 2007, amounted to approximately NIS 113 million and approximately NIS 65 million, respectively. As a result of these losses, its capital deficit and its working capital deficit as at June 30, 2007 amounted to approximately NIS 2,974 million and approximately NIS 1,595 million, respectively.

The Company's investment in DBS (primarily through shareholders' loans) at the balance sheet date amount to approximately NIS 1,562 million (without interest and linkage). The balance of the current debt of DBS to the Company and its subsidiaries amounts to approximately NIS 121 million, of which approximately NIS 99 million is owed to the Company. The Company has come to an arrangement with DBS for the collection of a debt balance of approximately NIS 55.6 million in arrears. Under the arrangement, the debt will be paid in 60 equal monthly instalments plus interest at prime + 1.5%, as at the balance sheet date the debt balance in the arrangement is approximately NIS 47 million. The remainder of the debt to the Company is a current debt balance, for which the terms of payment are the regular credit terms in effect between the Company and its customers.

On July 31, 2007 DBS issued to institutional investors, in frame of a private placement, debentures (Series A) at a total nominal value of approximately NIS 620 million, that will be registered in the TACT-institutional system (TACT - Tel Aviv Continuous Trading) of the Tel Aviv Stock Exchange. Towards the issuance, the debentures were rated by Maalot - The Israel Securities Rating Company Ltd. ("the Rating Company") at BBB-/stable.

The debentures are payable in 8 annual principal and interest payments every 5$^{th}$ of July in each of the years 2010 to 2017. The principal payments in each of the years 2010 to 2013 will be at a rate of 8% of the nominal value of the debentures, and the principal payments in each of the years 2014 to 2017 will be at a rate of 17% of the nominal value of the debentures. The debentures linked to the consumer price index commencing on June 2007, and bear linked annual interest at the annual rate of 7.9% (subject to various possible adjustments according to the debenture terms), that will be paid in semi-annual payments in January and July of each of the years 2009 – 2017.

DBS did not undertake to list the debentures on the stock exchange, but in the event that they shall be listed the linked annual interest paid for them commencing on the listing date will be reduced to 7.4%. In the event that the debentures shall not listed until July 31, 2008, the linked annual interest paid for them will be increased to 8.4%, while they are not listed (in the event of subsequent listing, the linked annual interest rate will be reduced to 7.4% commencing on the listing date).

In the event that the rating of the debentures shall be reduced by two rating levels while the debentures are not listed, the linked annual interest rate shall be increased to 8%, until the debentures return to their original rating or until they are listed on the stock exchange (in this event, the aforesaid interest rate decrease will also apply). In addition, should DBS fail to comply with the terms set in the financing agreement it had entered into with the banks, and as a condition for the banks ceding the said breach, DBS will undertake to pay to the banks additional interest to that of the bank interest margin, and if the debentures are not listed at the time, then as long as the said margin supplement is paid to the banks and the debentures are not listed, DBS will pay the holders of the debentures an annual interest supplement at the same rate.

The debentures are secured by a first floating lien on all of DBS' assets (other than exceptions as dictated by the provisions of the Communications Law), unlimited in amount. They are further secured by a first fixed charge, unlimited in amount, on DBS' rights and assets that were attached by it in favor of banks (other than exceptions as dictated by the provisions of the Communications Law). The said securities are first level and pari pasu to the floating liens and the fixed charge created by DBS in favor of the banks, in order to secure the bank credit.

## NOTE 7 – GROUP ENTITIES (CONTD.)

### A. D.B.S. Satellite Services (1998) Ltd. (Contd.)

The debentures issuance required the approval of the banks, and such an approval was obtained, subject to the terms set in the letter of agreement of the banks. The said debentures do not include collateral (or any other similar undertaking) of the Company to secure the payments to the holders of the debentures. The Company signed a letter of agreement in favour of the banks financing the DBS operations according to which: (a) it will take all steps required and will set in motion its influence as a shareholder in DBS in order that DBS will fulfil its commitments regarding the continued rating of the debentures. (c) It agrees to set a ceiling for the bank debts and the debt due to the DBS debentures for the purpose of beginning repayment of certain shareholders loans which were given by the Company to DBS (it should be mentioned that no restriction applies, as mentioned above, on the debts and supplier credit in respect of equipment and/or services from shareholders and on the spreading of DBS' past debt to the Company relating to fees for use of the Company's ADSL services).

As of the date of approval of the financial statements, the capital raised in the issue was received.

The loans that the minority in the consolidated Company put up were included in the statements at the fair value at the time received. As part of the debenture rating process of the consolidated company with the rating company, it was agreed to defer the dates on which the shareholders could initially demand settlement of the loans. When a change applies to the anticipated settlement dates of the loans, the difference between the current values of the anticipated cash flows due to the repayment of the loans (hereinafter – the difference) is credited according to the new repayment dates and according to the interest rates that are taken into account on the date the loans were received, and their value in the statements on the date of change (similar to the handling upon receipt of the loans) to the capital reserve. The said difference in the amount of NIS 164 million is expressed in the financial statements of the third quarter of 2007. The difference which will be credited to the capital reserve, as mentioned, is expected to affect the Group's financing costs in the future.

During 2005, the banks completed the provision of the entire credit facility to which DBS was entitled under the financing agreements.

The terms of the loans and the credit facility that DBS received from the banks, the balance of which as at June 30, 2007 is NIS 1,368 million, impose various restrictions on DBS that include, *inter alia*, restrictions on the encumbrance or sale of certain assets, a restriction on receipt of credit from other banks without prior approval, a restriction concerning repayment of shareholders' loans, and a requirement for compliance with financial criteria ("the Conditions").

On July 22, 2007 DBS and the banks entered into the eighth supplement ("the Supplement") to the financing agreement. This Supplement provided for the following subjects, *inter alia*:

(1) The terms set in the financing agreement were updated.
As at the date of approval of the financial statements, DBS is in compliance with the conditions set in the Supplement. However, since DBS prepares its financial statements in accordance with International Financial Reporting Standards (IFRS) that require an examination of DBS' compliance with the conditions as at the date of the financial statements, the loans are classified in these financial statements in frame of the short term liabilities.

(2) The designation of the capital raised in frame of the debenture issuance was set as aforesaid. According to the Supplement, the debenture issuance will be used by DBS for partial repayment of its bank credit, to repay the loan it had taken from an institutional body in 2006 (including a bridge loan granted by that body to DBS in June 2007), in the amount of NIS 100 million, and for DBS' current operations.

During 2005-2006 DBS was granted loans in the total amount of NIS 100 million by institutional bodies. In December 2006, DBS entered into an agreement with another institutional body for a loan in the amount of NIS 50 million. DBS holds an option to receive an additional loan in an identical amount to the amount already received. DBS exercised this option in June 2007. Further to the said debenture issuance, the loan agreement was amended and the parties agreed that DBS will repay the loan principal, in the total amount of NIS 100 million, on receipt of the capital raised in

## NOTE 7 – GROUP ENTITIES (CONTD.)

### A. D.B.S. Satellite Services (1998) Ltd. (Contd.)

the issuance, as aforesaid, since the institutional body purchased debentures in frame of the issuance. Accordingly, the loan was classified as being current.

On January 2, 2005, the Antitrust Commissioner gave his conditional approval for a merger of the Company and DBS (increasing the holdings of the Company in DBS to more than 50%). The merger was not realised with the elapse of a year from the date of the approval, and a new consent was required. On August 2, 2006, the Company and DBS submitted new merger notices to the Antitrust Commissioner, in the matter of exercise of options for shares in DBS by the Company, which would increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Authority gave notice of the Commissioner's opposition to the merger, and on February 18, 2007 it gave its reasons for the opposition. On May 15, 2007, the Company filed an appeal against the decision.

As at the date of approval of the financial statements, DBS exceeds the credit terms set in agreements with certain suppliers. DBS is acting to reduce the balances owed to these suppliers.

On December 24, 2006, the Board of Directors of DBS approved its budget for 2007. According to this budget, DBS will require additional external financing in 2007. As at the date of approval of the financial statements, DBS closed a private placement of debentures to institutional investors, in the total amount of NIS 620 million, as aforesaid. DBS' management estimates that the consideration of the said debenture issuance will provide it with the sources of financing required by DBS in the forthcoming year.

### B. Bezeq International Ltd.

Further to Note 32(4) to the Group's financial statements for the year 2006, regarding an agreement with Bezeqcall Communication Ltd. for the acquisition of all operations of Tadiran – Telecom Communication Services in Israel ("Tadiran") for a consideration of approximately NIS 93 million, the said agreement has been cancelled in light of the Antitrust Authority's decision to withhold approval of the transaction and following Tadiran announcement of its decision to cancel the agreement.

## NOTE 8 – CONTINGENT LIABILTIES

### A. Claims

During the normal course of business, legal claims have been filed against the companies in the Group, including applications for certification as class action lawsuits.

In the opinion of the managements of the Group's companies, based, *inter alia*, on legal opinions regarding the probability of success of the claims, including the applications for certification of the class action lawsuits, appropriate provisions in the amount of NIS 320 million, where such provisions were required, have been included in the financial statements to cover the exposure resulting from such claims.

In the opinion of the managements of the Company and the consolidated companies, the additional exposure (in addition to the above provisions) as at June 30, 2007, due to claims filed against the companies in the Group on various matters and the probability of realisation of which is remote or likely, amounts to approximately NIS 30 billion, of which approximately NIS 3.4 billion relates to claims filed by employees.

Concerning applications for certification as class action of lawsuits in respect to which the Group has exposure beyond the aforesaid (since the claims do not state a specific amount), see claims in Note 17A(4), (5), (7) and (19) to the financial statements as at December 31, 2006 .

For a detailed description of these claims, see Note 17A to the Group's annual financial statements as at December 31, 2006. Details of the significant changes to the status of the material contingent liabilities of the Group since December 31, 2006 are provided below:

(1) Further to Note 17A(4) to the financial statements as at December 31, 2006, on April 10, 2007 a ruling granted effect to the procedural arrangement, in frame of which the Company and Bezeq International will be struck off the claim (after undertaking to transfer any sum transferred to them by the Department of Customs and VAT, if at all, in connection with the claim, as instructed by the court).

(2) Further to Note 17A(27) to the financial statements as at December 31, 2006, regarding application for certification of a class action against Pelephone concerning the allegation of the misleading of the defendant's subscribers who reside in Eilat, who were charged VAT for cellular communication service, the claim was rejected without a cost payment order.

(3) Further to what is mentioned in Note 17a(18) to the financial statements as at December 31, 2006, on June 11, 2007, a hearing was held during which the Court ignored all the facts of the case requiring the rejection of the request for class action and stressed the fact that in the minutes of the Bezeq International's board of directors meetings some unfortunate things were heard relating to the management of Bezeq International opening the market to competition. Under these circumstances, the Court suggested that Bezeq International publish some form of apology and make some sort of contribution for public benefit. On June 24, 2007, Bezeq International sent notice to the Court stating that there was no need for an apology or a contribution, since there was no deception and/or misleading advertising. Furthermore, Bezeq International stated that in view of the respect it has for the Court, it would make a contribution to the public, which cannot be bound to the class action. As of the date of this report, no response has yet been received that contests this notice.

(4) In May 2007, a claim arrived at the Company's offices, together with a request to recognise it as a class action, that was filed with the District Court in Tel Aviv by a plaintiff claiming to have purchased shares of the Company in 2006. The claim was filed against the Company, two former CEOs of the Company, directors who served in the Company during the relevant period, as well as Ap.Sb.Ar. Holdings Ltd., that holds 30% of the Company's shares.

## NOTE 8 – CONTINGENT LIABILITIES (CONTD.)

### A. Claims (contd.)

The claim involves the assertion that the Company's financial statements for the years 2004 and 2005 contained false and misleading material information, including with respect to the annual profit, to property, plant and equipment and to shareholders' equity, in light of a retroactive depreciation amounting to approximately NIS 320 million in respect of property, plant and equipment that was not in use by the subsidiary Pelephone Communications Ltd.

The amount of the personal action is NIS 194, and the total amount of the claim for the Group is NIS 56.5 million.

(5) In April 2007, an application was filed with the District Court for certification of a class action against DBS and against Sports Channel Ltd. (the producer of Channel 5, Channel 5+, Channel 5 live and Channel 5 gold)and its managers, in connection with the broadcasts of Channel 5 live ("the Certification Application"). According to the applicant, the broadcasts of Channel 5 live involve the transfer of content from Channel 5+ to Channel 5 live, which contravenes "the basic promise of DBS as ratified in earlier legal proceedings". The applicant, whose cause of claim against DBS is violation of a contractual undertaking, breach of the duty of good faith in a contractual engagement and unjust enrichment, estimates the amount of the action at approximately NIS 63 million.

### B. Claims in respect of which exposure cannot yet be assessed or calculated

For a detailed description of the claims in respect of which the exposure cannot yet be assessed or calculated, see Note 17B to the Group's annual financial statements as at December 31, 2006. Details of material changes since December 31, 2006 are provided below:

(1) In June 2007, a claim was filed against Pelephone with the District Court in Tel Aviv, along with a request to recognise it as a class action. The aggregate amount of the claim is approximately NIS 239 million, and it concerns a group of customers that belong to the Russian sector and that the pricing plans, subject matter of the claim, were offered to them.

The claim raises allegations of Pelephone misleading of the customer at the time the agreement was entered into with him, conducting itself in bad faith, and continuously misleading the customer – it offered him the pricing plan without warning him that the charge is based on rounding up to 60 seconds units, rather than on 12-second charge units (according to the plaintiffs, this is provided for in the license).

In addition, it is claimed that Pelephone failed to attach the price list to the pricing plan as is required by its license, in order to advance its intention of misleading. The claim is being studied and a position about its effect cannot yet be formed. Pelephone will study the claim and will respond as required.

(2) In August 2007, the Company received a claim to which was attached an application to approve class action which was filed against the Company in the Tel Aviv District Court by a claimant claiming to be a customer of the Company who signed a contract with the subsidiary company DBS to receive infrastructure services for broad band internet (ADSL). The claimant is demanding reimbursement of all the fixed monthly payments made by the claimant for maintaining a land line telephone for which the claimant no longer has any use, since he claims that these payments were unlawfully collected since from the technological aspect, the provision of broad band internet could have been supplied without the land line being used. The claimant is claiming that the said claim be open to all the Company's customers and/or DBS customers who were subscribers of the Company's broad band internet services during the past two years and who requested disconnection of the Company's land line telephone and/or who stopped using it but continued paying the fixed monthly payments for it. The claimant requested that his claim be approved as a class action in the name of the customers as specified above and estimates the scope of the class action case as NIS 108 million. The Company is reviewing the claim and it is not possible at this stage to estimate the outcome.

## NOTE 8 – CONTINGENT LIABILITIES (CONTD.)

### B. Claims in respect of which exposure cannot yet be assessed or calculated (contd.)

(3) In July 2007, a statement of defense was filed on behalf of a body that was sued by DBS. At the same time, this body filed a statement of counter claim in the sum of approximately NIS 42.6 million against DBS and another company, in which the interested party is an interested party in DBS, jointly and severally. In the framework of the statement of defense and the statement of counter claim, it was charged that the liability for the faults in the decoders falls on DBS and/or the other company, *inter alia* since in its view, the decoders were not characterized properly by the defendants, were not properly checked by the defendants and since the decoders, at least in part, were not properly installed at the homes of DBS subscribers. In light of these and other claims, according to the statement of counter-claim, it suffered, in its view, various kinds of damage relating to the need to repair the decoders even after the warranty period under the contract, to provide spare parts, to provide human resources services and due to various payments made, it alleges, to the other company. In the alternative, the body is suing for expenses and loss of profits caused to it, it alleges, due to the acts and omissions of DBS and/or the other company, in the sum of US $ 15 million. For the purpose of fees, the claim has been set, as aforesaid, in the sum of approximately NIS 42.6 million. No statement of counter-defense has yet been filed. At this preliminary stage, before the position of DBS has been formed and before gathering the relevant data for preparing the response, the chances of the claim, if approved, cannot be assessed.

### C. Other contingencies

For a detailed description of other contingencies, see Note 17C to the Group's annual financial statements as at December 31, 2006. Details of material changes since December 31, 2006 are provided below:

(1) In May 2007, a request arrived at the Company's offices, pursuant to Article 194 of the Companies Law, that was sent by an applicant who claims to be a holder of the Company's publicly owned shares. According to the request, following the findings of the external examiner appointed by the Company to examine the manner in which various decisions are made and as well as the Company's conduct, that point to a multitude of shortcomings and failures related directly to the work of the Board of Directors, its committees, its members and the former CEO of the Company, the Company is requested to take legal action against the Board of Directors and the Company's other officers who were responsible for the same. The Company's Board of Directors rejected the demand and informed the applicant to that effect.

(2) Further to Note 17C(2) to the Group's annual financial statements for the year 2006, regarding commissions paid to DBS and the debts of DBS to the Company, the Company's Board of Directors rejected the demand and informed the applicant to that effect.

(3) Further to Note 17C(1) to the Group's annual financial statements for the year 2006, on May 27, 2007 the Antitrust Commissioner announced that it is considering exercising its authority under Article 43(A)(5) to the Antitrust Law, 5748-1988, to determine that the Company had abused its status, thus violating the provisions of Article 29A to the Law. This in view of the findings of an investigation carried out over the past few months by the Investigation Department of the Antitrust Authority.

The Commissioner is considering ruling that –

a. In the first half of 2006, and in particular in April and May 2006, the Company's employees initiated sanctions, in frame of which they delayed or failed to carry out works involving the connection of inland operators (Cellcom, Globcall and Golden Lines) to the Company's network.

## NOTE 8 – CONTINGENT LIABILTIES (CONTD.)

### C. Other contingencies (contd.)

b. During the afternoon hours of May 17, 2006, the existing connection between HOT Telecom and the Company's network was disconnected and was not repaired, due to sanctions of Company employees, until the night of May 18, 2006.

c. The Company failed to act as required in order to prevent or minimise these events and the ensuing damage to inland operators, to competition and to the public.

d. Thus the Company abused its status, in contravention of Article 29A to the Law.

Under Article 43(e) of the Antitrust Law, the Antitrust Commissioner's said ruling, if and insofar as made, shall serve as *prima facie* evidence in any legal proceeding.
The Company is required to submit in writing its position to the Antitrust Commissioner by September 15, 2007.

It should be noted that in May 2006, a claim was filed against the Company and against the cable companies, along with an application for certification as a class action, regarding a malfunction in HOT's telephone line that had occurred on May 17, 2006. On this matter see Note 17A12 to the Company's annual financial statements for the year ending December 31, 2006. The Antitrust Commissioner's said ruling will require reviewing this claim, based on the content of the determination and the extent of its implication on the matter in dispute.

(4) Further to Note 17C(7) to the Group's annual financial statements for the year 2006, concerning number portability, on May 24, 2007 the Company received a notice from the Director General of the Ministry of Communications, stating that he is considering imposing on the Company a financial sanction due to the alleged violation of the duty to provide number portability commencing on September 1, 2006, as follows:

a. For the period from September 1, 2006 to the date of the Director General's notice – a financial sanction in the amount of NIS 2,031,750.

b. For the period commencing on May 25, 2007 and ending on November 30, 2007 or until the date of remedy of the alleged violation (the earlier of the two) by the Company – NIS 6,450 for each additional day on which the violation continues.

c. For the period commencing on December 1, 2007 (which, according to the notice, allows the relevant licensees reasonable time to remedy the alleged violation) and ending on the date of remedy of the alleged violation – a financial sanction as specified in Articles 37B(b) and 37C(a) of the Communications Law following Amendment 36 (it should be noted that according to the provisions of these Articles, the relevant sanction amount is seven times the fine set in Article 61(a)(4) of the Penal Law (that is NIS 202,000), plus 0.25% of the annual income of the Company, plus a financial sanction of one fiftieth of such sanction for each day on which the violation continues.)

The subsidiaries Pelephone Communications Ltd. and Bezeq International Ltd. received similar notices. According to the notices from the Ministry of Communications, Pelephone and Bezeq International were given an opportunity to bring their positions before the Director General of the Ministry of Communications by June 24, 2007. In its response, the Company argued that its position does not constitute a violation of the provisions of the Law or of its license, that the matter is pending before the High Court of Justice, and that in any case, under the circumstances it will be unreasonable to impose sanctions on the Company, including in view of the date set by the Ministry of Communications as reasonable for implementation of the numbers portability (December 1, 1007). As noted in the financial statements as at December 31, 2006, the Company and Pelephone (together with other mobile operators) petitioned the High Court of Justice on this matter, contending, *inter alia*, that it was the Ministry of Communications that had failed to prepare a number portability plan as required by the provisions of the law.

## NOTE 8 – CONTINGENT LIABILTIES (CONTD.)

### C. Other contingencies (contd.)

(5) Further to Note 17C(6) to the Group's annual financial statements for 2006, in the first half of 2007, the Company took steps to obtain operation permits from the Supervisor of Non-Ionizing Radiation at the Ministry of the Environment, pursuant to the Radiation Law that came into effect at the beginning of 2007. Following these steps, the Company received operation permits for the communication facilities that it operates, with the exception of a few which still have a valid radiation permit by virtue of the Pharmacists Regulations. The Company is taking steps to obtain operation permits under the Radiation Law for these few facilities.

### D. Claim against affiliated company

In July 2007, a statement of claim was filed in the Jerusalem District Court against an affiliate of Bezeq International, the Israeli Police, the State of Israel, and 7 other defendants from the telecommunications field for a total amount above NIS 65 million for bodily damages allegedly caused to the plaintiff, regarding publication of lies and libel regarding the involvement of the defendant in securities violations and conspiracy to commit murder. In the opinion of the affiliated company and its legal advisors, since the claim is not supported by concrete evidence and as the affiliated company is not the principal party in the claim, the chances of the claim against the affiliated company are low and therefore the affiliated company did not make provisions for this claim in its financial statements.

## NOTE 9 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

**A.** Further to Note 29D to the Company's financial statements as at December 31, 2006, concerning the cancellation of discount arrangements included in the agreement between the Company and the Ministry of Defence dated May 8, 2005 (hereinafter "the 2005 agreement"), on April 22, 2007 the Company informed the Ministry of Communications and the Ministry of Defence of its decision to comply with this demand. It should be noted that the Company received a copy of the letter sent by the Ministry of Defence to the Ministry of Communications, that contained a request to freeze the instruction regarding cancellation of the discount arrangements set in the agreement between the parties, until the convening of a work meeting between the Ministry of Defence and the Ministry of Communication that will discuss the subject. However, as at the date of publication of this report, the Company has yet to receive a different instruction from the Ministry of Communications. It should be noted that in the Company's opinion, it was entitled to enter into the agreement in accordance with its general license. In addition, according the Antitrust Authority's notice dated August 2006, the agreement does not contravene the provisions of the Antitrust Law, and the Authority saw no justification, at that time, to insist on cancellation of the agreement. The Company already notified the Ministry of Communications of the Antitrust Authority's position in August 2006. It is further noted, that according to the agreement between the Company and the Ministry of Defence, according to which should one of the parties be unable to fulfil its undertakings provided for in the agreement due to a legal directive or resolution of a competent authority, the same shall not constitute breach, and the parties shall negotiate another agreement, the terms of which shall reflect, to the extent possible, the wishes of the parties in accordance with the agreement. The Company has requested an urgent negotiation meeting with the Ministry of Defence, but this request has not yet been granted. On July 22, 2007 the Company informed the Ministry of Defence, that commencing on April 22, 2007 the Ministry of Defence will be charged based on rates set in a prior agreement entered into with it, dated July 21, 2002 (hereinafter "the 2002 agreement"), and that this arrangement will apply unless otherwise agreed between the parties, or alternatively unless an explicit instruction of the Ministry of Communications is received, that freezes or cancels its previous instruction regarding cancellation of the discount arrangement provided for in the agreement dated May 8, 2005. On August 5, 2007 the Ministry of Defense informed the Company that the settling of accounts between the Company and the Ministry of Defense according to the fees in the 2002 agreement contradicts the provisions of the 2005 agreement and the Ministry of Defense pays its suppliers only according to agreements signed under the State Property Law.

## NOTE 9 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

The Company is unable to assess the developments at this stage, and therefore the financial statements include income from the Ministry of Defence that is based on the rates provided for in the agreement dated May 8, 2005, that are estimated to be lower than the rates in the previous agreement from 2002 and lower than the Company's regular rates (for the period commencing in October 2005 and ending on June 30, 2007).

**B.** Further to Note 26B to the financial statements as at December 31, 2006 regarding options to two employee directors, it was resolved not to hold the shareholders' meeting convened for this purpose and the Company is working to re-approve allocation of the options by its competent organs.

**C**. Further to Note 29E to the financial statements as at December 31, 2006, on July 29, 2007 an agreement was entered into with a company owned and controlled by Ap.Sb.Ar., in the framework of which the Company will be provided regular management and consulting services in consideration for 1.2 million US dollars annually, in the period commencing on October 11, 2005 and ending on December 31, 2008.

**D.** Further to Note 29H to the financial statements as at December 31, 2006, on July 28, 2007 Ap.Sb.Ar., that owns 30% of the Company's shares, informed the Company that it has entered into an agreement with the former CEO of the Company, Mr. Amnon Dick, according to which Ap.Sb.Ar. will pay him special compensation in the amount of NIS 5,750 thousand, as a gesture for his contribution to the Company. The remuneration is recorded in the Company's ledgers as a salary expense and at the same time in the capital reserve operating between the Corporation and the controlling shareholder.

**E.** Further to Note 29G in the financial statements as at December 31, 2006, in the matter of cancellation of the bonus for the former CEO, Mr. Yacov Gelbard, the Company decided that if this bonus is not returned to the Company, it will take all legal steps to collect the debt.

## NOTE 10 – REVENUES

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Fixed-line domestic communications | **2,524,095** | 2,535,863 | **1,265,927** | 1,262,255 | 5,086,022 |
| Cellular telephone | **1,767,696** | 1,708,032 | **886,037** | 863,822 | 3,493,541 |
| Multi-channel television | **670,677** | 626,365 | **338,325** | 316,452 | 1,284,337 |
| Sale of equipment to subscribers, installations and miscellaneous | **631,526** | 564,238 | **317,923** | 268,484 | 1,170,771 |
| International communications and internet services | **433,746** | 469,105 | **181,056** | 240,307 | 963,942 |
| | **6,027,740** | 5,903,603 | **2,989,268** | 2,951,320 | 11,998,613 |
| Other revenues | **113,614** | 127,386 | **63,407** | 67,570 | 233,217 |
| | **6,141,354** | 6,030,989 | **3,052,675** | 3,018,890 | 12,231,830 |

## NOTE 11 – OPERATING AND GENERAL EXPENSES

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| General expenses | **551,104** | 531,601 | **294,398** | 253,189 | 1,169,107 |
| Cellular telephone expenses | **891,262** | 916,915 | **439,154** | 456,973 | 1,854,347 |
| Materials and spare parts | **429,355** | 413,164 | **209,406** | 215,872 | 922,449 |
| Consumption of satellite services content | **201,736** | 216,157 | **97,690** | 107,715 | 441,268 |
| Services and maintenance by sub-contractors | **192,256** | 211,859 | **90,347** | 100,665 | 428,424 |
| Building maintenance | **165,752** | 170,204 | **83,849** | 85,947 | 347,849 |
| International communication expenses | **185,451** | 191,407 | **86,884** | 95,001 | 383,496 |
| Motor vehicle maintenance expenses | **93,211** | 91,518 | **47,380** | 46,550 | 190,079 |
| Royalties to the Government of Israel | **96,003** | 89,422 | **47,639** | 26,228 | 179,589 |
| Collection fees | **26,252** | 25,273 | **12,865** | 12,946 | 50,008 |
| | **2,832,382** | 2,857,520 | **1,409,612** | 1,401,086 | 5,966,616 |

## NOTE 12 – CONDENSED DATA FROM THE INTERIM SEPARATE FINANCIAL STATEMENTS OF THE COMPANY

### A. Income statement

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** (See B below) | **2,835,163** | 2,894,531 | **1,392,821** | 1,440,015 | 5,798,996 |
| **Costs and expenses** | | | | | |
| Depreciation and amortisation | **472,518** | 516,096 | **235,103** | 258,420 | 1,026,469 |
| Salary | **635,768** | 635,994 | **325,989** | 325,107 | 1,557,000* |
| General and operating expenses | **1,066,971** | 1,091,216 | **534,066** | 524,918 | 2,233,167* |
| Other expenses (income), net | **47,445** | 63,417 | **54,384** | 51,514 | 228,893 |
| | **2,222,702** | 2,306,723 | **1,149,542** | 1,159,959 | 5,045,529 |
| Operating income for the period | **612,461** | 587,808 | **243,279** | 280,056 | 753,467 |

* Reclassified

### B. Revenues segmentation

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Telephony | **1,942** | 2,050 | **947** | 1,018 | 4,088 |
| Internet | **337** | 298 | **172** | 149 | 608 |
| Transmission and data communication | **366** | 350 | **184** | 175 | 711 |
| Other services | **190** | 197 | **90** | 98 | 392 |
| Total | **2,835** | 2,895 | **1,393** | 1,440 | 5,799 |

## NOTE 13 –SEGMENT REPORTING

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

| | For the six-month period ended June 30, 2007 (unaudited) | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Domestic fixed–line communications** | **Cellular telephone** | **International communications, internet and NEP 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 | **2,674,274** | **2,144,348** | **624,641** | **689,570** | **8,521** | **-** | **6,141,354** |
| Inter-segment revenues | **160,889** | **154,541** | **19,571** | **18,296** | **21,088** | **(374,385)** | **-** |
| Total revenues | **2,835,163** | **2,298,889** | **644,212** | **707,866** | **29,609** | **(374,385)** | **6,141,354** |
| **Segment results** | **612,461** | **453,039** | **104,420** | **55,682** | **1,937** | **-** | **1,227,539** |

| | For the six-month period ended June 30, 2006 (unaudited) | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Domestic fixed–line communications** | **Cellular telephone** | **International communications, internet and NEP 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 | 2,753,569 | 2,015,410 | 600,921 | 651,720 | 9,369 | - | 6,030,989 |
| Inter-segment revenues | 140,962 | 170,285 | 39,818 | 17,902 | 17,922 | (386,889) | - |
| Total revenues | 2,894,531 | 2,185,695 | 640,739 | 669,622 | 27,291 | (386,889) | 6,030,989 |
| **Segment results** | 587,808 | 364,631 | 69,806 | 9,699 | 217 | - | 1,032,161 |

## NOTE 13 –SEGMENT REPORTING (CONTD.)

**For the three-month period ended June 30, 2007 (unaudited)**

| | Domestic fixed–line communications | Cellular telephone | International communications, internet and NEP 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 | **1,312,158** | **1,076,542** | **318,872** | **339,653** | **5,450** | **-** | **3,052,675** |
| Inter-segment revenues | **80,663** | **74,914** | **2,698** | **14,627** | **9,675** | **(182,577)** | **-** |
| Total revenues | **1,392,821** | **1,151,456** | **321,570** | **354,280** | **15,125** | **(182,577)** | **3,052,675** |
| **Segment results** | **243,279** | **239,920** | **53,595** | **31,681** | **2,075** | **-** | **570,550** |

**For the three-month period ended June 30, 2006 (unaudited)**

| | Domestic fixed–line communications | Cellular telephone | International communications, internet and NEP 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 | 1,367,007 | 1,013,064 | 304,328 | 329,771 | 4,720 | - | 3,018,890 |
| Inter-segment revenues | 73,008 | 84,207 | 19,345 | 12,853 | 8,905 | (198,318) | - |
| Total revenues | 1,440,015 | 1,097,271 | 323,673 | 342,624 | 13,625 | (198,318) | 3,018,890 |
| **Segment results** | 280,056 | 189,867 | 34,228 | 11,344 | 305 | - | 515,800 |

**Notes to the Financial Statements as at June 30, 2007**

## NOTE 13 –SEGMENT REPORTING (Contd.)

| | For the year ended December 31, 2006 (audited) | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed–line communications | Cellular telephone | International communications, internet and NEP 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 | 5,514,799* | 4,140,771* | 1,016,300 | 1,338,826 | 221,134 | - | 12,231,830 |
| Inter-segment revenues | 284,197* | 337,216* | 21,519 | 23,563 | 97,545 | (764,040) | - |
| Total revenues | 5,798,996 | 4,477,987 | 1,037,819 | 1,362,389 | 318,679 | (764,040) | 12,231,830 |
| **Segment results** | 746,320 | 691,682 | 131,416 | 7,707 | (11,923) | - | 1,565,202 |

* Reclassified.

## NOTE 14 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION

As noted in the financial statements for the year 2006, the Group first adopted IFRS in 2006, with January 1, 2005 set as the transition date. In preparing its opening balance sheet in accordance with IFRS and in the Group balance sheet as at January 1, 2006, the Group has adjusted amounts reported previously in financial statements prepared in accordance with its previous basis of accounting (Israeli GAAP).

Explanations of the material effects of the transition from Israeli GAAP to IFRS on the Group's financial position and on its results of operation as of June 30, 2006 and for the three-month period then ended, are provided below. For the full explanations in respect to the transition from Israeli GAAP to IFRS on the transition date and in respect to the reserve balance as at January 1, 2006, see Note 33 to the Group's financial statements for the year 2006.

**Material adjustments to the balance sheet line items**

| | Note | Israeli GAAP | Effect of the transition to IFRS June 30, 2006 | IFRS |
|---|---|---|---|---|
| | | NIS thousands | NIS thousands | NIS thousands |
| Property, plant and equipment | a-f, k, l | 9,131,967* | (2,298,432) | 6,833,535 |
| Intangible assets | d, g | 1,693,685 | 877,997 | 2,571,682 |
| Deferred tax assets | a-c, g, h, l | 532,866* | 457,257 | 990,123 |
| Equity capital | a-c, f-g, j, l | 7,060,677* | (1,641,227) | 5,419,450 |

**Material adjustments to the income statement line items for the six-month period ended June 30, 2007**

| | Note | Israeli GAAP | Effect of the transition to IFRS June 30, 2006 | IFRS |
|---|---|---|---|---|
| | | NIS thousands | NIS thousands | NIS thousands |
| Revenues | l | 6,045,223* | (14,234) | 6,030,989 |
| Costs and expenses | a-c, f-g, j, l | 5,176,869* | (178,041) | 4,998,828 |
| Net earnings for the period (attributable to shareholders of the Company) | a-c, f-g, j, l | 471,405* | 131,403 | 602,808 |
| **Earnings per share** | | | | |
| Basic and diluted earnings per share (in NIS) | | 0.18* | 0.05 | 0.23 |

* Restated – see section (l) below.

## NOTE 14 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

**Material adjustments to the income statement line items for the three-month period ended on June 30, 2006**

| | Note | Israeli GAAP | Effect of the transition to IFRS June 30, 2006 | IFRS |
|---|---|---|---|---|
| | | NIS thousands | NIS thousands | NIS thousands |
| Revenues | l | 3,024,968* | (6,078) | 3,018,890 |
| Costs and expenses | a-c, f-g, j, l | 2,566,195* | (63,105) | 2,503,090 |
| Net earnings for the period (attributable to shareholders of the Company) | a-c, f-g, j, l | 239,161* | 49,545 | 288,706 |
| **Earnings per share** | | | | |
| Basic and diluted earnings per share in NIS) | | 0.09* | 0.02 | 0.11 |

* Restated – see section (l) below.

**Notes to the material adjustments**

a. In accordance with the relief under IFRS 1, as of the transaction date, the Group chose to state some of the property, plant and equipment items (the switching, transmission and power group) at their fair value and to determine this value as deemed cost. The deemed cost was based on an external expert opinion. As a result, the property, plant and equipment balance decreased by NIS 1,246 million at June 30, 2006, to a fair value of approximately NIS 1,336 million at that date, while the deferred tax balances deriving from the differences in the measurement of the property, plant and equipment for tax purposes changed compared with the presentation of property, plant and equipment for accounting purposes, by approximately NIS 356 million as at June 30, 2006. The reserve balances were reduced on that date by the net amounts. The depreciation expenses for the six- and three-month periods ended on June 30, 2006 decreased by NIS 169 million and NIS 83 million, respectively.

b. On the date of transition to IFRS, in accordance with the directives of IAS 16, the residual value of the property, plant and equipment not included in the calculation of depreciation according to accepted accounting principles in Israel was measured. The revaluation was based on an opinion of an external appraiser. The effect was to increase the property, plant and equipment balances by approximately NIS 55 million and to reduce the depreciation expense for the six- and three-month periods ended on June 30, 2006 by approximately NIS 23 million and NIS 11 million, respectively. Another effect was to change the deferred tax balances derived from the differences in the measurement of the property, plant and equipment for tax purposes as compared with the presentation of property, plant and equipment fin the financial statements. The reserve balances were reduced by the same net amounts as at the above dates.

c. Under IAS 37, the Group is required to recognise liabilities to bear the costs of site decommissioning and clearing. Under IFRS 1, the Group selected a relief that allowed it to capitalise the expected costs of decommissioning and clearing sites at the transition date at historical capitalization rates.

   As a result, the property, plant and equipment balances as at June 30, 2006 increased by NIS 16 million, and the reserve balance decreased by approximately and NIS 9 million (net of tax) as at the same date.

d. Under IFRS, computer software and capitalised software development costs that do not constitute an integral part of the hardware attributed to them, are treated as intangible assets. Accordingly, with the transition to IFRS, the carrying balances at June 30, 2006, of approximately NIS 478

## NOTE 14 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

**Notes to the material adjustments (cont.)**

million, relating to computer software and to capitalised software development costs, were reclassified from the property, plant and equipment item to the intangible assets item.

e. Under accepted accounting principles in Israel, agreements granting the Group an indefeasible right of use of sea-bed cable capacity were treated as a finance lease and a related asset was recognised in the balance sheet in the property, plant and equipment item. Under IFRS and as provided for in IFRIC 4, that determines whether an arrangement includes a lease, there are criteria for determining whether a right to use an asset is an arrangement having the form of a lease. If it is not a lease, the arrangement should be classified as an arrangement for receipt of services. The effect of application of the provisions of IFRS and in the absence of the criteria required for the said arrangements to be defined as a lease, the amounts paid to the suppliers for a future right of use of sea-bed cable capacity were classified as deferred and other long-term expenses.

The effect of the transition to IFRS was to decrease property, plant and equipment by approximately NIS 190 million at June 30, 2006, against an increase in the following items:

(1) Other accounts receivable (prepaid expenses), of approximately NIS 19 million as at June 30, 2006.
(2) Other long-term assets (long-term prepaid expenses in respect of a right of use of capacity), of approximately NIS 149 million.

f. Under accepted accounting principles in Israel, customer acquisition costs in a subsidiary were partially capitalised to property, plant and equipment and depreciated over 6 years, and a part of the same was charged as a current expense to profit and loss. Under IFRS, these costs were capitalised and are depreciated over the term of the contractual engagement of the subscriber,that is usually one year.

The difference between the accumulated depreciation under accepted accounting principles in Israel and the accumulated depreciation under IFRS for the three-month period ended on June 30, 2006 amounts to approximately NIS 287 million (decrease in property, plant and equipment), and the effect on the depreciation expenses for the six- and three-month periods ended on June 30, 2006 is a decrease of approximately NIS 19 million and NIS 10 million, respectively.

g. Under accepted accounting principles in Israel, the Group recognised as an asset the net direct costs paid to a third party in respect of sale to subscribers who signed a commitment to remain customers of the Group as well as the losses in respect of subsidising equipment. These costs included the commissions paid to external dealers, as well as the losses in respect of subsidising the terminal equipment for customers (“Subscriber Acquisition”). This Subscriber Acquisition was depreciated to profit and loss over the term of the customer commitment, that is, up to 36 months.

Under IAS 38, the Group defers only the incremental direct sales commissions to employees and to external dealers in respect of sales to those subscribers who signed a commitment to remain customers of the Group. These costs are depreciated to profit and loss over the term of the commitment of the subscribers, which is up to 36 installments. The losses in respect of subsidising the telephones is attributed to profit and loss and are not deferred. As a result, the Subscriber Acquisition asset as at June 30, 2006 was reduced by approximately NIS 67 million. This adjustment has no material effect on profit and loss for the six-month period ended June 30, 2006, whilst the effect on profit and loss for the three-month period ended June 30, 2006 is an increase of approximately NIS 4 million before tax.

h. Under IFRS, deferred tax assets are classified as non-current assets, even if the expected date of their realisation is expected to be in the short term. Under accepted accounting principles in Israel, deferred tax assets were classified as current or non-current assets, depending on the classification of the assets in respect of which they were generated.

## NOTE 14 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

**Notes to the material adjustments (cont.)**

Accordingly, with the transition to IFRS, the balance of short-term deferred taxes was reclassified, as at June 30, 2006, in the amount of approximately NIS 202 million, from the accounts receivable and debit balances item under current assets, to the deferred tax item under non-current assets (in this Note, the deferred taxes are stated after the above reclassification).

i. Under IFRS, bank loans to a subsidiary, of approximately NIS 1,269 million, were stated as short-term loans, while under accepted accounting principles in Israel these loans were classified as long-term loans. The classification was changed due to the transition to IFRS and since the subsidiary failed to meet financial criteria set by the banks for these loans on the balance sheet date.

j. Under accepted accounting principles in Israel, the minority item in the Company is measured at the amount of the loans provided by the minority for DBS, a subsidiary, at their carrying value in the consolidated company, and stated net of those loans.

Under IFRS, the minority rights are stated in the consolidated balance sheet as a separate component of the shareholders' equity, in the amount of the loans provided by the minority for a subsidiary at their fair value, plus the costs of financing in respect of those loans, accumulated from the acquisition date to the balance sheet date. The minority equity in the capital deficit of the subsidiary is stated under distribution of profits between the majority shareholders and the minority shareholders.

k. Other material classifications made in accordance with the provisions of IFRS:

1. Leases of land from Israel Lands Administration classified as operating leases, of approximately NIS 224 million at June 30, 2006, were reclassified from the property, plant and equipment item to the deferred expenses item.
2. Materials and spare parts that were stated in a separate item between the current assets item and the property, plant and equipment item were reclassified to property, plant and equipment in the amount of NIS 73 million as at June 30, 2006.
3. Other income, net, was classified under other operating income, net.

**l. Restatement**

The financial statements as at June 30, 2006, were adjusted by way of restatement in order to retroactively reflect the following changes:

(1) Recording of amortisation of lease payments in respect of land from the Israel Lands Administration over the term of the lease and not as amortised since the establishment of the Company (4%). The effect of this amendment is the addition of approximately NIS 108 million to property, plant and equipment, and of approximately NIS 82 million to the balance of shareholders' equity as at June 30, 2006. The amendment does not have a material effect on the profit for the six- and three-month periods ended June 30, 2006.

(2) Presentation of receipts from interconnect to the cellular networks, that were not stated commencing 2000 as part of the Company's income, and correspondingly as an operating expense in the same amount, following examination of the criteria under international standards and in order to present them as accepted in Israel and worldwide. The effect of this amendment for the six- and three-month periods ended June 30, 2006 is an increase to income and a corresponding increase to operating and general expenses of approximately NIS 400 million and NIS 199 million, respectively.

(3) Amendment of the accounting treatment of the depreciation of property, plant and equipment not used by Pelephone, and the resulting tax implications. The effect of this amendment is to depreciate property, plant and equipment by approximately NIS 265 million, and to reduce the balance of shareholders' equity by approximately NIS 190 million June 30, 2006, as well as to reduce depreciation expenses by approximately NIS 20 million and NIS 10 million and to

## NOTE 14 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

### I. Restatement (Contd.)

increase net profit by approximately NIS 15 and NIS 7 million for the six- and three-month periods ended on June 30, 2006, respectively.

The table below shows the effect of restatement as aforesaid on the comparative numbers according to accepted accounting principles in Israel at June 30, 2006, before the effects of IFRS.

#### (1) Effect on the consolidated balance sheet

| | As previously reported | Effects of restatement | As reported in these financial statements prior to their adjustment to IFRS |
|---|---|---|---|
| | NIS thousand | NIS thousand | NIS thousand |
| Property, plant and equipment | 9,289,159* | (157,192) | 9,131,967 |
| Deferred tax assets | 484,435 | 48,431 | 532,866 |
| Shareholders' equity | 7,169,438 | (108,761) | 7,060,677 |

* Reclassified

#### (2) Effect on undesignated retained earnings (deficit)

| | As at June 30 2006 |
|---|---|
| | NIS thousand |
| As previously reported | (802,128) |
| Effect of restatement | (108,761) |
| | (910,889) |

#### (3) Effect on net earnings

| | For the six-month period ended June 30, 2006 | For the three-month period ended June 30, 2006 |
|---|---|---|
| | NIS thousand | NIS thousand |
| Net earnings as reported in the past | 455,578 | 230,066 |
| <u>Effect of restatement</u> | | |
| Increase in revenues | 400,096 | 199,096 |
| Decrease in depreciation expenses and amortisation | 21,416 | 12,257 |
| Increase in operating and general expenses | (400,096) | (199,096) |
| Increase in income tax | (5,589) | (3,162) |
| Net earnings as reported in these financial statements in the note on adjustment to IFRS | 471,405 | 239,161 |

## NOTE 15 – 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

| | June 30, 2007 | June 30, 2006 | December 31, 2006 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **1,726,904** | 1,660,715 | 1,451,006 |
| Non-current assets | **2,401,214** | 2,683,403 | 2,520,473 |
| | **4,128,118** | 4,344,118 | 3,971,479 |
| Current liabilities | **1,053,611** | 1,406,681 | 1,089,973 |
| Long-term liabilities | **1,251,050** | 1,549,234 | 1,383,859 |
| Total liabilities | **2,304,661** | 2,955,915 | 2,473,832 |
| Shareholders' equity | **1,823,457** | 1,388,203 | 1,497,647 |
| | **4,128,118** | 4,344,118 | 3,971,479 |

### B. Income statement

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from services and sales** | **2,298,889** | 2,185,695 | **1,151,456** | 1,097,271 | 4,477,987 |
| **Cost of services and sales** | **1,603,062** | 1,569,114 | **794,841** | 776,313 | 3,250,303 |
| Gross profit | **695,827** | 616,581 | **356,615** | 320,958 | 1,227,684 |
| **Sales and marketing expenses** | **196,470** | 197,109 | **94,045** | 99,403 | 417,178 |
| **General and administrative expenses** | **46,318** | 46,024 | **22,650** | 22,870 | 110,008 |
| | **242,788** | 243,133 | **116,695** | 122,273 | 527,186 |
| **Operating income** | **453,039** | 373,448 | **239,920** | 198,685 | 700,498 |
| **Financing expenses, net** | **253** | 35,084 | **8,132** | 32,232 | 17,687 |
| Earnings before income tax | **452,786** | 338,364 | **231,788** | 166,453 | 682,811 |
| **Income tax** | **125,591** | 87,774 | **58,677** | 42,133 | 196,910 |
| Net earnings | **327,195** | 250,590 | **173,111** | 124,320 | 485,901 |

## NOTE 15 – 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

| | June 30, 2007 | June 30, 2006 | December 31, 2006 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **377,011** | 366,532 | 338,662 |
| Non-current assets | **669,196** | 725,635 | 679,783* |
| | **1,046,207** | 1,092,167 | 1,018,445 |
| Current liabilities | **1,972,415** | 1,993,067 | 1,889,416 |
| Long-term liabilities | **2,047,392** | 1,822,367 | 1,989,685* |
| Total liabilities | **4,019,807** | 3,815,434 | 3,879,101 |
| Equity capital | **(2,973,600)** | (2,723,267) | (2,860,656) |
| | **1,046,207** | 1,092,167 | 1,018,445 |

* Reclassified

### B. Income statement

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** | **707,866** | 669,622 | **354,280** | 337,576 | 1,355,735 |
| **Cost of income** | **535,048** | 563,343 | **265,312** | 280,818 | 1,139,308 |
| Gross profit | **172,818** | 106,279 | **88,968** | 56,758 | 216,427 |
| **Sales and marketing expenses** | **67,564** | 60,269 | **32,848** | 27,779 | 122,996 |
| **General and administrative expenses** | **49,585** | 43,870* | **24,743** | 21,896* | 92,398* |
| Operating earnings | **55,669** | 2,140 | **31,377** | 7,083 | 1,033 |
| **Financing expenses, net** | **163,091** | 181,456 | **90,979** | 102,927 | 318,925 |
| Loss before income tax | **(107,422)** | (179,316) | **(59,602)** | (95,844) | (317,892) |
| **Income tax** | **5,522** | 1,668* | **5,231** | 942* | 1,915* |
| Net loss for the period | **(112,944)** | (180,984) | **(64,833)** | (96,786) | (319,807) |

* Reclassified

## NOTE 15 – 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

| | June 30, 2007 | June 30, 2006 | December 31, 2006 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **429,398** | 263,677 | 332,526 |
| Non-current assets | **426,867** | 349,319 | 340,734 |
| | **856,265** | 612,996 | 673,260 |
| Current liabilities | **338,459** | 235,856 | 307,724 |
| Long-term liabilities | **45,977** | 15,853 | 15,613 |
| Total liabilities | **384,436** | 251,709 | 323,337 |
| Shareholders' equity | **471,829** | 361,287 | 349,923 |
| | **856,265** | 612,996 | 673,260 |

### B. Income statement

| | For the six month period ended June 30 | | For the three month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 | 2006 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** | **644,212** | 496,381 | **321,570** | 254,848 | 1,021,573 |
| **Operating expenses** | **426,711** | 319,344 | **211,246** | 161,765 | 662,244 |
| Gross profit | **217,501** | 177,037 | **110,324** | 93,083 | 359,329 |
| **Sales and marketing expenses** | **67,967** | 71,862 | **32,589** | 37,296 | 148,594 |
| **General and administrative expenses** | **46,371** | 34,011 | **24,660** | 17,849 | 71,806 |
| **Other expenses (income), net** | **(1,257)** | 195 | **(520)** | (11) | 7,064 |
| Operating income | **104,420** | 70,969 | **53,595** | 37,949 | 131,865 |
| **Financing income (costs), net** | **935** | (9,257) | **1,572** | 147 | (6,965) |
| **Earnings of an associate accounted for by the equity method** | **1,644** | 4,013 | **1,170** | 2,389 | 11,051 |
| Earnings before income tax | **106,999** | 65,725 | **56,337** | 40,485 | 135,951 |
| **Income tax** | **(31,033)** | (19,319) | **(16,875)** | (11,723) | (40,391) |
| Earnings for the period | **75,966** | 46,406 | **39,462** | 28,762 | 95,560 |

* The above financial statements are presented solely in accordance with International Financial Reporting Standards (IFRS). In addition, commencing January 1, 2007, the financial statements include the operations of BezeqCall Communications Ltd.

## NOTE 16 – MATERIAL EVENTS DURING THE REPORTING PERIOD AND EVENTS SUBSEQUENT TO THE BALANCE SHEET DATE

A. On February 27, 2007 the Company's Board of Directors approved the allocation to the Company's executives of 56,836,888 options that are exercisable into 56,836,888 ordinary shares of the Company, par value NIS 1 each, each representing 2.1818% of the Company's issued capital before issue of the shares.

Following an enquiry of the Securities Authority in this matter and the results of the Company's review of the plan approval process, the Company's Board of Directors resolved in March 15, 2007 to have this options plan and the publicized profile in respect of the same cancelled. The Board of Directors intends to work towards the formation of a compensation plan for executives, that will replace the one cancelled.

B. In May – July 2007, the subsidiary Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav") sold 1,069,900,000 par value of debentures (Series 5) of the Company in private placements and on the Tel Aviv Stock Exchange, out of the debentures (Series 5) it purchased from the Company prior to the publication of the Company's prospectus dated May 24, 2004 ("the Prospectus"), and that had been listed for trading in accordance with the Prospectus and out of the debentures (Series 5) it had purchased from the Company in frame of a private placement in December 2004 (under blocking restrictions by law). The execution prices of the sales ranges between 111.8 and 112.5 (reflecting a yield to redemption of approximately 3.6% - 3.9%).

The proceeds from the said sale, in the approximate amount of NIS 1,199,961 thousand, were transferred to the Company by Bezeq Zahav in (partial) repayment of the loan granted to Bezeq Zahav by the Company for purchasing the Debentures (Series 5), as provided in the loan agreements between the parties.

C. Following an enquiry of the Securities Authority, it was decided to appoint an external examiner to investigate the matter of compensation granted to officers in the Company since the transfer of control in the Company from the State to Ap.Sb.Ar. Holdings Ltd. (including approval of the stock option plan for employees and managers, and approval of grants for officers), and to investigate the matter of restatement in the Group's financial statements as at December 31, 2004 and 2005. On April 26, 2007, the examiner submitted a report detailing the findings of his examination. The report specifies the shortcomings in the Company's work and methods to prevent their recurrence in the future, in respect of all matters examined. The Company's Board of Directors discussed the findings of the reports and resolved, *inter alia*, to work towards implementation of the recommendations and to draw the necessary conclusions, as required by the report. The Board of Directors also approved a joint announcement to the Company and its CEO, stating that the CEO will end his tenure as CEO of the Company, and as of June 26, 2007 Mr Avi Gabbay is the Company's Acting CEO. Decisions were made concerning, *inter alia*, the work procedures of the Board of Directors and the composition of its committees. Further to this, on June 28, 2007 the Company's Board of Directors adopted a new work procedure, that pertains to its meetings and to the manner of their management, as well as to the Board committees, their authorities and their work rules. For details on the matter of contingent liabilities submitted to the Company in respect of the aforementioned, see Notes 8A and 8C.

Further to this, the Board of Directors of the Company discussed and re-approved the grant of bonuses to officers in respect of the years 2005 and 2006.

D. On August 13, 2007, the Board of Directors of the Company resolved to recommend to the general meeting of the shareholders of the Company to pay a cash dividend to the shareholders in the total sum of NIS 760 million (constituting NIS 0.29 per share).

## NOTE 17 – DETAILS OF ADDITIONAL MOVEMENTS IN THE SHAREHOLDERS' EQUITY

| | Share capital | Premium on shares | Capital reserve in respect of a transaction between a corporation and a controlling shareholder | Capital reserve in respect of financial assets available for sale | Capital reserve in respect of option warrants for employees | Balance of deficit | Total | Minority rights in capital deficit of a subsidiary | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| | Refers to shareholders of the Company | | | | | | | | |
| **Six-month period ended June 30, 2007** | | | | | | | | | |
| **Balance as at January 1, 2007 (audited)** | **6,309,133** | **1,623,423** | **384,684** | **630** | **286,506** | **(2,849,381)** | **5,754,995** | **(564,250)** | **5,190,745** |
| Total earnings (losses) recognised in the period (unaudited) | **-** | **-** | **-** | **2,936** | **-** | **759,842** | **762,778** | **(34,535)** | **728,243** |
| Dividends to shareholders of the Company which do not comply with the earnings test (unaudited) | **(176,497)** | **(1,623,423)** | **-** | **-** | **-** | **-** | **(1,799,920)** | **-** | **(1,799,920)** |
| Payments to a former senior officer (Note 9c) (Unaudited) | **-** | **-** | **5,750** | **-** | **-** | **-** | **5,750** | **-** | **5,750** |
| **Balance as at June 30, 2007 (unaudited)** | **6,132,636** | **-** | **390,434** | **3,566** | **286,506** | **(2,089,539)** | **4,723,603** | **(598,785)** | **4,124,818** |
| **Six-month period ended June 30, 2006** | | | | | | | | | |
| **Balance as at January 1, 2006 (audited)** | 6,309,133 | 1,623,423 | 384,684 | 5,253 | - | (1,761,971) | 6,560,522 | (505,280) | 6,055,242 |
| Total earnings (losses) recognised for the period (unaudited) | - | - | - | (2,398) | - | 602,808 | 600,410 | (36,202) | 564,208 |
| Dividends to shareholders of the Company (unaudited) | - | - | - | - | - | (1,200,000) | (1,200,000) | - | (1,200,000) |
| **Balance as at June 30, 2006 (unaudited)** | 6,309,133 | 1,623,423 | 384,684 | 2,855 | - | (2,359,163) | 5,960,932 | (541,482) | 5,419,450 |

* On December 28, 2006, the general assembly of the shareholders of the Company approved the proposal of the Board of Directors regarding allocation of a cash dividend of approximately NIS 1.8 billion (at NIS 0.69 per share) as a dividend which does not meet the income test. On February 4, 2007 a court approved the dividend and as such the allocation was carried out on February 26, 2007.

** For the resolutions of the board of directors recommending that the general meeting of shareholders of the Company pay a dividend, see Note 16D.

## NOTE 17 – DETAILS OF ADDITIONAL MOVEMENTS IN THE SHAREHOLDERS' EQUITY (CONTD.)

| | Share capital | Premium on shares | Capital reserve in respect of a transaction between a corporation and a controlling shareholder | Capital reserve in respect of financial assets available for sale | Capital reserve in respect of option warrants for employees | Balance of deficit | Total | Minority rights in capital deficit of a subsidiary | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| | Refers to shareholders of the Company | | | | | | | | |
| **Three-month period ended June 30, 2007** | | | | | | | | | |
| **Balance as at April 1, 2007 (audited)** | **6,132,636** | **-** | **384,684** | **1,325** | **286,506** | **(2,450,631)** | **4,354,520** | **(577,933)** | **3,776,587** |
| Total earnings (losses) recognised in the period (unaudited) | **-** | **-** | **-** | **2,241** | **-** | **361,092** | **363,333** | **(20,852)** | **342,481** |
| Payments to a former senior officer (Note 9c) (Unaudited) | **-** | **-** | **5,750** | **-** | **-** | **-** | **5,750** | **-** | **5,750** |
| **Balance as at June 30, 2007 (unaudited)** | **6,132,636** | **-** | **390,434** | **3,566** | **286,506** | **(2,089,539)** | **4,723,603** | **(598,785)** | **4,124,818** |
| **Three-month period ended June 30, 2006** | | | | | | | | | |
| **Balance as at April 1, 2006 (audited)** | 6,309,133 | 1,623,423 | 384,684 | 20,922 | - | (2,647,869) | 5,690,293 | (521,320) | 5,168,973 |
| Total earnings (losses) recognised for the period (unaudited) | - | - | - | (18,067) | - | 288,706 | 270,639 | (20,162) | 250,477 |
| **Balance as at June 30, 2006 (unaudited)** | 6,309,133 | 1,623,423 | 384,684 | 2,855 | - | (2,359,163) | 5,960,932 | (541,482) | 5,419,450 |

## NOTE 17 – DETAILS OF ADDITIONAL MOVEMENTS IN THE SHAREHOLDERS' EQUITY (CONTD.)

| | Share capital | Premium on shares | Capital reserve in respect of a transaction between a corporation and a controlling shareholder | Capital reserve in respect of financial assets available for sale | Capital reserve in respect of option warrants for employees | Balance of deficit | Total | Minority rights | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| | Refers to shareholders of the Company | | | | | | | | |
| **The year ended December 31, 2006** | | | | | | | | | |
| **Balance as at January 1, 2006 (audited)** | 6,309,133 | 1,623,423 | 384,684 | 5,253 | - | (1,761,971) | 6,560,522 | (505,280) | 6,055,242 |
| Total earnings (losses) recognised for the period (audited) | - | - | - | (4,623) | - | 812,590 | 807,967 | (58,970) | 748,997 |
| Dividends to shareholders of the Company (audited) | - | - | - | - | - | (1,900,000) | (1,900,000) | - | (1,900,000) |
| Share-based payments made by the Company (audited) | - | - | - | - | 286,506 | - | 286,506 | - | 286,506 |
| **Balance as at December 31, 2006 (audited)** | 6,309,133 | 1,623,423 | 384,684 | 630 | 286,506 | (2,849,381) | 5,754,995 | (564,250) | 5,190,745 |