# "BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

## INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## MARCH 31, 2004

**Interim Consolidated Financial Statements as at March 31, 2004**

## Contents

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

Dear Sirs,

**Re: Review of the Unaudited Interim Consolidated Financial Statements for the Three Month Period Ended March 31, 2004**

At your request we have reviewed the interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited and its subsidiaries as at March 31, 2004, as well as the interim consolidated statement of operations, the interim statement of changes in shareholders' equity and the interim consolidated statement of cash flows for the three month period then ended.

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

Reports of other auditors were furnished to us which relate to the review of the interim financial statements of subsidiaries, whose assets as at March 31, 2004, constitute approximately 20.7% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 40.2% of the total revenues included in the interim consolidated statement of operations for the three months then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in the amount of approximately NIS 226 thousand as at March 31, 2004, and the Company's share in the losses in respect thereof in the amount of approximately NIS 65 thousand for the three month period ending on the same date.

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

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

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

1. The continuing opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.

2. A program of early retirement, as described in Note 6.

3. Claims made against the Company and against investee companies, as described in Note 7A.

4. The financial position of an affiliated company and financing agreements with banking institutions and shareholders of the affiliated company, including the non-compliance of some of the conditions detailed in the financing agreements. As described in Note 4B, the continuation of the activities of the affiliated company is dependent upon receipt of additional loans from shareholders within the framework of the financing agreements including loans from the Company in accordance with the work plan of the affiliated company.

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

May 17, 2004

## Interim Consolidated Balance Sheets

| | March 31 2004 (Unaudited) | March 31 2003 (Unaudited) | December 31 2003 (Audited) |
|---|---|---|---|
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Current assets** | | | |
| Cash and cash equivalents | **2,118,243** | 1,232,303 | 1,954,350 |
| Short-term investments | **1,063,489** | 813,567 | 1,340,341 |
| Trade receivables | **1,757,541** | 1,671,165 | 1,667,623 |
| Other receivables and debit balances | **390,895** | 509,214 | 415,372 |
| Inventory | **98,149** | 163,901 | 83,995 |
| | **5,428,317** | 4,390,150 | 5,461,681 |
| **Materials and spare parts** | **155,817** | 152,472 | 151,911 |
| **Investments and long-term receivables** | | | |
| Investments, deposits and debit balances | **774,108** | 647,468 | 765,971 |
| Investments in investee companies | **225,917** | 360,030 | 240,667 |
| | **1,000,025** | 1,007,498 | 1,006,638 |
| **Fixed assets** | | | |
| Cost | **28,625,327** | 29,756,237 | 28,385,188 |
| Less– accumulated depreciation | **20,127,320** | 20,136,763 | 19,686,070 |
| | **8,498,007** | 9,619,474 | 8,699,118 |
| **Other assets** | | | |
| Deferred charges and other assets | **246,770** | 252,031 | 208,677 |
| Deferred taxes | **528,677** | 400,046 | 560,739 |
| | **775,447** | 652,077 | 769,416 |
| | **15,857,613** | 15,821,671 | 16,088,764 |

| | March 31 2004 (Unaudited) | March 31 2003 (Unaudited) | December 31 2003 (Audited) |
|---|---|---|---|
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Current liabilities** | | | |
| Bank credit | **69,639** | 443,515 | 144,714 |
| Current maturities of: | | | |
| Long-term bank loans | **867,751** | 543,359 | 685,883 |
| Debentures | **173,314** | 586,331 | 598,153 |
| Trade payables | **1,050,675** | 979,651 | 1,130,716 |
| Employee severance benefits | **549,506** | 320,923 | 602,520 |
| Other current liabilities | **1,226,980** | 1,154,789 | 1,188,200 |
| | **3,937,865** | 4,028,568 | 4,350,186 |
| **Long-term liabilities** | | | |
| Long-term loans | **1,549,754** | 2,059,472 | 1,754,293 |
| Debentures | **2,547,884** | 2,233,349 | 2,324,582 |
| Employee severance benefits | **773,206** | 981,035 | 770,909 |
| Other long-term liabilities | **35,877** | 45,854 | 43,764 |
| | **4,906,721** | 5,319,710 | 4,893,548 |
| **Minority rights** | **163** | 1,133 | 88 |
| **Contingent liabilities (Note 7)** | | | |
| **Shareholders' equity** | **7,012,864** | 6,472,260 | 6,844,942 |
| | **15,857,613** | 15,821,671 | 16,088,764 |

| Adv. Miriam (Miki) Mazar | Amnon Dick | Ron Eilon |
|---|---|---|
| Chairperson of the Board | President & CEO | Chief Financial Officer |

Date of approval of the financial statements: May 17, 2004

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

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

## Interim Consolidated Statements of Operations

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 | 2003 | 2003 |
| | (Unaudited) | (Unaudited) | (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from telecommunications services (Note 9)** | **2,009,221** | 1,978,371 | 7,981,268 |
| **Costs and expenses** | | | |
| Operating and general expenses (Note 10) | **1,090,812** | 1,116,476 | 4,485,300 |
| Depreciation | **471,792** | 547,008 | 2,160,011 |
| Royalties to the Government of Israel | **47,372** | 60,171 | 242,608 |
| | **1,609,976** | 1,723,655 | 6,887,919 |
| Operating income | **399,245** | 254,716 | 1,093,349 |
| **Financing expenses, net** | **30,749** | 31,773 | 157,522 |
| Earnings after financing expenses | **368,496** | 222,943 | 935,827 |
| **Other expenses, net (Note 6A)** | **30,452** | 87 | 983,178 |
| Earnings (loss) before income tax | **338,044** | 222,856 | (47,351) |
| **Income tax** | **105,314** | 85,741 | 48,013 |
| Earnings (loss) after income tax | **232,730** | 137,115 | (95,364) |
| **Equity in losses of affiliates** | **64,884** | 69,019 | 343,334 |
| **Minority share in earnings (losses) of a consolidated company** | **(76)** | 570 | (862) |
| Net earnings (loss) | **167,922** | 67,526 | (437,836) |
| **Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)** | **0.064** | 0.028 | (0.179) |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

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

## Interim Statement of Changes in Shareholders' Equity

| | Share capital | Capital reserve – share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Dividend proposed subsequent to the balance sheet date | Retained earnings (deficit) | Total |
|---|---|---|---|---|---|---|
| | Reported amounts* | | | | | |
| | NIS thousands | | | | | |
| **Three months ended March 31, 2004** | | | | | | |
| Balance as at December 31, 2003 (audited) | **6,309,133** | **1,623,423** | **37,775** | **–** | **(1,125,389)** | **6,844,942** |
| Net earnings (unaudited) | **–** | **–** | **–** | **–** | **167,922** | **167,922** |
| Balance as at March 31, 2004 (unaudited) | **6,309,133** | **1,623,423** | **37,775** | **–** | **(957,467)** | **7,012,864** |

| | Share capital | Capital reserve – share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Dividend proposed subsequent to the balance sheet date | Retained earnings (deficit) | Total |
|---|---|---|---|---|---|---|
| | Amounts adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS thousands | | | | | |
| **Three months ended March 31, 2003** | | | | | | |
| Balance as at December 31, 2002 (audited) | 6,116,378 | 938,134 | 37,775 | 186,416 | (688,623) | 6,590,080 |
| Net earnings (unaudited) | – | – | – | – | 67,526 | 67,526 |
| Dividend paid (unaudited) | – | – | – | (186,416) | 1,070 | (185,346) |
| Balance as at March 31, 2003 (unaudited) | 6,116,378 | 938,134 | 37,775 | – | (620,027) | 6,472,260 |
| **Year ended December 31, 2003** | | | | | | |
| Balance as at December 31, 2002 (audited) | 6,116,378 | 938,134 | 37,775 | 186,416 | (688,623) | 6,590,080 |
| Net loss (audited) | – | – | – | – | (437,836) | (437,836) |
| Dividend paid (audited) | – | – | – | (186,416) | 1,070 | (185,346) |
| Issuance of shares (audited) | 192,755 | 685,289 | – | – | – | 878,044 |
| **Balance as at December 31, 2003 (audited)** | 6,309,133 | 1,623,423 | 37,775 | – | (1,125,389) | 6,844,942 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

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

## Interim Consolidated Statements of Cash Flows

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 | 2003 | 2003 |
| | (Unaudited) | (Unaudited) | (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Cash flows from operating activities** | | | |
| Net earnings (loss) | **167,922** | 67,526 | (437,836) |
| Adjustments to reconcile net earnings (loss) to net cash flows from operating activities (see A below) | **589,968** | 663,083** | 3,129,841 |
| Net cash derived from operating activities | **757,890** | 730,609** | 2,692,005 |
| **Cash flows from investing activities** | | | |
| Investment in fixed assets | **(397,243)** | (388,890) | (1,413,803) |
| Proceeds from disposal of fixed assets | **22,706** | 30,373** | 86,492 |
| Investment in long-term deposits and investments | **(16,173)** | (25,531) | (159,564) |
| Proceeds from long-term deposits and investments | **15,444** | 24,352 | 77,216 |
| Decrease (increase) in short-term investments, net | **260,167** | 340,295 | (107,137) |
| Increase in materials and spare parts | **(49,282)** | (6,754) | (260) |
| Investment in investee companies | **(46,908)** | (50,816) | (190,037) |
| Investment in other assets | **(45,662)** | (15,227) | (51,124) |
| Net cash used in investing activities | **(256,951)** | (92,198)** | (1,758,217) |
| **Cash flows from financing activities** | | | |
| Issuance of debentures (net of deduction of issuance expenses) | **315,000** | – | – |
| Repayment of other debentures | **(516,035)** | (155,664) | (207,623) |
| Receipt of long-term loans | **72,026** | 151,733 | 493,191 |
| Repayment of long-term loans | **(132,962)** | (115,230) | (557,302) |
| Repayment of short-term bank credit, net | **(75,075)** | (75,336) | (374,137) |
| Proceeds from issuance of shares | **–** | – | 878,044 |
| Dividend paid | **–** | (185,346) | (185,346) |
| Net cash derived from (used in) financing activities | **(337,046)** | (379,843) | 46,827 |
| **Increase in cash and cash equivalents** | **163,893** | 258,568 | 980,615 |
| **Balance of cash and cash equivalents at the beginning of the period** | **1,954,350** | 973,735 | 973,735 |
| **Balance of cash and cash equivalents at the end of the period** | **2,118,243** | 1,232,303 | 1,954,350 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2
** Reclassified

The notes to the financial statements are integral part thereof.

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

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 (Unaudited) | 2003 (Unaudited) | 2003 (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **A – Adjustments to reconcile net earnings to net cash flows provided by operating activities** | | | |
| Revenue and expenses not involving cash flows: | | | |
| Depreciation | **471,792** | 547,008 | 2,160,011 |
| Disposal of assets and impairment in value of fixed assets | **–** | – | 327,295 |
| Deferred taxes | **(63,014)** | 18,424 | (137,670) |
| Company's equity in losses of affiliated companies | **64,884** | 69,019 | 343,334 |
| Minority share in earnings (losses) of a consolidated company | **(76)** | 570 | (862) |
| Increase (decrease) in employee severance benefits, net | **(50,717)** | (24,984) | 46,488 |
| Loss (gain) on disposal of fixed assets | **80** | 1,275 | (1,634) |
| Provision for decrease in value of investments | **–** | – | 14,603 |
| Erosion (appreciation) and interest on long-term investments and debts | **(3,916)** | 14,792 | 36,407 |
| Erosion (appreciation) of short-term investments, net | **16,685** | 3,961 | (75,381) |
| Appreciation (erosion) of long-term liabilities: | | | |
| Debentures | **(502)** | 52,117 | 207,133 |
| Long-term loans and other long-term liabilities | **41,379** | (32,709) | (77,647) |
| Amortization of other assets and deferred expenses | **20,107** | 40,886 | 127,191 |
| Changes in current assets and liabilities: | | | |
| Decrease (increase) in trade receivables | **(99,305)** | 48,022 | 29,835 |
| Decrease in receivables and debit balances | **83,465** | 84,603 | 129,706 |
| Decrease (increase) in inventory | **(14,295)** | (572) | 78,083 |
| Increase (decrease) in trade payables | **53,122** | (173,820) | (123,852) |
| Increase in other current liabilities | **82,351** | 12,434** | 63,054 |
| Increase (decrease) in deferred revenues | **(12,072)** | 2,057 | (16,253) |
| | **589,968** | 663,083** | 3,129,841 |
| **B– Non-cash transactions** | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit | **92,624** | 152,754 | 313,119 |
| Sale of fixed assets on credit | **399** | – | – |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2
** Reclassified

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

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 1 – GENERAL

**A.** These interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim financial statements pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB ) and to the provisions of Chapter D of the Securities Regulations (Periodic and Immediate Reports), 5730-1970.

**B.** These statements should be read in conjunction with the annual financial statements of the Company and its consolidated companies as at December 31, 2003, and for the year then ended, and the accompanying notes (hereinafter - the Annual Reports).

**C.** The Company presents in the notes to the interim financial statement only the significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of cellular telephone services, international communication services, domestic communication services, the opening of these markets to competition and decisions of the Ministerial Committee for Privatization to reduce the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2003. The significant changes that occurred from the date of those annual financial statements to the date of these financial statements, are as follows:

1. Further to Note 1A to the financial statements as at December 31, 2003, concerning the Company's license, on March 31, 2004, the Company license was amended by a comprehensive and extensive revision and consolidated into a format that includes all the amendments made to the license since it was granted in 1994. The license sets out the conditions for the Company's operation and states, *inter alia*, that the Company will provide universal telephony services, associated services and infrastructure services. Under the license, the management of the subsidiaries and the management of the Company are separate, and the introduction of a new service by the Company requires the approval of the Minister of Communications.

   According to the Ministry of Communications' notice to the Ministerial Committee for Privatization, the amended license is intended to adapt the general license to the competitive environment in which the Company operates, however the Company believes that certain provisions in the license are expected to restrict the Company in its operations and will impede its ability to compete. In addition, on February 5, 2004, the Government, and on 24 March, 2004, the Knesset Finance Committee, approved an amendment to the Bezeq Order that brings it into line, *inter alia*, with an amendment made to the decision on the privatization of the Company and amendments to the Communications Law.

2. Further to Note 1B to the financial statements as at December 31, 2003, concerning changes in the Company's tariffs and the update thereof, call completion tariffs in the Bezeq network for calls originating in a cellular network and international interconnect tariffs will be lowered on June 1, 2004, at an average of 8.2%.

   In addition, based on the updating formula determined in the Regulations, the Company's tariffs are expected to be lowered on June 1, 2004, by an average of approximately 4.3%. An update of the interconnect tariffs is subject to a hearing to be arranged by the Ministry of Communications for the Company.

3. Further to Note 1E(2) to the financial statements as at December 31, 2003, concerning the expansion of competition in the international communications market, the Communications Regulations (Telecommunications and Broadcasts) (Processes and Conditions for Receipt of a General License for the Provision of International Telecommunications Services), 5764-2004 were published on March 30, 2004, and will become valid on April 22, 2004. Most of the arguments of Bezeq International were accepted, and the Regulations determine that a license will not be granted to a corporation in which an interested party is an international operator, nor to a corporation which is a domestic carrier or a cellular operator or a significant operator in the operation of international transmission service sector (as defined in the Regulations), nor to a corporation in which an interested party is an international operator or in which there is a party with significant influence (as defined in the Regulations) which is a cellular operator.

**NOTE 1 – GENERAL (CONTD.)**

The Regulations also determine that in other situations of cross-ownership a license will only be granted to a corporation if the Minister is convinced that grant of the license will promote competition in the communications arena or in the telecommunications activity sector or is in the public interest. The Minister of Communications may also stipulate restrictions and conditions in the license concerning the relationship between the licensee and companies which own a right to domestic communication servicess, a cellular operator or a significant operator as aforesaid, including regarding filling positions and the appointment of officers, information transfer, the existence of separate companies or separate accounting systems for operations, and, in addition, concerning technological or commercial restrictions in setting up an international telecommunications system, in providing services, in implementing interconnect connections and in granting use of communications installations of the licensee.

The shareholders' equity of a corporation applying for a general license pursuant to these Regulations is not less than NIS 20 million. The Regulations also stipulate that whoever receives a license will be required to set up an international telecommunications network and to commence provision of international telephone services within six months of the date of grant of the license.

In the opinion of Bezeq International the increase in competition will cause a further decrease in the prices of international calls and, as differentiated from the commencement of competition in 1997, the extent of the international traffic will not significantly increase as a result thereof, as call prices today do not prevent the public from using the service. In addition, Bezeq International considers that the aforementioned increase in competition is expected to adversely affect the results of its activities and its financial position, although at this stage, Bezeq International is not able to estimate, the extent of that effect.

**D.** The offer for sale and the offering to the public under the Company's prospectus which is scheduled for publication at the end of May 2004, is expected to include the following securities:

An offer for sale to the public by the State of Israel, of 147,607,510 ordinary shares of NIS 1 par value each of the Company (constituting approximately 5.67% of the issued share capital of the Company and approximately 5.62% at full dilution).

An offering by the Company of 798,175,200 registered by name debentures (Series 4) out of a series of 1,600,000,000 debentures of a par value of NIS 1 each, payable in three equal annual installments.

In addition, the Company will issue, immediately prior to the prospectus, a series of 600 million debentures (Series 5) of NIS 1 par value each, to institutional investors and to a company wholly-owned and controlled by the Company. The debentures will be listed for trading in the framework of the prospectus.

The final details of the offer for sale and the offering described above have not yet been completed, and in any case are subject to change.

**NOTE 2 - REPORTING POLICIES AND ACCOUNTING PRINCIPLES**

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

B. **Definitions**

In these financial statements –

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

**NOTE 2 - REPORTING POLICIES AND ACCOUNTING PRINCIPLES (CONTD.)**

Reported value – an amount adjusted for inflation to the transition date (December 31, 2003), plus amounts in nominal values added after the transition and less amounts deducted after the transition date.

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

Nominal financial reporting – financial reporting based on reported values.

C. **Termination of adjustment of financial statements**

In October 2001 the IASB published Accounting Standard No. 12 – "Termination of Adjustment of Financial Statements". Under this Standard, and Accounting Standard No. 17 from December 2002, the adjustment of financial statements is to be terminated from January 1, 2004. Until December 31, 2003 the Company continued to prepare adjusted statements in accordance with Opinion 36 of the Institute of Certified Public Accountants in Israel. Commencing January 1, 2004, the Company is applying the provisions of the Standard

D. **Financial statements in reported values**

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

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

3. In the financial statements, "cost" means cost at the reported amount value.

4. All comparative data for prior periods are stated adjusted to the CPI of December 2003.

5. Balance Sheets:

   a. Non-monetary items are stated in reported values.
   b. Monetary items are stated in the balance sheet in historical nominal values as at the balance sheet date.

   Statements of Operations:

   a. Revenues and expenses deriving from non-monetary items or from provisions included in the balance sheet, are derived from the difference between the value reported in the opening balance and the value reported in the closing balance.
   b. The remaining items of the Statement of Operations are stated in nominal values.

E. **Initial Application of Accounting Standards**

**Accounting Standard No. 20, period of amortization of goodwill**

The Company is applying Accounting Standard No. 20 concerning the period of amortization of goodwill (hereinafter – the Standard). The Standard states that goodwill will be methodically amortized over its useful life by the straight-line method. The amortization period should reflect the best estimate of the period in which future economic benefits can be expected to derive from the goodwill. The amortization period will not exceed 20 years from the date of first recognition. The Standard applies to financial statements whose periods commence on January 1, 2004 or thereafter. The change in the amortization period of the balances of goodwill as at January 1, 2004 is treated as a prospective change of estimate ("from now on”). Such balances of goodwill were amortized by the straight-line

**NOTE 2 - REPORTING POLICIES AND ACCOUNTING PRINCIPLES (CONTD.)**

method during the balance of the period remaining for completion of the amortization period determined. Application of the new Standard does not have a material effect on the financial position and operating results of the Company.

**NOTE 3 - PERCENTAGES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES**

The changes that occurred in the Consumer Price Index (“CPI”) and in the dollar and euro exchange rates are as follows:

| | Consumer Price Index | Exchange rate of the US dollar | Exchange rate of the euro |
|---|---|---|---|
| | % | % | % |
| During the three-month period ended: | | | |
| March 31, 2004 | **(0.001)** | **0.034** | **0.000** |
| March 31, 2003 | 0.779 | (1.056) | (2.983) |
| During the year ended December 31, 2003 | (1.848) | (7.557) | 17.824 |

**NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES**

**A. Pelephone Communications Ltd. ("Pelephone")**

Further to Note 8D(3) to the financial statements as at December 31, 2003, concerning the decision of the Board of Directors of the Company on February 26, 2004, to exercise the option to acquire Pelephone: on April 20, 2004, the Company approached the Director General of the Government Companies Authority and requested government approval for exercise of the option. On April 29, 2004, the Company approached the Minister of Communications for his approval of the transaction in accordance with the general license of Pelephone. In addition, the Company sought the approval of the Antitrust Commissioner.

Upon exercise of the option, the Company will bear the cost of exercising the option (at least US $60 million, or approximately NIS 263 million), the cost of approximately US $389.8 million (approximately NIS 1,770 million) in respect of the amounts that the corporation owes the bank and in respect of conversion of the debenture – waiver of the Company's right to repayment of the loan.

Exercise of the option was supposed to cause violation of the Company's undertaking towards two groups of foreign banks which extended loans to it, whereby the Company would maintain a ratio of 35% between shareholders' equity and tangible assets (the total aforementioned bank loans approximately NIS 760 million). However, the Company has reached agreement with the aforementioned banks to reduce that ratio to 25% for a period of one year (starting from the date of exercise of the Company's option to purchase the Pelephone shares).

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

In January 1999 DBS received a license from the Ministry of Communications for satellite television broadcasts, and commenced provision of services in July 2000. DBS has accumulated considerable losses and negative cash flows. The loss for the year 2003 amounted to approximately NIS 555 million and the loss in the three-month period ended March 31, 2004, amounted to approximately NIS 110 million. As a result of these losses, the capital loss and the deficit in working capital at DBS as at March 31, 2004, amounted to approximately NIS 2,916 million and NIS 1,801 million, respectively. The working capital deficit includes bank credit of NIS 1,305 million.

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

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

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date amounts to approximately NIS 1,223 million (nominal). The Company's share in the accumulated losses of DBS is approximately NIS 1,115 million, of which approximately NIS 64 million was recorded in the period of account. The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 74 million.

On May 23, 2001, a financing agreement ("the Financing Agreement") was signed between DBS and certain banking institutions ("the Banks"), stipulating, *inter alia*, undertakings by DBS to meet certain suspending conditions and to comply with cumulative milestones and various financial requirements (hereinafter – the Conditions).

On December 30, 2002, DBS, the shareholders and the Banks signed an agreement increasing the credit line from the Banks (hereinafter - Interim Credit Line), which will be implemented concurrently with additional investments of the shareholders in an amount not less than a sum equal to 150% of the amount that will be injected by the Banks. Receipt of the Interim Credit Line was subject, *inter alia*, to DBS's compliance with financial and operating conditions set out in this agreement. At the time of approval of these financial statements, the shareholders and the Banks had transferred to DBS their entire share of the Interim Credit Line. However, some of the Conditions laid down in the Financing Agreement and the Interim Credit Line are not being met. In parallel with the signing, as aforesaid, the parties were discussing an increase in the Interim Credit Line in the framework of an amendment to the Financing Agreement (hereinafter – the Amendment Agreement).

An economic examination completed by the Banks in March 2003 determined that the overall financing needs of DBS did not exceed the Interim Credit Line plus the addition to it in the Amendment Agreement (including the proportional part of the shareholders). On August 6, 2003, the Amendment Agreement was signed by the Banks and DBS. Under that Agreement, the Banks will extend to DBS additional amounts to those extended under the Financing Agreement and the Interim Credit Line, subject to DBS complying with the conditions and milestones stipulated in the Amendment Agreement, including further investments of shareholders of not less than 150% of the amounts that will be made available by the Banks. The Amendment Agreement took effect in December 2003. As at the date of approval of these financial statements, some of the conditions in the Amendment Agreement are not being met and therefore the Banks have not yet injected the amounts which were supposed to have been made available in the first quarter of 2004 under this Agreement. DBS is working with the Banks to amend the suspending conditions and milestones of the Amendment Agreement (see below). In accordance with the Amendment Agreement, in February 2004 DBS converted NIS 1,225 million of short-term credit to long-term loans. In these financial statements the long-term loans were classified under current liabilities of DBS since DBS is not meeting some of the conditions of the Amendment Agreement.

Grant of additional loans from the Company to DBS was subject (as long as the Company was a government company), *inter alia*, to the approval of the Ministerial Committee for Privatization (hereinafter – the Committee), by virtue of conditions laid down by the Committee for the approval it granted the Company to invest in DBS. On January 14, 2003, the Committee approved an increase in the Company's investment up to double the percentage of its holdings in DBS shares multiplied by $600 million up to a ceiling of $ 300 million. In the opinion of the management of DBS the total investments approved for the Company by the Committee covers the Company's share in the Interim Credit Line plus its proportional part in the Amendment Agreement.

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS on July 10, 2002 (hereinafter – the New Shareholders' Loans) would have priority over the shareholders' loans to DBS which were made earlier (hereinafter – the Old Shareholders' Loans). Under the agreement, the New Shareholders' Loans will be entitled to repayment in full by DBS before any distribution of dividends by DBS and/or the repayment of the Old Shareholders' Loans extended to DBS by shareholders, this being subject to DBS's cash flow and its obligations under the agreements with the Banks (including the priority of repayment of the bank financing). The New Shareholders' Loans are linked to the CPI and bear

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

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

annual interest of 5.5%. In addition, under the same agreement, the shareholders who invest in the New Shareholders' Loans are permitted to choose between an allotment of shares and options for shares deriving from their investments. On April 25, 2004, the DBS shareholders received options that will enable adjustment of their percentage holding in DBS to the percentage of their investments in the company as at March 31, 2004. If the Company's holding in DBS will exceed 50%, exercise of the options by the Company (as opposed to their receipt) requires Government approval, approval by the Minister of Communications in consultation with the Council for Cable and Satellite Broadcasts and approval by the Antitrust Commissioner. The options are convertible at any time for no additional consideration and can be transferred as if they were shares, subject to the approvals of the Banks pursuant to the Financing Agreement. The options received by the Company will bring its holding, if they are exercised, to approximately 54.02% in DBS. The Old Shareholders' Loans are linked to the CPI ("known") and are interest-free. According to a note of amendment to the aforementioned agreement, the New Shareholders' Loans made under the framework of the Amendment Agreement will be linked to the known CPI plus interest at an annual rate of 11%. Under the Agreement, any change in the interest rate is subject to the consent of 75% of the shareholders. No date was set for repayment of these loans.

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

On March 9, 2004, the Board of Directors of DBS approved a multi-year work plan for 2004 and 2005 (hereinafter – the Work Plan), *inter alia,* following a report commissioned by the Company from an outside economic consulting firm on the business condition of DBS, which was presented to the Board of Directors of the Company on January 8, 2004. The report reveals a negative difference between DBS's financing plan and its financing requirements . According to the Work Plan, DBS will need significant additional amounts of outside financing in the aforementioned years, over and above the Amendment Agreement.

In view of the requirements of DBS, the difficulty of obtaining additional bank financing and the non-participation of the other shareholders in financing DBS beyond the present Financing Agreement, the Board of Directors of the Company adopted a resolution on March 30, 2004, which was later amended, to approve an additional investment (beyond the present Financing Agreement) of approximately NIS 440 million by the end of 2005, which would be made gradually, according to the requirements of DBS and the Work Plan. The investment of NIS 440 million will take into account development of regulatory conditions in the communications market that are to the satisfaction of the Company, and subsequent to implementation of the Banks' commitment under the present Financing Agreement. Implementation of the resolution is subject to receipt of the requisite approvals and the remarks of the Government Attorney General.

In the opinion of the Company, relying on its legal advisers, continuation of investment by the Company in DBS does not require the approval of the authorities provided the Company has not exercised the options issued to it. . The Government Companies Authority notified the Company that the Deputy Government Attorney General has confirmed that further investment by the Company in DBS does not require the approval of the Ministerial Committee for Privatization.

According to the decision of the Board of Directors of the Company, further investment will be by way of new preferred shareholders' loans, and the Company will receive options for shares in accordance with existing agreements between the shareholders and DBS. The Board of Directors also approved

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

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

immediate implementation of the balance of the investment under the present Financing Agreement (NIS 55 million, which was transferred in full during April and May 2004) against receipt of such options. Under the present Financing Agreement of DBS and the extent of the Company's investment in DBS, the Company will be entitled, in respect of the investments expected in the plan, to shares that will increase its holdings to about 60% and/or options for shares which, if exercised, will bring its holdings to that percentage (all assuming that another shareholder will carry out its commitment and under the agreement, that if not, the Company will be entitled to shares that will bring its holdings to approximately 61%).

On the matter of the expected consolidation of the financial statements of DBS following the above resolution of the Board of Directors, see Note 13.

The Management of DBS believes that the continuation of its operations depends on the continued receipt of additional loans from shareholders under the financing agreements, including loans from the Company in accordance with DBS's Work Plan, and that there is a good chance of arranging the financial resources required by DBS in the coming year.

**C. Walla! Communications Ltd. ("Walla")**

In February 2004 Walla published a prospectus for an offering of options to its existing shareholders by way of rights. Bezeq International made a prior commitment to exercise Options (Series 3) in a total amount equal to the shareholders' loans it had extended to Walla as at September 30, 2003 (approximately NIS 14 million). The commitment of Bezeq International is subject to Section 328 of the Companies Law, i.e. Bezeq International will not exercise options in such a way that after exercise it will hold more than 44.9% of the issued capital of Walla except in compliance with the provisions of the law.

In March 2004 Bezeq International purchased 7,073,980 Options (Series 3) (36.74% of all the options offered) for a consideration of NIS 1,414 thousand, which was set-off against the aforementioned shareholders' loans. In March 2004 Bezeq International exercised 3,417,940 Options (Series 3) for a consideration of NIS 6,152 thousand, which was set-off against the aforementioned shareholders' loans. Following exercise of the options, the percentage of Bezeq International's holding in Walla increased from 36.74% on December 31, 2003 to 44.87% as at the date of the interim financial statements (at full dilution as at March 31, 2004 – 35.36%).

**D. Attachment of financial statements of an affiliated company**

The Company attaches to these financial statements the financial statements of D.B.S. Satellite Services (1998) Ltd.

**NOTE 5 – FIXED ASSETS**

**A. Depreciation policy**

Pursuant to the Company's policy of periodically re-examining the useful lives and the values of its assets, a panel was appointed in 2003 to assess the need to revise those periods and to make recommendations to Management. The examination included only the fixed assets of the Company and was based on the balance of its fixed assets as at December 31, 2003. In May 2004 the panel submitted its recommendations to the Management of the Company on the estimated useful life of the assets. The recommendations took into consideration mainly the investment plans of the Company, the technological innovations in the fixed-line communications sector, the depreciation rates in similar communications companies around the world, and the regulation and the opening of fixed-line communications to competition.

The modifications in the estimated useful lives recommended in the report included shortening the life of terminal equipment used for communications networks from 5 years to 4 years, and shortening the

## NOTE 5 – FIXED ASSETS (CONTD.)

### A. Depreciation policy (contd.)

life of new copper cabling from the exchanges to the distribution boxes from 20 years to 15 years. Conversely, it was recommended that the lives of SDH transmission be extended from 7 years to 8 years, and of data communications networks (ADSL, ATM) from 5 years to 7 years. The panel also recommended extending through 2010, the amortization period of the network in which there was investment through 1991 and which should have been fully amortized by the end of 2007. In addition, the panel recommended an estimated useful life for the new transmission systems and data networks which are scheduled for operation in the near future.

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

The table below shows the effects of the aforementioned on the Company's financial statements:

| | For the three months ended March 31, 2004 |
|---|---|
| | (Unadited) |
| | Reported amounts* |
| | NIS thousands |
| Reduction in depreciation expense | 19,250 |
| Increase in operating income | 19,250 |
| Increase in fixed assets | 19,250 |
| Increase in net earnings | 12,320 |
| Increase in earnings per share | 0.005 |

**B.** Further to Note 9G to the financial statements as at December 31, 2003, concerning the resolution of the Board of Directors of the Company to close the Inmarsat station, and the notice of the Ministry of Communications to the Company that it is not authorized to decide on the closure of the station, the Company (with the knowledge of the Ministry of Communications) contacted representatives of the Ministry of Defense and Israel Defense Forces ("IDF") in an attempt to reach an arrangement for termination of the service. The IDF representatives stated unequivocally that the Inmarsat service is an essential service that the IDF cannot forgo. The Company is now attempting to find a strategic partner for this service.

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

## NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

### A. Early retirement plan

In September 2000, the Company reached an agreement with workers' representatives for extension of the 1997 collective agreement for early retirement ("the Retirement Agreement"). Under the Retirement Agreement 1,770 additional employees would take early retirement from April 1, 2001 through December 31, 2006 (with an option to extend the final retirement date for certain employees through December 31, 2008). Of these, 300 are not transferred employees. In addition, the Agreement allowed the Company to terminate the employment of employees who are in compensation tracks in excess of the aforementioned quota. Under this plan, 854 employees had retired by March 31, 2004.

The Company's Management does not expect any significant costs arising as a result of employees who retire in compensation tracks (if they retire) under the Retirement Agreement or in another framework.

In May 2003 the Knesset enacted the Israeli Economy Recovery Plan (Legislative amendments for achieving budgetary targets and economic policy for fiscal 2003 and 2004), 5763-2003. This law includes, *inter alia*, an amendment to the Supervision of Insurance Business Law, 5741-1981, which relates to the old pensions funds operating at a deficit, including the Makefet Fund. Under the amendment, the retirement terms of all members of these pensions funds were made equal, in accordance with a uniform constitution which, according to the amendment to the law, took effect on October 1, 2003, so that the rights of members in those pension funds who were a party to special pensions agreements, were harmed.

Towards the end of 2003 the Company commenced negotiations with the workers' representatives for amendment and extension of the collective retirement agreement, and for clarification of the legal questions that arose from the existing agreement due to the aforementioned amendment of the Supervision of Insurance Business Law. On March 18, 2004, the Company (after approval by its Board of Directors), the New Histadrut and the workers' representatives signed an amendment to the Retirement Agreement in which certain amendments to the current Retirement Agreement were agreed upon which were intended to regulate and clarify the uncertainty created by the Supervision of Insurance Business Law. *Inter alia,* it was agreed that that by September 30, 2004, 400 employees would retire, and also that the pension terms of all the transferred employees accepting retirement under the Retirement Agreement of September 2000 would remain in effect despite the amendments to the Pensions Law, and that the Company would bear any additional costs required. In addition, the parties agreed that they would commence intensive negotiations to regulate the retirement of the remaining transferred employees by 2011, as well as the demands of the Management for organizational and other changes. A provision will be recorded in the financial statements if and when the negotiations result in an agreement.

On May 12, 2004, the Government Companies Authority approved, with the consent of the Commissioner of Wages, the amendment to the Retirement Agreement dated, March 18, 2004.

On April 1, 2004, the Supervisor of the Insurance and Savings (?) Capital Market published a circular – "Early Retirement Financed by the Employer in Old Pension Funds". According to the circular, the discount rate for capitalizing the cost of early pension was changed from 3.5% to 3% and the management fees were raised to 1.75%. As a result of the aforementioned and additional updates , the Company recorded an additional provision of approximately NIS 30 million in the financial statements as at March 31. 2004.

**B.** Further to Note 16E to the financial statements as at December 31, 2003, concerning claims filed by the Company against the Makefet Fund, the Makefet Fund has filed statements of defense at the court in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company.

## NOTE 7 - CONTINGENT LIABILITIES

### A. CLAIMS AND CONTINGENT LIABILITIES

The Company and the investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 19A to the Company's financial statements as at December 31, 2003. No significant changes occurred in contingent liabilities up to the date of the signing of these financial statements, except for the following:

(1) Further to Note 19A(3) to the financial statements as at December 31, 2003, in the matter of a claim filed against the Company alleging that the process for selecting the equipment to be purchased by the Company was unlawfully managed, in violation of the tenders laws and the rules of good administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony, it was decided with the consent of the parties to refer the dispute to an arbitrator, who will decide on the amount of compensation to be paid to the plaintiff by the Company, with a floor and ceiling mechanism in amounts that are not material.

(2) Further to Note 19A(4) to the financial statements as at December 31, 2003, in the matter of a declaratory claim filed by 2,423 pensioners of the Company, in a request for recognition of certain wage components as part of their determining wage for the matter of their pension, the financial implications of the claim described in that section are significant and could, under certain assumptions, reach as much as about NIS 1,046 million.

(3) Further to Note 19A(7) to the financial statements as at December 31, 2003, concerning an action together with an application for approval as a class action against the Company, Bezeq International and the other international communications operators, alleging unlawful collection of 17% VAT for some collect calls received by Company subscribers in Israel and originating abroad, the Company believes, relying on its legal advisers, that in the circumstances of the matter to date and noting, *inter alia*, the status of the Company (and of the other defendant communications companies) as a formal respondent, and the utterance of the plaintiffs' lawyer that there is no claim for independent relief against the communications companies (including the Company), it would appear that the Company is not expected to suffer financial exposure in connection with the claim (and if there is any exposure, then it will be minor). On April 18, 2004, the Supreme Court decided to stay the proceedings in this case until after a ruling is issued by the Supreme Court in another case.

(4) Further to Note 19A(12) to the financial statements as at December 31, 2003, concerning a claim together with an application for approval as a class action against the Company in the matter of restitution of a commission that was allegedly collected unlawfully in respect of calls in Israel from a public telephone operated by means of a Bezeqcard – on February 23, 2004, the Telecommunications Regulations (Payments for the telecommunications services listed in the Addendum to the Law) (Amendment of the Regulations 5759-1999, 5760-2000, 5761-2001), 5764-2004 were published, containing amendments to the Telecommunications Regulations (Payments for the telecommunications services listed in the Addendum to the Law), in respect of the years 1999-2001. Following that amendment, the Company contends that there is no longer any basis for the claim and the application for recognition as a class action.

(5) Further to Note 19A(13) to the financial statements as at December 31, 2003, concerning the notice of a party to a collective dispute which was filed by the New Histadrut in the name of employees of the Company, the financial implications of the claims as described in the aforementioned section are considerable, and could, under certain assumptions, reach as much as approximately NIS 1,357 million.

(6) Further to Note 19A(14) to the financial statements as at December 31, 2003, concerning a claim together with an application for recognition as a class action, which was filed against the Company, alleging that the Company unlawfully collects arrearage interest on arrears in payments for services provided by other communications providers, the Company filed its amended response on May 3, 2004.

## NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

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

(7) Further to Note 19A(16) to the financial statements as at December 31, 2003, concerning the "derivative claim" filed by a Company shareholder against 20 directors and certain senior managers who served the Company during October-November 2000 and against the Company, the plaintiff was granted an extension for filing the application until April 1, 2004, but failed to filed the application by that date. The Company is unable, relying on its legal advisers, to estimate the chances of the claim at this stage (if it is ever filed). However, in view of the nature of the derivative claim, the Company does not foresee any exposure in respect of the claim, and therefore no provision has been included in the financial statements.

(8) Further to Note 19A(18) to the financial statements as at December 31, 2003, concerning a claim together with an application for recognition as a class action, in the matter of alleged overcharging for calls from Company subscribers to cellular network subscribers of Cellcom and Pelephone during part of 1996, the application for approval as a class action was denied by consent on February 17, 2004, and accordingly, the statement of claim was stricken.

(9) Further to Note 19A(20) to the financial statements as at December 31, 2003, concerning a renewed statement of claim filed against Bezeq International and against the State of Israel together with an application for recognition as a class action, alleging that the tariffs for international telecommunications services during the period May 10, 1996 to July 8, 1997, were overpriced and unreasonable and exploited the status of Bezeq International as a monopoly, in view of reducing prices as the international calls market opened to competition – in February 2004, at the request of the State and Bezeq International the District Court stayed the implementation of the decision on approval as a class action. On January 23, 2004, the State filed an application for leave to appeal the decision that recognized the claim as a class action and on March 7, 2004, Bezeq International also filed an application for leave to appeal that decision. On February 10, 2004, the Supreme Court ruled that the State's application requires a response and on April 4, 2004 that Bezeq International's application requires a response.

The legal advisers of Bezeq International estimate that Bezeq International has meritorious arguments against the decision of the District Court, and accordingly, no provision was included in the financial statements of Bezeq International in respect of this claim.

(10) Further to Note 19A(23) to the financial statements as at December 31, 2003, concerning a claim filed by the State of Israel against Pelephone in respect of royalties allegedly payable to the State for the period from January 1994 through February 1996, the mediation process started in 2002 has not yet ended and it is unclear whether it will produce results.

In the opinion of the management of Pelephone, relying on its outside legal advisors who are handling the claim, Pelephone has a genuine defense against the claim. Pelephone’s financial statements include a provision which in the estimation of Pelephone’s management is proper and sufficient should Pelephone indeed be required to pay any amount under the framework of the claim/mediation process.

On the matter of the undertaking made by the Company towards Pelephone, the Company estimates that the risk that it will be charged with payment is low and therefore no provision was made in the financial statements.

(11) Further to Note 19A(25) to the financial statements as at December 31, 2003 in the matter of a claim filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd. ("Paltel") against Pelephone and another cellular company, to the best of Pelephone's knowledge Paltel alleged in this claim that it was granted a license to provide communications services in areas of the Palestinian Authority and that Pelephone carried out telecommunications operations and granted telecommunications services in the areas of the Palestinian Authority without a permit and in violation of local law.

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

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

It was recently learned that the Ramallah court might have given a decision in the claim. According to the Emergency Order (Judea, Samaria and the Gaza Strip – Jurisdiction in offenses and legal assistance) (Areas of the Palestinian Authority, legal assistance in civil matters), 5759-1999, enforcement of decisions given by the court of the Authority may be executed only of approved by the Commissioner for Legal Assistance at the Ministry in Justice. Pelephone believes that such a decision, if given, is without jurisdiction, contrary to public order and to the provisions of the Intermediate Agreement and the Extension of the Term of Emergency Regulations Law (Judea and Samaria and the Gaza Strip, Jurisdiction in offenses and legal assistance), 5727-1967. If an attempt is made to submit this decision for the approval of the Commissioner, or to enforce it in any other way, Pelephone will act to prevent such approval / enforcement and/or execution proceedings or for their revocation for the reasons given above, which were the foundation for the decision of the Commissioner to prevent the submission of the claim to Pelephone from the outset, and also since the very holding of a hearing in the claim in the Ramallah court without service of process in accordance with the law and the agreement, constitutes breach of the agreement and a violation of the sovereignty of the State of Israel, and any decision given in the claim as aforesaid is invalid.

(12) Further to Note 19A(32) to the financial statements as at December 31, 2003, concerning a claim, filed by 66 Company pensioners who retired under the retirement agreement of November 1997, for enforcement of an agreement from April 2001, which was intended to enable employees to change the track they had selected; on May 3, 2004, the plaintiffs filed an application for amendment of the statement of claim in order that that the court will allow another 155 pensioners to join the claim.

### B. COMMITMENTS

Further to Note 19B(6) to the financial statements as at December 31, 2003, concerning Pelephone winning a tender for frequencies, Pelephone was granted a right to future allocation of those frequencies, upon the exercise of which Pelephone will pay the reduced amount plus the frequency fees in respect of the relevant period, all plus linkage differentials and interest as is customary. In March 2004 Pelephone paid NIS 32 million (proportionally consolidated amount approximately NIS 16 million) on account of the balance of the payments. The balance in the amount of NIS 67 million (proportionally consolidated amount approximately NIS 34 million) was recorded in Pelephone's books as a right to use frequencies, under the Other assets items against Trade payables.

On May 4, 2004. Pelephone received a letter from the Director General at the Ministry of Communications and the Supervisor of the Budgets Division at the Ministry of Finance, in which it was informed that according to an amended calculation made by the Ministries of Finance and Communications, the amount Pelephone must pay at the time of allocation of the frequencies in the future is NIS 51 million rather than the NIS 33 million agreed upon in March 2004. Pelephone has not yet presented its position on this to the Ministries. Pelephone is unable to estimate when the third generation frequencies might be used, however, it does believe that it will need them in the future and therefore it is keeping open the option to buy them back.

## NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

### C. FUTURES CONTRACTS

**Hedging Contracts (Forward)**

**Consolidated**

| | Currency purchased | Currency payable | Final repayment date | Amounts receivable | Amounts payable |
|---|---|---|---|---|---|
| | | | | NIS millions | |
| **Currency exchange contracts at predetermined interest rates** | Dollars | CPI-linked NIS | February 2005 | 259 | 275 |
| | Euro | CPI-linked NIS | September 2005 | 518 | 467 |
| **Forward contracts at predetermined exchange rate** (excluding premium/discount) | Dollars | NIS | December 2005 | 859 | 867 |
| | Euro | NIS | December 2005 | 1,114 | 1,121 |
| | CPI-linked NIS | NIS | January 2006 | 711 | 725 |

## NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27A to the financial statements as at December 31, 2003, concerning a claim filed by the Company against the Ministry of Defense for payment of amounts in connection with a dispute on the matter of a discount of 18% which the Ministry of Defense deducted from the payments collected by the Company for other communications providers – on March 16, 2004, the State filed a statement of defense. In the opinion of the Company, relying on its legal advisers, the chances of the Company's claim cannot be estimated. No income was recorded in the financial statements in respect of this claim.

B. Further to Note 27D to the financial statements as at December 31, 2003, concerning the officers' insurance policy held by the Company, the insurance ceiling is $150 million per event and per period (of 12 months), plus 20% for legal expenses.

On December 3, 2003, the general meeting of the shareholders of the Company approved making an undertaking to indemnify the officers of the Company in the matter of a framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State by virtue of the framework agreement. The undertaking was limited to the sum of NIS 890 million (the extent of the financing), linked to the CPI published after the capital is raised in accordance with the framework agreement.

C. On May 13, 2004, the general meeting of the shareholders of the Company approved making an undertaking to officers on the subject of indemnification and insurance, as follows:

(1) An undertaking of the Company in the matter of extending a loan to officers to finance reasonable litigation expenses in legal proceedings and an undertaking of the Company to purchase an insurance policy for officers at reasonable cost.

(2) Grant of notes of indemnity in advance to officers of the Company on the following matters:

a. The claim of a shareholder who held 15% or more of the share capital of the Company. The total extent of the indemnity will not exceed $150 million plus $30 million in respect of legal expenses (a claim of this kind was exclude from the Company's officers insurance policy).

**NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)**

b. In anything relating to a prospectus of an offer for sale of securities of the Company by the State of Israel and an offering by the Company, which is scheduled for publication in May 2004. The total extent of the indemnity (including in respect of the advance undertakings to indemnify given up to publication of the prospectus and in respect of advance undertakings to indemnify 'which will be given, if given, immediately prior to transfer of control in the Company by the State) will not exceed 25% of the shareholders' equity of the Company (according to the financial statements for 2003, linked to the November 2003 CPI).

D. On April 20, 2004, the Board of Directors of the Company resolved that the Company will indemnify the employees of the Group, who participated in the preparation of the prospectus scheduled for publication in May 2004 and who are not officers of the Company, in respect of a financial liability that will be imposed upon them and in respect of reasonable litigation expenses they might bear, in any matter connected with the prospectus, in the same format as the note of indemnity given to officers.

**NOTE 9 – REVENUES FROM TELECOMMUNICATION SERVICES**

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 (Unaudited) | 2003 (Unaudited) | 2003 (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from communication services–** | | | |
| Domestic fixed-line communications | **422,463** | 543,562 | 1,990,649 |
| Fixed fees | **612,645** | 542,050 | 2,289,868 |
| Cellular telephone | **517,352** | 485,869 | 1,989,970 |
| International communications and internet services | **190,342** | 165,624 | 683,037 |
| Installation and sale of equipment to subscribers | **167,106** | 134,817 | 590,866 |
| Other | **17,009** | 18,648 | 74,851 |
| | **1,926,917** | 1,890,570 | 7,619,241 |
| Other revenues | **82,304** | 87,801 | 362,027 |
| | **2,009,221** | 1,978,371 | 7,981,268 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 10 – OPERATING AND GENERAL EXPENSES

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 (Unaudited) | 2003 (Unaudited) | 2003 (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Salaries and related expenses – | | | |
| Operations | **405,814** | 425,117** | 1,648,415** |
| General and administrative | **75,109** | 79,999** | 304,463** |
| General expenses | **178,135** | 173,985 | 733,412 |
| Materials and spare parts | **138,567** | 144,583 | 597,676 |
| Cellular telephone expenses | **126,895** | 112,038 | 480,536 |
| Building maintenance | **68,777** | 82,526 | 352,405 |
| Services and maintenance by sub-contractors | **69,535** | 66,633 | 250,220 |
| International communications expenses | **45,770** | 38,645 | 159,478 |
| Vehicle maintenance expenses | **29,725** | 29,048 | 118,050 |
| Collection fees | **8,758** | 8,614 | 36,160 |
| | **1,147,085** | 1,161,188 | 4,680,815 |
| Less – salaries charged to investment in fixed assets | **56,273** | 44,712 | 195,515 |
| | **1,090,812** | 1,116,476 | 4,485,300 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2
** Reclassified

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 11 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

### A. Statements of Operations

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 (Unaudited) | 2003 (Unaudited) | 2003 (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from telecommunication services (Note 11B)** | **1,267,978** | 1,339,901 | 5,230,561 |
| **Costs and expenses** | | | |
| Operating and general expenses (Note 11C) | **554,203** | 601,287 | 2,366,547 |
| Depreciation | **380,695** | 452,587 | 1,776,279 |
| Royalties to the Government of Israel | **36,771** | 45,375 | 181,116 |
| | **971,669** | 1,099,249 | 4,323,942 |
| Operating income | **296,309** | 240,652 | 906,619 |
| **Financing expenses, net** | **13,866** | 16,129 | 62,372 |
| Earnings after financing expenses, net | **282,443** | 224,523 | 844,247 |
| **Other expenses (revenues), net** | **29,932** | (1,994) | 846,948 |
| Earnings (loss) before income tax | **252,511** | 226,517 | (2,701) |
| **Income tax** | **86,091** | 86,029 | 33,513 |
| Earnings (loss) after income tax | **166,420** | 140,488 | (36,214) |
| **Company's equity in losses (earnings) of investee companies** | **(1,502)** | 72,962 | 401,622 |
| Net earnings (loss) | **167,922** | 67,526 | (437,836) |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 11 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

### B. REVENUES FROM TELECOMMUNICATIONS SERVICES

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | **2004** | **2003** | **2003** |
| | **(Unaudited)** | **(Unaudited)** | **(Audited)** |
| | **Reported amounts*** | **Amounts adjusted for the effects of inflation in shekels of December 2003** | |
| | **NIS thousands** | **NIS thousands** | **NIS thousands** |
| Domestic fixed-line communications | **425,977** | 545,763 | 2,006,567 |
| Fixed fees | **584,866** | 515,796 | 2,184,650 |
| Cellular telephone | **107,067** | 127,793 | 428,149 |
| International communications | **34,884** | 34,736 | 134,212 |
| Installation and sale of equipment to subscribers | **45,433** | 32,567 | 144,338 |
| Other | **19,367** | 19,560 | 80,105 |
| | **1,217,594** | 1,276,215 | 4,978,021 |
| Other revenues | **50,384** | 63,686 | 252,540 |
| | **1,267,978** | 1,339,901 | 5,230,561 |

### C. OPERATING AND GENERAL EXPENSES

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | **2004** | **2003** | **2003** |
| | **(Unaudited)** | **(Unaudited)** | **(Audited)** |
| | **Reported amounts*** | **Amounts adjusted for the effects of inflation in shekels of December 2003** | |
| | **NIS thousands** | **NIS thousands** | **NIS thousands** |
| Salaries and related expenses – | | | |
| Operations | **290,723** | 322,985** | 1,206,623** |
| General and administrative | **57,973** | 64,335** | 241,206** |
| General expenses | **78,317** | 72,406 | 342,492 |
| Materials and spare parts | **29,728** | 21,853 | 93,601 |
| Building maintenance | **62,037** | 76,538 | 322,099 |
| Services and maintenance by sub-contractors | **53,524** | 52,167 | 207,843 |
| International communications expenses | **4,310** | 2,498 | 10,685 |
| Vehicle maintenance expenses | **25,317** | 24,754 | 101,597 |
| Collection fees | **8,547** | 8,463 | 35,916 |
| | **610,476** | 645,999 | 2,562,062 |
| Less– salaries charged to investments in fixed assets | **56,273** | 44,712 | 195,515 |
| | **554,203** | 601,287 | 2,366,547 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

** Reclassified

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 12 – SEGMENTS OF BUSINESS OPERATIONS

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

| | For the three months ended March 31, 2004 | | | | | |
|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Others | Adjustments | Consolidated |
| | Reported amounts* | | | | | |
| | NIS thousands | | | | | |
| **Revenues** | | | | | | |
| Revenues from external sources | **1,216,871** | **533,661** | **193,563** | **65,126** | **–** | **2,009,221** |
| Inter-segment revenues | **51,107** | **1,472** | **4,047** | **9,528** | **(66,154)** | **-** |
| Total revenues | **1,267,978** | **535,133** | **197,610** | **74,654** | **(66,154)** | **2,009,221** |
| **Segment results** | **296,309** | **66,810** | **34,549** | **1,577** | **–** | **399,245** |

| | For the three months ended March 31, 2003 | | | | | |
|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Others | Adjustments | Consolidated |
| | Amounts adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS thousands | | | | | |
| **Revenues** | | | | | | |
| Revenues from external sources | 1,287,428 | 463,451 | 165,512 | 61,980 | – | 1,978,371 |
| Inter-segment revenues | 52,473 | 1,082 | 2,292 | 7,753 | (63,600) | – |
| Total revenues | 1,339,901 | 464,533 | 167,804 | 69,733 | (63,600) | 1,978,371 |
| **Segment results** | 240,652 | (15,028) | 28,378 | 554 | 160 | 254,716 |

| | For the year ended December 31, 2003 | | | | | |
|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Others | Adjustments | Consolidated |
| | Amounts adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS thousands | | | | | |
| **Revenues** | | | | | | |
| Revenues from external sources | 5,023,754 | 2,021,807 | 689,378 | 246,329 | – | 7,981,268 |
| Inter-segment revenues | 206,807 | 5,568 | 13,958 | 40,236 | (266,569) | – |
| Total revenues | 5,230,561 | 2,027,375 | 703,336 | 286,565 | (266,569) | 7,981,268 |
| **Segment results** | 906,619 | 96,013 | 90,001 | 72 | 644 | 1,093,349 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

## NOTE 13 – PROFORMA CONSOLIDATED INTERIM REPORTS

A. Through March 31, 2004, the financial results of D.B.S. were included in the Company's financial statements under the equity method due to the percentage holding of the Company in the share capital of D.B.S. being less than 50% (so long as the options received from D.B.S. are not exercised). In addition, the Company is unable to pass certain decisions by the Board of D.B.S. due to the provisions of the Articles of D.B.S. requiring a special majority of 75%.

The Company investment in D.B.S. in recent years has experienced a number of significant gradual changes that were mainly changes in percentage shareholdings, commitments to invest in D.B.S. and the financing thereof and in the actual investments. These developments gradually brought the Company to the status of being a dominant interested party in D.B.S. and to the position that with the implementation of the decision of the Board to transfer NIS 440 million under the terms determined by the decision, that the Company expects for the first time that it will become the only shareholder which is financing the activities of D.B.S. Implementation of the Board decision is expected towards the end of the second quarter of 2004 and accordingly the Company intends to fully consolidate the financial statements of D.B.S. with its financial statements as of this date.

Assumptions made in preparation of the proforma financial statements:

1. The proforma financial statements are presented under the assumptions that D.B.S. is consolidated together with the financial statements of the Company commencing January 1, 2004.

2. At the date of commencement of the consolidation goodwill in the amount of approximately NIS 400 million has been created. For the purposes of the proforma note this amount has been treated as unallocated and amortized over a period of 20 years commencing from the date of initial consolidation.

3. For the purposes of the proforma statement of income, the company has included 100% of the losses of D.B.S. which were accumulated in the first quarter of 2004, less the amounts committed by the minority shareholders to cover this loss.

It is should be pointed out that the goodwill and the Company's share in the losses of D.B.S. do not necessarily reflect the amounts which the company will record in respect of D.B.S. on consolidation when it takes place for the first time.

## NOTE 13 – PROFORMA CONSOLIDATED INTERIM REPORTS (CONTD.)

### B. PROFORMA BALANCE SHEET

**Summary proforma interim consolidated financial statements of the Company as at March 31, 2004, including a full consolidation of D.B.S. and the Company's share in the losses of D.B.S., commencing as of January 1, 2004, are presented below.**

| | March 31, 2004 |
|---|---|
| | (Unadited) |
| | Reported amounts* |
| | NIS thousands |
| **Current assets** | |
| Cash and cash equivalents | 2,118,243 |
| Short-term investments | 1,065,334 |
| Trade receivables | 1,785,217 |
| Other receivables and debit balances | 554,179 |
| Inventory | 98,149 |
| | 5,621,122 |
| **Materials and spare parts** | 155,817 |
| **Investments and long-term receivables** | |
| Investments, deposits and debit balances | 774,108 |
| Investments in investee companies | 56,263 |
| | 830,371 |
| **Fixed assets** | |
| Cost | 30,793,691 |
| Less– accumulated depreciation | 21,210,958 |
| | 9,582,733 |
| **Other assets** | |
| Deferred charges and other assets | 961,272 |
| Deferred taxes | 528,677 |
| | 1,489,949 |
| | 17,679,992 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 13 – PROFORMA CONSOLIDATED INTERIM REPORTS (CONTD.)

### B. PROFORMA BALANCE SHEET (CONTD.)

| | March 31, 2004 |
|---|---|
| | (Unadited) |
| | Reported amounts* |
| | NIS thousands |
| **Current liabilities** | |
| Bank credit | 1,374,485 |
| Current maturities of: | |
| Long-term bank loans | 867,751 |
| Debentures | 173,314 |
| Trade payables | 1,486,477 |
| Employee severance benefits | 549,506 |
| Other current liabilities | 1,322,129 |
| | 5,773,662 |
| **Long-term liabilities** | |
| Long-term loans | 1,549,754 |
| Debentures | 2,547,884 |
| Employee severance benefits | 777,610 |
| Other long-term liabilities: | |
| Loans extended by the minority at DBS | 1,022,307 |
| Less – minority share in DBS deficit | (1,022,307) |
| Others | 53,475 |
| | 4,928,723 |
| **Minority rights** | 163 |
| **Shareholders' equity** | 6,977,444 |
| | 17,679,992 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

## Notes to the Interim Consolidated Financial Statements as at March 31, 2004

## NOTE 13 – PROFORMA CONSOLIDATED INTERIM REPORTS (CONTD.)

### C. PROFORMA STATEMENT OF OPERATIONS

| | For the three months ended March 31, 2004 |
|---|---|
| | (Unadited) |
| | Reported amounts* |
| | NIS thousands |
| **Revenues** | **2,230,009** |
| **Costs and expenses** | |
| Operating and general expenses | **1,282,877** |
| Depreciation | **567,955** |
| Royalties to the Government of Israel | **53,072** |
| | **1,903,904** |
| Operating income | **326,105** |
| **Financing expenses, net** | **66,585** |
| Earnings after financing expenses | **259,520** |
| **Other expenses, net** | **46,447** |
| Earnings before income tax | **213,073** |
| **Income tax** | **105,314** |
| Earnings after income tax | **107,759** |
| **Equity in losses of affiliates** | **1,052** |
| **Minority share in earnings (losses) of a consolidated company** | **(25,795)** |
| Net earnings | **132,502** |
| **Primary and diluted earnings per NIS 1 par value of common shares (in NIS)** | **0.051** |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

## NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD.

### 1. BEZEQ INTERNATIONAL LTD.

### A. Balance sheet

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 | 2003 | 2003 |
| | (Unaudited) | (Unaudited) | (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **145,283** | 157,733 | 149,765 |
| Investments | **20,951** | 9,984 | 12,704 |
| Fixed assets | **384,124** | 487,229 | 375,703 |
| Other assets | **11,673** | 7,261 | 2,695 |
| | **562,031** | 662,207 | 540,867 |
| Current liabilities | **265,109** | 316,757 | 276,061 |
| Long-term liabilities | **180,179** | 169,936 | 180,881 |
| Shareholders' equity | **116,743** | 175,514 | 83,925 |
| | **562,031** | 662,207 | 540,867 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

### 1. BEZEQ INTERNATIONAL LTD. (CONTD.)

### B. Statement of Operations

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 | 2003 | 2003 |
| | (Unaudited) | (Unaudited) | (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from international telecommunication services** | **197,610** | 167,805 | 703,336 |
| **Operating expenses** | **117,714** | 97,314 | 431,066 |
| Gross profit | **79,896** | 70,491 | 272,270 |
| **Marketing, general and administrative expenses** | **45,347** | 42,112 | 188,299 |
| Operating income | **34,549** | 28,379 | 83,971 |
| **Financing expenses, net** | **3,106** | 3,431 | 21,830 |
| Earnings after financing, net | **31,443** | 24,948 | 62,141 |
| **Other expenses (income), net** | **(1,167)** | 2,782 | 128,580 |
| Earnings (losses) before income tax | **32,610** | 22,166 | (66,439) |
| **Income tax** | **323** | 460 | 3,489 |
| Earnings (losses) after income tax | **32,287** | 21,706 | (69,928) |
| **Company's equity in losses (earnings) of an affiliated company** | **(531)** | 664 | 619 |
| Net earnings | **32,818** | 21,042 | (70,547) |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

### 2. PELEPHONE COMMUNICATIONS LTD.

### A. Balance sheet

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 | 2003 | 2003 |
| | (Unaudited) | (Unaudited) | (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **1,311,664** | 1,246,502 | 1,264,002 |
| Long-term trade receivables | **206,708** | 200,461 | 199,136 |
| Investment in investee companies | **1,767** | - | 2,253 |
| Deferred income tax | **192,824** | 331,024 | 238,367 |
| Fixed assets, net | **2,937,676** | 2,905,335 | 2,977,528 |
| Other assets | **386,226** | 406,718 | 339,506 |
| | **5,036,865** | 5,090,040 | 5,020,792 |
| Current liabilities | **1,995,764** | 1,954,585 | 1,761,626 |
| Provision for losses of investee company | **5,264** | 4,846 | 5,372 |
| Long-term liabilities | **1,102,560** | 1,340,087 | 1,386,774 |
| Shareholders' equity | **1,933,277** | 1,790,522 | 1,867,020 |
| | **5,036,865** | 5,090,040 | 5,020,792 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2

**Notes to the Interim Consolidated Financial Statements as at March 31, 2004**

## NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

### 2. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

### B. Statement of Operations

| | For the three months ended March 31 | | For the year ended December 31 |
|---|---|---|---|
| | 2004 (Unaudited) | 2003 (Unaudited) | 2003 (Audited) |
| | Reported amounts* | Amounts adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from cellular services, sales and services** | **1,070,264** | 929,066 | 4,054,749 |
| **Cost of cellular services, sales and services** | **780,031** | 807,180 | 3,238,098 |
| Gross profit | **290,233** | 121,886 | 816,651 |
| **Sales and marketing expenses** | **115,993** | 114,913 | 470,935 |
| **General and administrative expenses** | **41,322** | 37,028 | 152,447 |
| | **157,315** | 151,941 | 623,382 |
| Operating income (loss) | **132,918** | (30,055) | 193,269 |
| **Financing expenses, net** | **23,710** | 22,955 | 143,786 |
| **Other expenses (income), net** | **2,745** | (182) | 167 |
| Earnings (losses) before income tax | **106,463** | (52,828) | 49,316 |
| **Income tax (tax benefit)** | **37,800** | (1,496) | 18,289 |
| Earnings (loss) after income tax | **68,663** | (51,332) | 31,027 |
| **Company's equity in losses (earnings) of an affiliate** | **2,406** | 364 | 6,224 |
| Net earnings (loss) | **66,257** | (51,696) | 24,803 |

* Concerning termination of adjustment for inflation at the December 2003 CPI, see Note 2