Chapter B of the Periodic Report
Directors' Report on the State of the Company's Affairs
for the year ended December 31, 2006

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies together are hereinafter referred to as "the Group") for the year ended December 31, 2006 (hereinafter: "the Directors' Report").

The Group operates in four areas which are reported as business segments in the Company's consolidated reports as set forth below:

1) **Fixed-line domestic communications**

2) **Cellular**

3) **International communications and internet services**

4) **Multi-channel television**

The Company has other areas of activity which are not material to the Group's operations, and these are included in the financial statements as at December 31, 2006 of the Company in the "Other" business segment, consisting mainly of network end Point services and customer service centre services.

The Group reports for the first time, in the 2006 financial statements, financial statements prepared in accordance with the International Financial Reporting Standards (IFRS), this being subsequent to a comprehensive discussion by the Board of Directors and resolution to approve Management's recommendation to adopt the IFRS in 2006, even though the regulations require adoption only from January 2008. As a result thereof the 2005 financial statements, which were prepared in the past in accordance with generally accepted accounting principles in Israel, were presented in accordance with IFRS. The effect of the transition to reporting in accordance with international standards on the financial position of the Company and on the results of its operations and its cash flows, is described in Note 33 to the financial statements. In order to properly reflect the financial position of the Company according to Israeli GAAP before the transition to IFRS, the financial statements of the Group were adjusted by way of restatement, as explained in Note 33(u) to the financial statements.

1. Financial Position

A. The Group's assets as at December 31, 2006, amounted to approximately NIS 17.54 billion, compared with NIS 19.39 billion on December 31, 2005. Of these, approximately NIS 6.49 billion (approximately 37%) are property, plant and equipment compared with approximately NIS 7.25 billion (approximately 37%) on December 31, 2005.

Most of the decrease stems from the fixed-line domestic communications segment. In this segment there was a decrease in total assets compared with the previous year of approximately NIS 780 thousand, mainly resulting from the realisation of financial assets held for trading which was moderated by an increase in the cash balances. In addition, there was a decrease in the depreciated cost of property, plant and equipment resulting from the difference between depreciation expenses and the investment made in the reporting period.

In the cellular segment, assets decreased from approximately NIS 4.72 billion as at December 31, 2005 to approximately NIS 3.97 billion as at December 31, 2006. Most of the decrease arose from the realisation of financial assets held for trading which were used for distribution of a dividend and repayment of loans and from a decline in the depreciated cost of the property, plant and equipment. Additionally, there was a reduction in the deferred tax balances due to the utilization of past losses for tax purposes.

In the international communications and internet services segment, there was a decrease in total assets compared with December 31, 2005, mainly due to an decline in cash balances. The reduction is mainly in respect of repayment of loans to the Company and distribution of a dividend, which will be offset by a positive cash flow from ongoing activities.

In the multi-channel television segment, there was a reduction in total assets compared with December 31, 2005, which derived primarily from a reduction in the net investment balance in property, plant and equipment.

B. The shareholders' equity of the Company at December 31, 2006, amounted to approximately NIS 5.76 billion, comprising approximately 33% of the total balance sheet, compared with approximately NIS 6.56 billion on December 31, 2005, which comprised approximately 34% of the total balance sheet. The decrease in shareholder' equity derives from dividends paid and declared in the reporting period amounting to NIS 1.9 billion. The decrease was moderated by the Group's net earnings. Subsequent to the date of the reports, an additional dividend of NIS 1.8 billion was distributed in February 2007 (see Note 20 to the financial statements).

C. Total Group debt at December 31, 2006 amounted to approximately NIS 8.02 billion, compared with approximately NIS 9.41 billion on December 31, 2005. The Group's debt to financial institutions and debenture holders as at December 31, 2006, amounted to approximately NIS 7.46 billion, compared with approximately NIS 8.91 billion on December 31, 2005. The decrease is primarily attributable to a reduction in liabilities in the cellular segment and the fixed-line domestic communications segment. The reduction was partly offset by a rise in liabilities in the multi-channel television segment.

The Company's auditors have drawn attention to the financial position of DBS, as appears in Note 32(3) to the financial statements, including an assessment from DBS's management based on the budget for 2007 and an alternative business plan according to which there is a good chance of arranging the financial sources which will be required for the coming year.

D. Group cash balances as at December 31, 2006, amounted to approximately NIS 3.59 billion, compared with approximately NIS 4.56 billion on December 31, 2005. The decrease is primarily attributable to the realisation of securities held for trading in the cellular segment and in the fixed-line domestic communications segment, which were realized for payment of a dividend of NIS 1.6 billion in the reporting year and for the repayment of liabilities. The decrease was partially offset by cash flow from current operations in the principal segments of the Group's operations.

2. Results of Operations

A. Principal results

Net earnings attributable to the shareholders of the Company for 2006 amounted to approximately NIS 809 million, compared with net earnings of approximately NIS 666 million in the corresponding year. The rise in the net earnings is primarily attributable to an increase in operating income and a decrease in the costs of financing, which were offset by a gain from the sale of an operation recorded in 2005. Earnings after financing expenses amounted to approx NIS 1,227 million compared with NIS 1,052 million in the corresponding year.

Below are details of the changes in the results of the segments compared to the corresponding year.

Segment	2006 NIS millions	2005 NIS millions
Fixed-line domestic communications	746	919
Cellular	692	585
International communications and internet services	131	100
Multi-channel television	8	(78)
Others	(12)	1

Net earnings per share for 2006 amounted to NIS 0.311 per NIS 1 par value, compared with earnings of NIS 0.256 per share in the corresponding year.

B. Revenues

Group revenues in 2006 amounted to approximately NIS 12.23 billion compared with earnings of approximately NIS 11.92 billion in the corresponding year.

Revenues from fixed-line domestic communications decreased from approximately NIS 5.89 billion in 2005 to approximately NIS 5.80 billion in the year reported (a decrease of approximately 1.6%). Most of the decrease in the segment's revenues is attributable to tariff reductions in June 2005 and July 2006 and a decrease in call traffic. The decrease in revenues was moderated primarily by ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). The Company's auditors drew attention to the continuing opening of the communications sector to competition and the effects of regulation..

Revenues from the cellular telephone segment increased from approximately NIS 4.43 billion in 2005 to approximately NIS 4.48 billion in the year reported. The growth derived from the increase in revenues from cellular services caused by an increase in content revenues, in average per-subscriber use and in the number of customers. In contrast, there was a decrease in revenues from the sale of terminal equipment resulting from a decline in the number of handsets sold and upgraded and from sales campaigns in 2006.

Revenues from the international communications and internet services segment increased from approximately NIS 847 million in 2005 to approximately NIS 1,038 million in the reporting period. The increase is attributable to a growth in revenues in all sectors and an increase in global activity. In addition, there was an increase in internet revenues deriving from an increase in the number of high-speed internet customers, sale of capacity and growth of integration.

Revenues in the multi-channel television segment increased from approximately NIS 1,221 million in 2005 to approximately NIS 1,362 million in the reporting period, resulting from an increase in the number of subscribers and an increase in the average revenue per customer.

C. **Depreciation and amortisation**

The Group's depreciation and amortisation expenses decreased from approximately NIS 1,934 million in 2005, to approximately NIS 1,864 million in the year reported, resulting from a decrease in the depreciation expense due to property plant and equipment being fully depreciated and a decrease in investments in new property in the fixed-line domestic communications and the international communications and internet services segments. The decrease was offset by an increase in depreciation expenses in the cellular segment due to the accelerated amortization of sites designated for dismantling and due to an increase in the multi-channel segment.

D. **Salaries**

The Group's salary expenses in 2006 amounted to approximately NIS 2,586 billion, unchanged as compared to the corresponding year.

In the fixed-line domestic communications segment, salary expenses decreased as a result of the retirement of employees, and a decrease in the value of stock options allocated by the State to Company employees in 2005 compared with the value of the options allocated to employees by the Company in 2006. This decrease was offset by salary increases. In addition, salary expenses decreased in the cellular segment and increased in the international communications and internet services and multi-channel television segments.

E. **Operating and general expenses**

The Group’s operating and general expenses in 2006 amounted to approximately NIS 5.97 billion, unchanged as compared to the corresponding year.

In the fixed-line domestic communications segment, operating and general expenses decreased from approximately NIS 2,391 million in 2005 to approximately NIS 2,233 in the year reported. The decrease derived from a reduction in royalties expenses due to a 0.5% reduction in the royalties rate from January 1, 2006 (see Note 29B to the financial statements), a reduction in the provision for royalties in the fixed-line domestic communications segment resulting from an agreement with the Ministry of Communications to end past disputes up to and including 2002 (see Note 29B to the financial statements), and a deduction for interconnect (see Note 29C). In addition, there was a decline in materials and spare parts, subcontractor services and maintenance, cellular telephone and building maintenance.

In the cellular segment, general and operating expenses decreased from approximately NIS 2,813 million in 2005 to approximately NIS 2,741 million in the year reported, resulting from a reduction in the costs of terminal equipment alongside a decrease in revenues from the sale of terminal equipment, in addition to a decrease in the costs of spare parts and laboratory repairs and a decrease in salary expenses and doubtful debts. The decrease was partly offset by an increase in site maintenance and an increase in call termination charges, expenses for content operations and advertising expenses.

In the international communications and internet services segment there was an increase in general and operating expenses from approximately NIS 485 million in 2005 to approximately NIS 641 million in the year reported. The increase is primarily due to growth in global operations in parallel with growth in revenues, and a growth in expenses related to internet customers and customer recruitment expenses.

In the multi-channel television segment, general and operating expenses increased from approximately NIS 843 million in 2005 to approximately NIS 889 million in the year reported, resulting from an increase in content expenses and leasing fees for satellite segments.

F. Other operating expenses (income), net

Other operating expenses, net, for the Group totalled approximately NIS 250 million in 2006, compared with Other operating expenses, net, totalling approximately NIS 100 million in the corresponding year.

The expenses in 2006 derived mainly from the fixed-line domestic communications segment, which recorded a provision of approximately NIS 309 million in respect of employer-employee relations upon retirement, due to the new collective agreement and the change in the organizational structure of the Company. The provision recorded in respect of the same item in 2005 amounted to approximately NIS 83 million, due to an arrangement with an alternative insurance entity for Makefet Fund for regulating the terms of early retirement of employees.

In addition, net capital gains stemming primarily from the realization of real estate assets of approximately NIS 159 million, were offset by provisions in respect of contingent claims.

G. Operating income

The Group's operating income in 2006 amounted to approximately NIS 1,565 million, compared with approximately NIS 1,527 million in the corresponding year, a decrease of approximately NIS 38 million. The decrease in operating income is attributable to the changes in the results of the segments described above in the revenue and expense items. These changes led to a decrease in the profitability of the fixed-line domestic communications segment, an increase in the cellular telephone segment and international communications and internet services segment, and an improvement in the results of operations in the multi-channel television segment.

H. Financing expenses

The Group's net financing expenses in 2006 amounted to approximately NIS 338 million, compared with approximately NIS 371 million in the corresponding year, a decrease of approximately NIS 33 million. The decrease is due to a reduction in financing expenses in the cellular segment deriving from erosion of CPI-linked loans and a reduction in the number of loans in the segment.

Financing expenses also decreased in the fixed-line domestic communications segment as compared with the corresponding year, mainly as a result of an increase in income from the capital market, cancellation of the provision in connection with an agreement with the Ministry of Communications to terminate past disputes (see Note 29B to the financial statements), and income from a venture capital fund in which the Company invested..

J. Quarterly data – Consolidated statements (in NIS millions)

The financial statements for quarters 1-3 were prepared again in order to comply with the International Financial Reporting Standards (IFRS)

	2006	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenue	12,232	3,116	3,082	3,019	3,015
Costs and expenses	10,667	3,187	2,532	2,444	2,504
Operating income	1,565	(71)	550	575	511
Financing costs	338	29	92	146	71
Earnings before Group's equity in earnings of associates	1,227	(100)	458	429	440
Equity in earnings of associates	11	7	2	1	1
Earnings before income tax	1,238	(93)	460	430	441
Income tax	488	21	187	143	137
Earnings for the year	750	(114)	273	287	304
Earnings attributable to the shareholders of the Company	809	(108)	290	308	319
Minority interest in a consolidated company	(59)	(6)	(17)	(21)	(15)
Total earnings recognised in the period	750	(114)	273	287	304

The fourth quarter ended with an operating loss, mainly due to provision of NIS 309 in respect of an early retirement plan (see Note 16G to the financial statements), and due to share-based payments of NIS 287 million to employees (see Note 26 to the financial statements).

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2006 amounted to approximately NIS 3,709 million, compared with approximately NIS 3,162 million in the corresponding year, an increase of approximately NIS 547 million. The increase in cash flows generated by operating activities is primarily attributable to an increase in operating income, to revenues and expenses not involving cash flows, and changes in the assets and liabilities items. Most of these changes were in the cellular segment.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the year reported included approximately NIS 953 million invested in development of communications infrastructures, compared with investments amounting to approximately NIS 1,477 million in the corresponding year. During 2006, the Group realised investments in net financial assets of approximately NIS 1,534 million – mainly negotiable securities, compared with net investments of approximately NIS 827 million in the corresponding year.

In the year reported, the Group repaid debts and paid interest of approximately NIS 2,151 million, of which approximately NIS 1,269 million was on account of long-term loans, and NIS 280 million of debentures and NIS 602 million in interest payments. The Group raised new debt in the year reported, amounting to approximately NIS 93 million, totalling net debt repayment of approximately NIS 2,058 million. This compares with the net debt raised amounting to approximately NIS 53 million in the corresponding year. In the year reported, a dividend totalling NIS 1,600 million was distributed (see Note 20 to the financial statements).

The average monthly short-term borrowing from banks in 2006 was approximately NIS 128 million. The average monthly long-term liabilities in 2006 were approximately NIS 7,950 million.

Working capital at December 31, 2006 is negative and amounted to approximately NIS 1,169 million, compared with positive working capital of approximately NIS 617 million on December 31, 2005. The decrease is due to the fixed-line domestic communications segment, resulting from an increase in current maturities of debentures, an obligation to pay a dividend declared, and realization of monetary assets held for trading. The decrease was moderated to some extent by an increase in the working capital of the other principal Group companies.

4. The considerations of the Board of Directors in deciding on or recommending grant of payments to each of the five highest salary recipients of its officers

The salary of the five highest-salaried officers was approved by the Board of Directors in accordance with the recommendation of the CEO (except regarding the CEO himself and the Chairman of the Board whose salary was approved by the Audit Committee, the Board of Directors and the general meeting of the shareholders). The salary levels of the officers are comparable to those at similar corporations in the country.

5. Group involvement in the community and donations

The Group is active in the community through its involvement in social institutions and organizations such as the education system in underprivileged areas and the confrontation line, and its contributions during the year reported amounted to approximately NIS 2.6 million. In addition, Group employees volunteer in additional and diverse community involvement activities. For example, in the academic year, some 500 Group employees gave workshops to junior high school students on “Exposure to Modern Communications”, in cooperation with the Ministry of Education.

During the period of the fighting in the north the Group’s companies embarked on various activities for residents of the north which included, *inter alia* ,the connection of televisions to the internet and satellite television, free calls, renovation of shelters and their equipment and the provision of service under fire to citizens and soldiers. In addition, the employees donated and distributed food products, games and gift packages for the residents.

During the reporting period the Company donated approximately NIS 1.5 million to institutions and organizations in the community the principal subjects of which are listed below:

In the project “Children and Parents Study Computer and Internet”, which has been ongoing for some five years, the Company's employees voluntarily mentor underprivileged parents and children on selected subjects in the field of computers and the internet. The cost of the project, in addition to the hours volunteered by the employees, amounts to some NIS 250,000 per year.

In the “Summer for the Community” project, which the Company has initiated for the past three years, children of employees worked in medical institutions and community centres during the summer. The cost of the project to the Company was approximately NIS 1 million.

In the last quarter of the year the “Milk, Bread and Eggs” not-for-profit association, which was established by Company employees and pensioners, began functioning. The association works in cooperation with the local authorities to locate disadvantaged families in order to supply them with basic food products.

Pelephone has no binding policy regarding donations and its management discusses each case on an individual basis. During the reporting period, Pelephone donated some NIS 229 thousand to various associations.

Bezeq International is involved in ongoing operations on behalf of underprivileged communities in Petach Tikva, it adopted “lone” soldiers, adopted a fighting division and participated in projects for special needs children. During the reporting period, Bezeq International's expenses amounted to approximately NIS 900,000.

6. Details concerning market risks exposure management

Responsibility for management of the Company’s market risks

The person responsible for management of the Company's market risks is the Deputy CEO and CFO, Ran Oz. For details of his education and experience, see Section 13(D) in Chapter D of the Periodic Report.

Description of market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment and the prices of securities.

Most of the Company's debentures are linked to the consumer price index and those which are eurobonds or denominated in euro, bear fixed interest, and therefore a change in the interest rate will affect their fair value and not their carrying value.

In addition, the Company has euro-linked debentures bearing variable interest and exposed to changes in the eurobond rate.

The Company has investments in negotiable bonds that are shown in the Company's books at their market value. This market value is influenced by changes in the interest rates in the economy.

At the date of this report, the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that it will do so under future market circumstances. Furthermore, the Company takes into account such influences when considering the types of loans it takes and when managing its investment portfolio.

Exchange rates – Changes in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future earnings and cash flows, mainly the repayment of currency-linked liabilities and payments for the currency-linked purchase of equipment and raw materials.

In order to minimize this exposure, the Board of Directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed an amount equivalent to $150 million, of which not more than the equivalent of $50 million would relate to currencies other than the U.S. dollar. In addition, the Company is able to implement additional hedging transactions from time to time against exposure related to expected transactions during one year of operation, this being limited to a total volume not exceeding the equivalent of $100 million – of which not more than the equivalent of $30 million would relate to currencies other than the U.S. dollar. The reduction of exposure during the reporting period was accomplished by purchase (or sale, depending on the direction of the exposure) of forward transactions in currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward transactions is equal to or shorter than the time frame of the hedged exposure.

The Company recorded no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing expenses of approximately NIS 46 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year.

The Company's tariff updating mechanism as set forth in the Regulations allows tariffs to be updated according to the rise in the CPI (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs and on its revenues. On the other hand, the influence of the rate of inflation on the Company's expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms.

In addition, the Company invests a considerable part of its cash balances in unlinked shekel value deposits, and these deposits are exposed to changes in their real yield caused by a change in the rate of inflation.

The low rate of inflation prevailing in Israel in recent years has considerably reduced the financial significance of this risk.

The Company has a surplus of liabilities over CPI-linked assets. As part of its policy of minimizing exposure, the Company has made hedging transactions against the CPI so as to reduce this risk.

Prices of raw materials and equipment – Cash flows generated by the Company's operations are used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral price indices, exchange rates and global prices. The Company does not hedge against this exposure.

Prices of securities – The Company invests some of its financial balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors set investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments, while the share component will not exceed 15% of the investment portfolio and will include shares invested in the TASE 100. The types of bonds and their proportional part in the portfolio were determined according to criteria based on linkage, redemption date and separation between government and non-government bonds. Additionally, a monetary ceiling was determined for the various types of investments.

Supervision and implementation of market risk management policy – As part of the financial management policy at the Group level, a "Finance Team" was appointed and meets once a month, *inter alia*, to make recommendations on market risk policy and management to the boards of directors of the Company and its subsidiaries. These recommendations and regular updates on exposure to market risks are then discussed by those boards of directors from time to time, as necessary. Exposure reports are presented to the Board of Directors of the Company once every quarter.

Description of the risks and their management in the subsidiaries – The persons responsible for management of the market risks in the principal consolidated companies are the Chief Financial Officers of those companies and at Pelephone – the Treasurer of the company. The subsidiaries enter into hedging transactions in accordance with the decisions of their boards of directors and under their supervision.

The financial statements include financing expenses of approximately NIS 64 million from hedging transactions entered into during the year reported..

Linkage based report

Information on the linkage terms of the monetary balances of the Company and the Group at December 31, 2006, follows;

	In unlinked NIS	In CPI-linked NIS	In or linked to the dollar	In or linked to euro	Total monetary balances
	NIS Thousands	NIS Thousands	NIS Thousands	NIS Thousands	
Assets					
Cash and cash equivalents	2,578,740		48,244	4,806	2,631,790
Trade receivables	2,036,496	12,181	55,353	7,421	2,111,451
Other receivables	152,310	4,370			156,680
Other investments, including derivatives	328,876	489,712	123,454	29,624	971,666
Trade receivables and other long-term receivables	387,909	24,484	4,751		417,144
Long-term investments and loans, including derivatives	259,965	36,633	7,821	38,627	343,046
Total assets	5,744,296	567,380	239,623	80,478	6,631,777
Liabilities					
Loans and borrowings	765,928	1,242,008		1,629,411	3,637,347
Trade payables	992,158		380,967	20,443	1,393,568
Dividend proposed	300,000				300,000
Other liabilities and current provisions	825,277	283,950	2,542	74,800	1,186,569
Debentures		3,147,436		30,380	3,177,816
Long-term liabilities to banks		480,830			480,830
Loans provided by a minority and others		733,432			733,432
Employee benefits	1,279,239				1,279,239
Other long-term liabilities and provisions	51,857	19,176			71,033
Total liabilities	4,214,459	5,906,832	383,509	1,755,034	12,259,834

Positions in derivatives at December 31, 2006 (consolidated)

(amounts following are in NIS thousands)

Dollar / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - not recognized for accounting	380,013	104,358	-	-	(6,596)	16	-	-

Euro / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging – not recognized for accounting	1,574,435	-	-	-	(30,967)	-	-	-

CPI / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - not recognized for accounting	50,000	-	300,000	-	(5,755)	-	(7,920)	-

Sensitivity analysis

Sensitivity to changes in the dollar/NIS rate of exchange

	Gain (loss) from the changes		**Fair value**	**Gain (loss) from the changes**	
	10%	5%	–	-5%	-10%
Hedging instruments not recognized for accounting			–		
Dollar/shekel forward transactions	23,065	11,540	(6,580)	(11,540)	(23,109)
Cash	4,824	2,412	48,244	(2,412)	(4,824)
Trade receivables	5,535	2,768	55,353	(2,768)	(5,535)
Other investments	13,596	6,798	135,959	(6,798)	(13,596)
Suppliers and service providers	(38,097)	(19,048)	(380,967)	19,048	38,097
Firm commitments – rent contracts	(5,952)	(2,976)	(803)	2,976	5,952
Firm commitments – space segments	(41,717)	(20,859)	(417,172)	20,859	41,717
Guarantees	(9,295)	(4,648)	(92,950)	4,648	9,295
Total	**(48,041)**	**(24,013)**	**(658,916)**	**24,013**	**47,997**

The table shows the items sensitive to changes in the dollar/shekel exchange rate. The sensitivity of the items in the balance sheet was tested, as were off-balance-sheet items. The firm commitments are off-balance-sheet commitments, denominated and/or linked to the dollar and therefore sensitive to changes in the exchange rate.

Sensitivity to changes in the euro/NIS exchange rate

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	10%	5%		-5%	-10%
Cash	481	240	4,806	(240)	(481)
Trade receivables	742	371	7,421	(371)	(742)
Other investments	2,671	1,335	26,708	(1,335)	(2,671)
Deposit investments	3,863	1,931	38,627	(1,931)	(3,863)
Hedging instruments not recognized for accounting					
Euro/shekel forward transactions	157,452	78,545	(30,967)	(78,713)	(157,480)
Eurobonds	(169,148)	(84,574)	(1,691,478)	84,574	169,148
Debentures	(3,257)	(1,628)	(32,567)	1,628	3,257
Trade payables	(2,044)	(1,022	(20,443)	1,022	2,044
Current liabilities	(4,270)	(2,135)	(42,697)	2,135	4,270
Total	**(12,658)**	**(6,510)**	**(1,732,070)**	**6,342**	**12,631**

The table shows the items sensitive to changes in the euro/shekel exchange rate. The Company has forward transactions for the purchase of euro against shekels for up to seven months. These transactions serve as hedges against the euro-denominated-linked debt.

Sensitivity to change in the consumer price index

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	10%	5%		-5%	-10%
Trade receivables	24	12	12,181	(12)	(24)
Receivables and debit balances	9	4	4,370	(4)	(9)
Other investments	979	489	489,712	(489)	(979)
Debit balances	122	61	61,117	(61)	(122)
Hedging instruments not recognized for accounting					
CPI/shekel forward transactions	2,680	1,340	(13,675)	(1,340)	(2,680)
Other liabilities and provisions	(571)	(286)	(285,705)	286	571
Non-negotiable debentures	(3,658)	(1,829)	(1,828,986)	1,829	3,658
Debentures Series 4	(2,558)	(1,279)	(1,278,840)	1,279	2,558
Debentures Series 5	(966)	(483)	(482,892)	483	966
Bank loans	(2,631)	(1,316)	(1,315,722)	1,316	2,631
Loans from others	(270)	(135)	(134,939)	135	270
Loans provided by minority	(1,129)	(564)	(564,250)	564	1,129
Total	**5,874**	**60**	**(5,339,655)**	**(11,569)**	**(17,383)**

A sensitivity test of 5% and 10% (up and down) was conducted on an inflation assessment of 2% per year, based on the Inflation Target Centre at the Bank of Israel.
The Group has debentures and loans from banks and other sources, which are linked to the CPI.

Sensitivity to changes in real shekel interest rates

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	10%	5%		-5%	-10%
Non-negotiable debentures	(18,814)	(9,472)	(1,828,986)	9,606	19,348
Bank loans	(3,549)	(1,814)	(1,315,722)	1,760	3,601
Loans from others	7,463	3,551	(134,939)	(4,729)	(9,112)
Total	**(14,900)**	**(7,735)**	**(3,279,647)**	**6,637**	**13,837**

The companies of the Group have non-negotiable debt and CPI-linked bank loans to institutional entities. The table tests the debt for changes in the real interest rate.

<u>Sensitivity to change in shekel interest rate</u>

Company	12%	10%	5%	Fair value	-5%	-10%	-12%
Dollar/shekel forward transactions	596	505	248	(6,580)	(246)	(474)	(589)
Euro/shekel forward transactions	4,090	3,355	1,658	(30,967)	(1,780)	(3,497)	(4,213)
Long-term trade receivable debts	(7,191)	(6,009)	(3,018)	793,862	3,046	6,120	7,357
Total	(2,505)	(2,148)	(1,112)	756,315	1,020	2,149	2,555

The sensitivity analysis of the shekel interest rate includes another scenario (12% up and 12% down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 12% in December 2001).

<u>Sensitivity to change in dollar interest rates</u>

Company	15%	10%	5%	Fair value	-5%	-10%	-15%
Dollar/shekel forward transactions	(788)	(532)	(199)	(6,580)	268	538	805

The sensitivity analysis of the dollar interest rate includes another scenario (15% up and 15% down), which examines the most extreme daily change that occurred in recent years (a daily change of 15% in June 2003).
Calculation of the fair value of the forward transactions was by discounting the difference between the price set on the date of measurement for forward transactions for the same future date, and the price in the transaction signed by the Company, multiplied by the nominal value of the transaction and discounted from the date of clearing the transaction to the measurement date.
The interest rates used for calculation of the fair value are risk-free rates for the relevant period (shekel interest and dollar interest).

<u>Sensitivity to change in euro interest rates</u>

Company	10%	5%	Fair value	-5%	-10%
Euro/shekel forward transactions	(2,869)	(1,484)	(30,967)	1,323	2,775

Analysis of sensitivity to changes in the securities rates

	Gain (loss) from the changes			**Fair value**	**Gain (loss) from the changes**		
	12%	10%	5%		-5%	-10%	-12%
Shares	4,372	3,644	1,822	36,436	(1,822)	(3,644)	(4,372)

	Gain (loss) from the changes			**Fair value**	**Gain (loss) from the changes**	
	118%	10%	5%		-5%	-10%
Share	9,229	782	391	7,821	(391)	(782)

The sensitivity analysis of the share portfolio includes another scenario (12% up and 12% down), in order to examine an extreme situation (a daily change at that level would result in suspension of trading in the security).

Analysis of sensitivity to changes in securities rates

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	2%	1%		-1%	-2%
CPI-linked debentures	47,868	23,934	478,679	(23,934)	(47,868)
Foreign currency line	8,972	4,486	89,719	(4,486)	(8,972)
Debentures series 4	(127,884)	(63,942)	(1,278,840)	63,942	127,884
Debentures series 5	(48,289)	(24,145)	(482,892)	24,145	48,289
Total	**(119,333)**	**(59,667)**	**(1,193,334)**	**59,667**	**119,333**

The sensitivity analysis of the debentures was made at values of 1% and 2%, based on a historical examination of the maximum change in the prices of CPI-linked and foreign currency-linked debentures.

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	2.50%	1.25%		-1.25%	-2.50%
Unlinked shekel debentures	7,225	3,612	288,989	(3,612)	(7,225)

The sensitivity analysis of the shekel (unlinked) debentures was made at values of 1.25% and 2.5%, based on a historical examination of the maximum change in the prices of shekel debentures.
The interest rates used for calculation of the fair value are risk-free rates for the relevant period (shekel interest, euro interest and dollar interest).

Calculation of the fair value of the forward transactions was by discounting the difference between the price set on the date of measurement for forward transactions for the same future date, and the price in the transaction signed by the Company, multiplied by the nominal value of the transaction and discounted from the date of clearing the transaction to the measuring date.

The exchange rates taken for the sensitivity analyses are the representative rates on December 29, 2006:
Dollar/shekel exchange rate – 4.2250.
Euro/shekel exchange rate – 5.5643.

7. Directors with accounting and financial expertise

A. The Company's Board of Directors determined that the minimum number of directors who have accounting and financial expertise, as required by the provisions of the Companies Law, is one (and together with the outside directors – two). The Board of Directors believes that this number will enable it to fulfill the duties imposed upon it by law and by the articles of association, including review of the financial condition of the Company and preparing and approving the financial statements, taking into consideration the size and complexity of its operations.

B. Directors serving in the Company who have the above skills are Zehavit Cohen, Menachem Inbar, Adam Chesnoff and David Blumberg (an external director). For information about their relevant education and experience, see Sections 12(f), 12(g), 12(h) and 12(i) in Chapter D of the Periodic Report. Yigal Cohen-Orgad, a former external director whose term of office ended on January 25, 2007, has the aforementioned expertise.

8. Disclosure concerning an internal auditor in a reporting corporation

(1) **The Company's Internal Auditor**

a) Name: Malka Dror

b) Date of commencement of office: August 14, 2006 (appointed as substitute)

c) The Internal Auditor complies with the conditions set forth in Article 3(A) of the Internal Audit Law. Qualifications: BA in Economics (Hebrew University); CISA (Certified Information Systems Auditor – USA);

Internal auditing experience: 22 years in various internal auditing positions.

d) The Internal Auditor complies with the provisions of Article 8 of the Internal Audit Law and Article 146(B) of the Companies Law.

e) The auditor was granted 44,287options to purchase Company shares held by the State as part of an option outline for Company employees for 2005 on November 15, 2005, within the framework of the State's obligations in connection with the Company's privatization process, and 32,856 options of the Company to purchase its shares as part of the option outline for Company employees on February 22, 2007, in accordance with the Company's obligation under the collective agreement from December 5, 2006.

f) The Internal Auditor has no material business connections or other material connections with the Corporation or with a body affiliated to it.

g. Employment basis: The Internal Auditor is a Company employee.

(2) At its meeting on August 14, 2006, the Board of Directors approved the appointment of Malka Dror who served as manager of the Audit Department in the Company's Audit Unit, as acting internal auditor following a recommendation from the Audit Committee based on her professional qualifications and experience.

(3) The authority and responsibility of the Company's internal auditor are determined in the procedure "The Internal Auditor of the Company". The procedure was revised and approved by the Board's Audit Committee on January 4, 2006.

Duties of the internal auditor according to the procedure

a. To examine whether the activities of the Company, its officers and senior employees are proper from the perspective of upholding the law and proper business management.

b. To examine that the Company's operations were carried out lawfully, by a qualified person, while adhering to principles of efficiency, thrift and purity of ethics, and to ensure that they contribute to the achievement of the goals defined.

c. To indicate deficiencies in the management of the business of the Company.

d. To examine the authenticity and quality of the financial and management information.

e. To inspect the cash management, the Company's liabilities and arrangements to safeguard the Company's assets and their entirety, and their operative efficiency and use.

f. To check whether the Company's decisions, including at the Board and its committee levels, were made in accordance with proper procedures.

g. To inspect the Company's information systems and information security system – in the computer environment and in the computer systems.

h. To examine the correctness of the Company's transactions with its senior managers, with their families or with corporations under their control.

i. To examine the correctness and effectiveness of the Company's procedures for entering into commitments.

j. To investigate complaints made by Company employees and complaints from the public regarding damage to purity of ethics and proper procedures.

k. To recommend that the Audit Committee determine or amend procedures on significant topics.

l. To expose deficiencies, identify the reasons for their existence, and note the causes responsible for them.

m. To make proposals for correcting the deficiencies and preventing their recurrence.

n. To re-audit in order to follow up implementation of the recommendations in the various departments.

The internal auditor's authorities in the Company in accordance with the procedure

a. The Company's internal auditor may demand and receive any information, explanation and document required at her discretion for the performance of her duty, and every

Company employee is obliged to provide any document or information at the Company's internal auditor's first request. Every Company employee requested to provide information to the auditor is required to comply with the request at the time and in the manner determined thereof.

b. The internal auditor is authorized to perform an audit at any time, with a scope that he deems appropriate, in any of the Company's departments.

c. The manager and employees of the audited department will allow the internal auditor and her staff to perform the audit and will assist them with any request.

d. For performance of her duty, the internal auditor shall be granted access to any ordinary or computer databank, to any database and to any automated or non-automated data processing work program in the Company.

e. The internal auditor may enter and inspect any of the Company's assets.

f. The above authorities are also granted to audit department staff and to any person acting on behalf of the internal auditor.

(4) The former internal auditor, Danny Friedman, tendered his resignation after being offered a position in another company. He ended his term of office on August 14, 2006.

(5) **<u>Organizational officer responsible for the internal auditor</u>**

According to a resolution of the Company's Board of Directors, the Chairman of the Board is the organizational officer responsible for the internal auditor.

(6) **<u>Work program</u>**

The work program is annual.

The guiding principle behind the annual work program for the internal audit is the risk inherent in the Company's processes and operations. In order to assess the risks, the audit prepares a ‘control risk survey’ of the Company every year. As part of this survey, the audit examines, in cooperation with the Company's senior management, the material exposures and risks in the Company's operations and the control environment existing for the management of these risks. The survey’s findings are used to compile the topics for the annual and multi-year work program.

The considerations taken into account in the compilation of the work program are these: reasonable coverage of all the Company’s areas of business (finance; sales and marketing; human resources and payroll, investments, mergers and acquisitions; safety and security; information technology – IT; economics and logistics; engineering and planning).

Preparation of follow-up checks – at the request of the Board’s Audit Committee or the recommendation of the Internal Auditor.

In addition to the subjects determined in the annual work program, the audit prepares ‘special examinations’. These examinations are not included in the work program, and are prepared at the request of the Chairman of the Board of Directors, Chairman of the Audit Committee or the CEO.

The Audit Committee of the Board of Directors accepts and approves the work plan.

The auditor may propose subjects at her discretion. Investigations of these subjects are authorized by the CEO and the Audit Committee.

During the reporting period the auditor did not examine any material transactions.

(7) **<u>The audit’s response to corporations comprising a material holding</u>**

In all the corporations representing material holdings of the Company, with the exception of Bezeq On Line Ltd., there are internal auditors (either as employees or outsourced). In 2006 the Company's auditor served as internal auditor of Bezeq On Line Ltd. The audit reports are discussed in the audit committees and/or Boards of Directors of these corporations, on which senior officers of the Company serve. The Company auditor regularly receives the audit reports of the corporations which are fully held by the Company: Bezeq International Ltd. and BezeqCall Communications Ltd. (until it was merged with Bezeq International at the beginning of 2007).

At the request of the Chairman of the Board of Directors, the internal auditor prepares special audit examinations for the affiliated companies. During the year reported, the internal auditor published six reports: One at DBS, two at BezeqCall Communications Ltd. and three at Bezeq On Line Ltd.

(8) **Scope of employment**

(A) **Number of hours of employment in the year**

The audit's work program for 2006 included twelve thousand audit hours. The internal audit unit at the end of the reporting period employed fifteen fulltime employees of whom thirteen are auditors, including the internal auditor.

(B) **Scope of the internal auditor's work in the reporting period**

During the reporting period the number of employees was reduced by two from fourteen auditors to twelve (among them the internal auditor who ceased his employment in the Company). As a result of the organization change and Company's retirement program and personnel changes in the department in keeping with the requirements and qualifications of the remaining internal auditors, the number of employee in the internal audit department was reduced at the beginning of 2007 – subsequent to the reporting period – by six additional employees.

After examining the work plan for 2007, the standard for the audit department was set at six auditors of appropriate expertise and qualifications. The auditors will implement the audit plan, which amounts to approximately 10,000 work-hours, compared with 12,000 in 2006, and it was decided that if necessary, and depending on the required qualifications, the number of auditors will be re-examined during the year to ensure compliance with the annual plan.

(9) The Company's internal audit in Bezeq is prepared pursuant to the binding standards of the IIA (Institute of Internal Auditors).

Standard 1312 of the IIA requires an external audit once every five years.

In 2004, the Company's internal audit unit underwent an external audit, which concluded that the unit carries out its work in accordance with accepted professional internal audit standards.

(10) **Access to information**

The internal auditor has been furnished with documents and information as stipulated in Article 9 of the Internal Audit Law, and she has been granted permanent direct access to the Corporation's information systems.

(11) **Auditor's report**

(A) The internal auditor submits the audit reports in writing.

(B) The internal auditor routinely submits the audit reports during the reporting period to the Chairman of the Board of Directors, the CEO, the Chairman of the Audit Committee and committee members. During the reporting period 25 audit reports regarding the Company were submitted at the following times:

January – three reports
February – two reports
March – two reports
April - three reports
May – four reports
June - one report
July – three reports
September – one report
November – three reports
December – three reports

(C) **Dates on which the Audit Committee convenes**

The Board's Audit Committee regularly discusses the audit reports submitted by the internal auditor during the year reported. Over the course of the year, the Committee held

10 meetings. The following table presents the meeting dates during the year reported, divided into quarters:

First quarter	Second quarter	Third quarter	Fourth quarter
February 7, 2006	May 16, 2006	July 11, 2006	November 22, 2006
March 8, 2006		August 22, 2006	November 27, 2006 The audit reports were not discussed at this meeting
		September 12, 2006	December 26, 2006 The audit reports were not discussed at this meeting
			January 21, 2007 This meeting was held instead of the meeting which had been scheduled for December 26 and which was postponed.

26 audit reports were discussed at these meetings. Approximately 17 of the reports discussed were published during the year reported and 9 at the end of the previous year reported. In addition to discussions on the audit reports, the committee discussed additional subjects that it is obligated by law to discuss and decide thereon.

(11) **<u>Assessment of the Board of Directors regarding the work of the Internal Auditor</u>**

In the opinion of the Company's Board of Directors, based on that described in sections (1) – (10) above, the scope of the Company audit performed in 2006, the nature and continuity of the internal auditor's activities, and the work program, which are reasonable in the circumstances, they are sufficient to achieve the objectives of the audit.

(12**)** **<u>Remuneration</u>**

(A) The internal auditor is not one of the five highest salaried of the Corporation's senior officers.

(B) The auditor was granted options as set forth in Section (1)(E) above.

(C) The remuneration received by the internal auditor does not affect her professional judgment.

(13) **<u>Disclosure of exposure caused by non-compliance with conditions</u>**

The binding conditions in the matter of the Corporation's internal auditor have been fulfilled pursuant to the fourth appendix of Article 10(b)(11) or pursuant to any law.

9. <u>Critical accounting estimates</u>

The preparation of the financial statements according to international accounting principles obligates the management to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities. Management bases its estimates and assessments on past experience and on estimating values and opinions and additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments based on various assumptions and conditions. Information on the principal matters of uncertainty in critical assessments and judgments in the application of the accounting policies is provided in the Financial Statements (see Note 2F). We believe that these assessments and estimates are critical because every change in them and the assumptions has the potential to materially affect the financial statements.

<u>Estimated useful life of property, plant and equipment</u>

The estimated useful lives of <u>property, plant and equipment</u> determine the depreciation expenses that will be recorded in the reporting period.

The main part of the telecommunications infrastructure is managed in accordance with asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past experience, taking into consideration expected technological changes, Company plans or other changes. If such changes take place earlier than expected or differently from expected, the remaining useful life of such assets may be shortened. This results in an increase in future depreciation expenses. If the changes take place later than expected, the remaining useful life may be extended, and this results in a decrease in the depreciation expenses. In light of the importance of the Group's depreciation expenses in respect of the above changes, the effect on the operating results and the financial condition of the Group may be extremely significant.

Estimating the value of items of property, plant and equipment

Certain items of property, plant and equipment have been revalued to fair value upon the transition to IFRS based on their deemed cost, which was determined on the basis of their value on the transition date (January 1, 2005) in accordance with the Group's assessments based on the valuation of an external appraiser (attached as an appendix to the financial statements). In addition, the costs of dismantling, clearing and restoring sites were capitalized at the date of transition to IFRS. The residual value of the Company's copper cables was assessed by the Company, based on the opinion of an external appraiser (attached as an appendix to the financial statements).

The use of estimates and value appraisals affects the fixed asset and depreciation expenses items – see Note 9 to the Financial Statements.

Liability for employee benefits

These liabilities are based on actuarial calculations which include many calculation assumptions which may be different in practice. The assumptions relate, *inter alia*, to interest rates for discounting, mortality tables, wage creep and leaving rates – for details, see the actuary's letter attached to the financial statements.

With regard to changes in estimates in respect of employee benefits, see Note 16 to the Financial Statements.

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since the Company's business plans anticipate realization of the tax benefit. Naturally, actual business results can differ from business plans, and this can affect the future realization of the tax benefit (see Note 8 to the financial statements).

Provisions and contingent liabilities

The Group's companies have contingent liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions of extremely significant amounts are pending against Group companies.

The Company makes regular estimates of the potential liabilities associated with every claim and action. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is reasonable for the Company to bear the costs of settling claims and whether they can be reliably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with charges for the Company, in amounts materially different from the provisions included in the financial statements, if any. For details of contingent liabilities, see Notes 15 and 17 to the financial statements.

Provision for doubtful debts

The financial statements include a provision for doubtful debts calculated generally on the volume of trade receivable balances, based on assessments and past experience, and specifically in respect of debts whose collection is in doubt. Actual results may differ from the assessments and estimates made, and could affect the results of operations accordingly (see Note 6 to the financial statements).

Goodwill and the value of investment in investee companies

The value of the Company's holding in DBS and in Pelephone, for examining the need for a reduction in respect of impairment, is calculated by estimating the present value of future cash flows. The estimate is based on various forecasts, including, among others, projected cash flows for the coming years, a forecast of the number of subscribers and average revenue per user (ARPU), and the business forecasts. These are based on assumptions, estimates and sensitivity to changes in the discounted interest rate (see Note 10 to the financial statements).

Employee stock options plan

The fair value of the options granted to Company employees was determined according to the Company's assessment, based on the opinion of an external appraiser (attached as an appendix to the financial statements). The value determined reflects the fair value of the services rendered to the Company in exchange for the options, and was measured by the Black and Scholes model and based on parameters that include the share price, the exercise price, volatility and average useful life. The value is also sensitive to a risk-free interest rate of government debentures (see Note 26 to the financial statements).

Assessment of financial instruments

The value of financial instruments is calculated according to the classification, based on market prices, present value of the cash flows and various value assessment models. The values are sensitive to changes in parameters that served as the basis for these assessments (see Note 30 to the financial statements).

10. Miscellaneous

A. **Disclosure concerning the remuneration of the external auditor**

Below are the fees in respect of the auditors of the main companies in the Group in respect of auditing services and services related to the audit for 2006:

- **The Company** – To Somekh Chaikin for 11,850 hours – approximately NIS 2,716 thousand.
- **Pelephone** – To Kesselman and Kesselman and to Somekh Chaikin, for 5,724 hours – approximately NIS 1,342 thousand.
- **DBS** – To Kesselman & Kesselman for 3,754 hours – approximately NIS 737 thousand for auditing services and tax services.
- **Bezeq International** – To Somekh Chaikin and to Brightman for 3,675 hours – approximately NIS 572 thousand for auditing services and approximately NIS 140 thousand for tax services.

B. **Event subsequent to the date of the financial statements**

On March 29, 2007, the Board of Directors of the Company resolved to appoint Dr. Yoram Danziger as external examiner, to investigate the issues arising from the immediate reports of the Company – on March 20, 2007, regarding the matter of approval of a stock options plan for employees and managers, on March 26, 2007, in the matter of the approval of grants for officers, and on March 26, 2007 in the matter of restatement – following the letters of the Securities Authority to the Company on March 25, 2007 and March 28, 2007. The external examiner, who will commence his work on April 1, 2007, is requested to submit his interim findings to the Board of Directors and to the Securities Authority by no later than April 12, 2007, and his final findings by April 26, 2007.

To remove even the slightest suspicion concerning the complete freedom of action of the external examiner and his access to all material in the Company as he deems necessary, the CEO of the Company, Yacov Gelbard, requested the consent of the Board of Directors for him to take leave of absence until the external examiner submits his interim findings as aforesaid. The Board of Directors acceded to Mr. Gelbard's request, and resolved that during his absence, the position of Acting CEO would be filled by Yitzhak (Ika) Abravanel, who is currently Deputy CEO of the Company.

We thank the managers of the Group companies, its employees and the shareholders.

Dov Weissglas	**Yacov Gelbard**
Chairman of the Board of Directors	CEO